EXD/085 COMMENTS

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Colchester Braintree Borders Garden Community – Savills 250 dpa Scenario Analysis

We comment below on EXD/085, Savills' revised appraisal in response to the Inspector's request for their figures to be redone at 250dpa.

What has Changed?

The new appraisal surprisingly shows an increase in residual from £110,127 to £112,000 per acre (the Hyas analysis for 250dpa shows RLVs which are – as any objective participant would expect – significantly lower than for 300dpa). The route map below shows how the increase arises:

Route map from Saviills original residual calculation to ED085		
	£m	Per acre
Savills EXD/061 Sept 2019	191	£110,127
Extra finance charges from longer programme	-62	
Extra infrastructure cost	-67	
Extra sales proceeds (5%)	191	
Extra developer profit	-51	
Other	-7	
Savills ED/085 Jan 2020	195	£112,000

It seems that Savills have taken the opportunity to prepare what is effectively a new appraisal rather than a sensitivity to the previous one. We comment on some of the key changes below.

Housing Delivery Rate

The delivery rate is not 250dpa as requested by the Inspector because in some years it rises to 500 dpa. As a result the cash flows show the final house sales in 2080, nine years before the final infrastructure costs are paid. This can only be found by looking through the many pages of detailed cash flows submitted as EXD/085 (1/2). Housing sales revenue rises from £4.6m per month to £9.2m from Feb 2030 to April 2034, and again from Feb 2040 to August 2044. £4.6m corresponds to 250dpa and £9.2m to 500dpa.

This is a major flaw which undermines the credibility of the entire appraisal. If corrected it would increase the finance charges very significantly (given the effect of compounded interest) and drive the RLV well below the £100,000 per acre benchmark. Furthermore, from an objectivity perspective, we would question why it was not set out in the assumptions and why the obviously incorrect assumption about infrastructure has been made.

House Prices

Sales prices have been increased by 5%, explained by the slower delivery rate and supply/demand considerations. Savills sales price per square metre is now £3773 compared to £3594 per Hyas for the same rate of delivery.

<u>There is no real justification for such significant optimism and it is tempting to conclude that the increase has been included to preserve the residual value at a level which proves viability.</u>

From a RICS guidance perspective, at the very least unchanged house prices should have been shown as a sensitivity (in reality unchanged house prices should have been the base case and the 5% increase should have been a sensitivity):

"It is strongly recommended that financial appraisals are sensitivity tested as a minimum, and with more complex schemes further scenario/simulation analysis should also be undertaken. This is to ensure that a sound judgment can be formulated on viability." (RICS Professional Guidance: Financial Viability in Planning, 2012, p5).

<u>Such a sensitivity analysis would obviously show an RLV well below £100,000/acre, which we assume is why it was not provided, contrary to professional guidance.</u>

Infrastructure Costs

Infrastructure costs have increased from £777m to £844m (£49,747 per dwelling) including fees and contingency.

Given our concerns expressed at the EiP that the infrastructure quantum and phasing from Savills and other private sector developers was "low and slow" and indeed not compatible with Plan policies, this might seem like a move in the right direction.

However, Savills' expert opinion appears to be that the increase in infrastructure is driven effectively by "friction costs" of a longer term development – more individual contracts, more temporary arrangements before permanent solutions etc. If this theory is sound, there are two significant implications:

i) The Hyas analysis for 250dpa (which already shows a lack of viability for CBBGC and WOBGC) should have increased its infrastructure costs when moving from 300dpa to 250dpa. In fact Hyas actually kept quantum unchanged and just inappropriately rephased the costs, as outlined by Mr O'Connell at the EiP

ii) Savills have not actually improved the infrastructure provision to meet Plan policies at all – any increase is wasted on these friction costs.

Below we update a section of a table provided by Mr O'Connell previously demonstrating the "low and slow" nature of Savills' infrastructure application for CBBGC.

