The Smith Institute
The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

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Designed and produced by Owen & Owen

financing the future

2005

financing the future

Edited by Paul Hackett

THE LAND RESTORATION TRUST
Restoring land for the community

THE SMITH INSTITUTE

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Published by the Smith Institute

ISBN 1 902488 95 4

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Preface
Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank which has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years, the Institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

This monograph considers the practical methods by which finance can be raised and deployed to deliver sustainable communities. The Government's long term commitment to ensuring full employment and prosperity in every region of Britain has been accompanied by significantly increased public investment in the newly designated 'growth areas'. However, it is clear that the promised 'step change' in approach will require investment of a much higher order if the new developments are to be viable, and if sustainable communities are to be created for the long term. Delivering on the Government's plans will demand not only more effective ways of spending public investment, but also the use of novel and imaginative policy tools and financial instruments to encourage private investment in the development of sustainable communities.

The Smith Institute is pleased to be publishing this collection of essays by key experts in the field of developing, financing and planning large scale public infrastructure projects. The contributions offer close analysis of the strengths and weaknesses of a range of different methods of financing sustainable communities; provide a valuable appraisal of specific policy instruments from the perspective of those most closely involved in their use; and draw on international comparisons in order to identify the ways in which such tools can be used more efficiently, effectively and flexibly. We hope that these contributions will help to inform the debate around the best ways of delivering sustainable communities across the UK.

The Smith Institute thanks Paul Hackett for agreeing to edit this collection of essays, and gratefully acknowledges the support of The Land Restoration Trust towards this publication and the associated seminar.

Foreword
John Healey MP, Financial Secretary to the Treasury

This is a valuable and timely contribution to the debate about how we can deliver housing, infrastructure and sustainable growth in all our regions.

Labour has set some tough third term challenges in this policy territory: to increase the supply, quality and affordability of housing; give people more housing choice; tackle problems of low demand to help revitalise our most deprived communities; invest in new infrastructure and services; and raise the level of home ownership.

As a direct result of economic stability and rising prosperity, since 1997 Britain now has one million more homeowners. Over 70% of households now own their own home but even so nine out of ten would prefer to do so, if they could, and further action is needed if Government is to help more people realise their housing aspirations.

Expectations are high, but we are determined to work with local government and the private and voluntary sectors to deliver not only the housing and growth amibitions we set out in the Sustainable Communities plan and five-year housing and regeneration plans, but also to go further.

Before long, we will respond to Kate Barker's independent review of housing supply which set out a series of wide-ranging reforms to help improve the functioning, stability and affordability of the housing market. In considering our response, the Government recognises that more housing must be supported by the timely provision of the infrastructure needed to sustain it: schools, health centres, transport and local services.

And if we are to deal with Britain's historic under investment in its infrastructure, then we must consider how that investment is funded.

As the contributors to this pamphlet have shown, there are no single solutions and no quick fixes. They argue that different policy tools are needed in different places. They identify important common features as close partnership working, public participation, effective governance and a coordinated approach to area based investment. And they set out the case for making the best use of public spending and public assets, while at the same time developing greater funding flexibility and new ways to lever in extra private finance.

I welcome 'Financing the Future' as an intelligent and challenging contribution to this debate.

Introduction: Funding sustainable communities

Paul Hackett, former Special Adviser to the Deputy Prime Minister
and Public Policy Consultant

The government has made a long-term commitment to tackle the different housing and growth problems facing the regions of England. After decades of disinvestment, spending on housing and regeneration has been increased and extra public investment has been made available for newly designated "growth areas" in the South and for urban renewal in the North. However, despite this higher spending under the government's Sustainable Communities Plan more resources are clearly needed to deliver the step change in approach promised by the Deputy Prime Minister.

The essays in this pamphlet focus less on the policy issues surrounding the government's housing and growth agenda, and more on the practicalities of how best to maintain and increase investment in sustainable communities. Given the political and budgetary constraints on public finances and the increasing demands on government, the authors have addressed themselves to the key funding questions: How can existing funding be better spent? How can public funds lever in more private finance? What new policy tools, financial instruments and arrangements are available, and will they work? And what can we learn from the past and experience overseas?