Specifically, the infrastructure during the early phases within the Plan Period (assuming a 2029 start as Hyas does and scaling up infrastructure to match Hyas' 21,000 dwellings for comparability) are 30% lower than Hyas, while infrastructure across the plan period is 20% lower. This is clearly substantial and will mean that the Plan's Policies cannot be met.

Figure 1: Infrastructure Quantum and Phasing Comparison on a True Like for Like Basis

	West Tey		
£m	**Plan Period**	**Post Plan Period**	**Total**
Hyas (250dpa, 10%) *	305	998	1,303
Savills **	217	826	1,043
% Disc to Hyas	**Plan Period**	**Post Plan Period**	**Total**
Hyas (250dpa, 10%) *	NA	NA	NA
Savills **	-29%	NA	-20%

* *10% contingency applied to Hyas for comparability as Savills are at 10%*

** *Savills adjusted from 17k dwellings to 21k to match Hyas.*
First completion moved from 2024 to 2029 to match Hyas (i.e. Plan Period = 5 years for each)

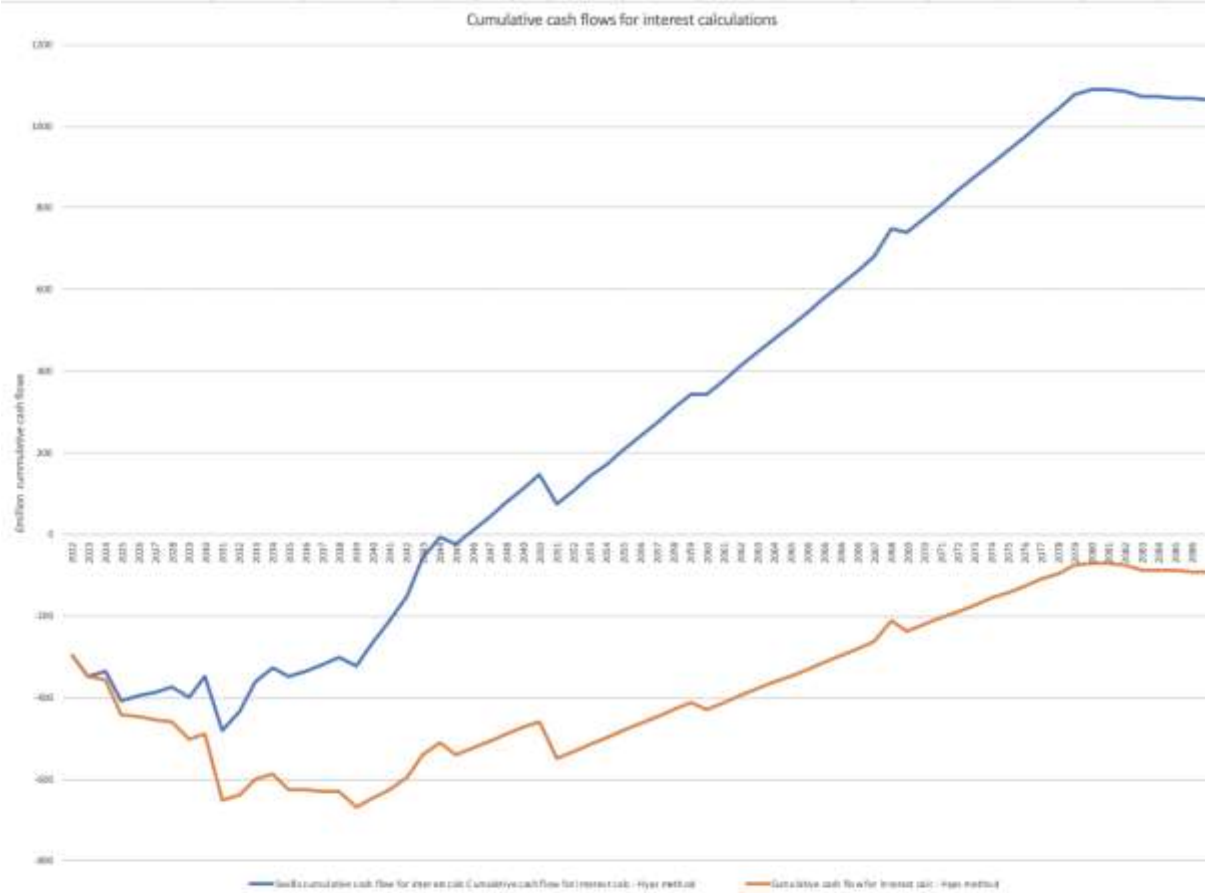
Finance Charges

The finance charge of £156m is lower than the Hyas equivalent of £493m by a staggering 3x. This is despite Savills assuming (correctly in our view) that the land is purchased up front at £100,000 per acre plus acquisition costs. The reasons for the difference are:

(i) Delayed infrastructure payments in the Savills model. Note that their infrastructure payments extend until 2089 whereas housing sales terminate in 2080, a totally spurious assumption and indeed a basic error.

(ii) The differing assumptions about the withdrawal of the £1.3billion developer profit. Hyas implicitly assume that it is dividended to the developer over the project period (realistic), whereas Savills implicitly assume that the developer gets nothing until the project goes cash positive in about 2046 (22 years post commencement based on the Savills timeline) - a totally unrealistic assumption.

The impact on implied cumulative cashflow (effectively debt) is very significant:



We have laid out our views on both these points at length in earlier submissions. We would only add at point (ii) that no reliance should be placed on L&Q as an exceptionally "patient" investor. At present we have no evidence that L&Q (or any other developer) is capable of sustaining projects with completely "off-market" payback periods, or that its capital disciplines (as a developer) are any different from the remainder of the market.

Furthermore we note we are surprised that Savills' RICS-certified surveyors would feel comfortable making such an aggressive assumption regarding a particular developer accepting such a delayed profit payout, when their professional guidance states:

"In undertaking scheme-specific viability assessments, the nature of the applicant should normally be disregarded, as should benefits or disbenefits that are unique to the applicant. The aim should be to reflect industry benchmarks in both development management and plan making viability testing." (RICS Professional Guidance: Financial Viability in Planning, 2012, p5).

Observations on Conclusion of EXD/085

Savills conclude by noting *"The scheme is still viable under these assumptions"* (they have noted a benchmark land value of £100k/acre previously).

However, this clearly fails to take into account Harman Guidance (p16) that *"Given the clear emphasis on deliverability within the NPPF, Local Plan policies should not be predicated on the assumption that the development upon which the plan relies will come forward at the 'margins of viability"*

<u>Harman guidance was the prevailing Local Plan viability guidance at the time this Plan was prepared and therefore must be taken into account fully. £112k/acre is clearly marginal relative to a benchmark of £100k/acre and therefore the Savills conclusion that the scheme is viable is flawed.</u>

Broad Observations Regarding Lack of Objectivity in Context of EXD/085

<u>It is clear that any objective assessment of a 250dpa scenario would produce lower RLVs than the higher delivery rate scenario. Here Savills' work patently lacks objectivity (as set out herein), focusing instead on defending a client's commercial position.</u>

This (and the shortcomings we have outlined herein) is in clear violation of RICS professional guidance:

"Financial viability assessments for planning purposes should be approached on an objective and best practice basis to the extent that the conclusions are capable of unbiased objective scrutiny" (RICS Professional Guidance: Financial Viability in Planning, 2012, p5)

Commentary on Appendix 1.0

In Appendix 1.0, Ms Gregory, an Associate Director of Savills, attempts to address the points discussed around finance rates and inflation in the Matter 7 session of the EiP.

The letter asserts that Mr O'Connell's assertion at the EiP was that the finance rate used in viability analysis should have a margin added to it to reflect inflation. It goes on to say this is incorrect and to defend the 6% used by Savills and others, which it notes is a real interest rate (i.e. one not reflecting inflation), saying: "*In no case* [i.e. by no-one carrying out the viability analysis for the NEA Local Plan] *has an additional allowance been added to the interest rate to reflect inflation."*

<u>Unfortunately this letter represents a comprehensive misunderstanding of the entire content of the EiP discussion of this topic, as well as fails to take notice of the RICS professional guidance which the letter broadly highlights as being of critical importance:</u>

Mr O'Connell's relevant assertions in submissions and at the EiP were as follows:

(i) 6% is an inappropriately low real finance rate to be used in the context of the Hyas viability analysis (a real finance rate being one applied in the context of modelling which does not incorporate inflation, such analysis being the standard in Local Plan viability modelling).

<u>The reason for the rate being too low is the unusual complexity and risk profile of the project as envisaged by Hyas</u> (and therefore NEAs), in particular the purchase of land over time, which means the project never has any credit worthiness.

Indeed, the consistency of rates across analyses shows that a "standard" real finance rate has been applied by various participants to a very "non-standard" project – clearly little consideration has been given to the project's credit profile

(ii) Separately, Hyas had included inflation modelling (i.e. "nominal" not "real") in their analysis, which showed very high RLVs.

However, Hyas had used the real finance rate from their non-inflation modelling also in the inflation modelling. <u>This is technically incorrect – a nominal analysis must use a nominal finance rate just as a real analysis must use a real finance rate</u>. The nominal finance rate is simply the real finance rate plus inflation (e.g. 6% real + 2% inflation = 8% nominal), as explained at the EiP.

Where a nominal finance rate is applied to the Hyas inflation analysis (Mr O'Connell cited CBBGC as an example at the EiP), the RLVs are broadly in line with the non-inflation analysis.

This is unsurprising as the application of inflation is clearly not equivalent to alchemy. <u>The Hyas inflation analysis (and any other inflation analysis which makes the same error) is simply technically incorrect via a basic error and therefore cannot be relied upon in any way.</u>

Therefore Mr O'Connell did not at all suggest that the 6% used in the real viability analysis (specifically Hyas, but by extension analysis such as that in EXD/085) should be increased for inflation. <u>He asserted that a real rate of 6% is fundamentally too low; and then separately that for any modelling involving inflation, 6% - or indeed a more appropriate real rate used – would need to be increased by inflation.</u>

To ensure that there is no further confusion on this point from RICS professionals, we cite RICS guidance below:

"*B1.1.9 Change in values can be specifically incorporated into the cash flow and it is important to identify whether the cash flow incorporates expected changes* [this means inflation]. *The adoption of either current or projected values raises questions of consistent treatment of other inputs, such as the costs; it also raises questions of whether real or nominal rates of interest are used in the valuation, i.e. target rates of return and the use of real or nominal finance rates….* [this question then being answered later in the guidance:] *B1.2.8.6 The issue of cash flows expressed in expected nominal or current values is relevant to the treatment of finance. Interest rates will vary depending on how the cash flow is expressed, with nominal rates of return on nominal cash flows and real rates of return on cash flows that have not been projected forwards."* (RICS Professional Guidance: Valuation of Development Property, 2019 [this was the paper discussed at the EiP])

There is consistent guidance in RICS' *Professional Guidance: Financial Viability in Planning, 2012*.

We believe the Inspector was already absolutely clear on this point at the end of the EiP for Matter 7, but we would be happy to provide further information if helpful.

As a separate note, Ms Gregory's letter comments on L&Q's weighted cost of capital of 3.4% (though we believe this actually refers to L&Q's cost of debt not their cost of capital, from an examination of their annual report). Regardless of the distinction of cost of capital vs. cost of debt, either way the observation is hugely misleading as the majority of L&Q's business comprises their housing association activity which has a large asset base and therefore high credit worthiness. As Mr O'Connell set out at the EiP and in written submissions, it is not possible to read across from a developer's corporate balance sheet to a project-level cost of debt; here it is even more problematic as the corporate level cost of capital quoted for L&Q refers to a diversified business in which development activity is significantly the smaller part (and where the company will undoubtedly seek higher returns than it does for the low-risk housing association activity). As a result, the group corporate level cost of debt (/cost of capital) tells us absolutely nothing about the potential cost of debt applied at a development project level.