Funding sustainable communities

Of course, more investment does not guarantee a successful outcome. For example, funding was made available for the public housing boom of the 1950s and 1960s, but much of it was unsustainable. Weak leadership, lack of skills, poor planning and political inertia can also act as barriers to responsible growth.

However, without the extra resources it is difficult to see how the government can meet its long-term housing and growth targets. The scale of the task is huge and the costs of market failure in terms of housing supply and uneven growth continue to impact negatively on the economy. Furthermore, public acceptability of the Sustainable Communities Plan depends not only on making the resources available, but also on synchronised investments in the improvement of local infrastructure.

The Sustainable Communities Plan and the ODPM's five-year plans form an ambitious agenda for change, not least because they focus on joined-up policy solutions and linked investment decisions that pull on the purse strings of several government departments –

covering not only housing, planning and regeneration but also transport, flood defences, hospitals, schools, crime prevention, job creation, and improving the quality of the local environment.

Over the five years to 2008, the government has allocated some £39 billion to Sustainable Communities. While the scale and scope of the investment has been widely applauded, the total cost of the plan will far exceed existing and planned budgets. Consultants Roger Tym & Partners estimate that over the next 15-20 years around £55 billion will be needed to support housing growth in the wider South East. Kent County Council claims it will need at least £10 billion more to meet infrastructure costs.

Added to this are: the extra £1.2 billion to £1.6 billion a year that Kate Barker identified in her 2004 *Review of Housing Supply* as necessary to address the backlog of social housing and to keep up with demographic trends; the estimated £15 billion to £20 billion on-going cost of meeting the government's 2010 "decent homes" target; and the extra investment needed to lift the economic performance of the North and to tackle low housing demand in certain areas. More of the additional funding will also have to be home grown (particularly in "assisted areas") as EU Structural Funds are cut back post-2006.

Bridging the funding gap

Given the myriad different projects and timeframes it is impossible to quantify the funding gap accurately. However, the absence of any headline figure does not disprove the need for more investment. In fact, the government anticipates leveraging in significant sums of private finance to support the Sustainable Communities Plan. Some £10 billion of developer contributions is expected through planning gain in the growth areas. In the first phase of investment in the Thames Gateway, the ODPM anticipates some £2 billion of additional private-sector funding. Private finance is also central to the government's social housing, mixed communities and neighbourhood renewal programmes.

Ministers want to make sure that the flow of private funding adds to public investment rather than displaces it, and that it helps to open up new opportunities. There is also a desire for more flexible, longer-term financing mechanisms that can lever in private finance in a more integrated way.

Historically, around £1 of public funding in land reclamation and regeneration levers in an additional £2.50 to £3 of private investment (either directly or through project-related investment). The ratio varies from project to project and depends on land values and market conditions. Of course, not all public-sector investment attracts private finance. But even if a third of the funding allocated under the Sustainable Communities Plan levered in £3 for every £1 of public spend, then the extra investment would be some £30 billion. New funding mechanisms and new incentives to attract more private finance could increase this figure significantly. Not all the extra investment would be up-front, but it would clearly make a big difference.

Assets, cash flow and efficiency savings

As Whitehall prepares for the next three-year spending round, civil servants know they will have to run even faster in order to meet their public service agreement targets on housing and growth floor targets while, at the same time, making continued efficiency savings. Extra investment will be released through Gershon-inspired efficiency programmes (such as the £1 billion-a-year savings earmarked for local authorities), although most of the gains are already factored into existing spending plans.

However, there may be scope to achieve further efficiency gains with the introduction of more local area agreements (which pool various funding streams from central government to local authorities in order to reduce costs and strengthen local decision making) and possible pooling of procurement and other local services. Additional investment in community development trusts and other not-for-profit enterprises is also expected, following recent revisions to government accounting guidance to end the restrictive so-called "clawback" rules whereby organisations had to return the proceeds of the sale of any property bought with public funds. (The changes in effect allow community organisations to use public funds or assets more flexibly to generate income or as collateral for lending.)

There are also potential savings within the social housing sector, where costs have risen sharply. How far these savings add to the level of investment will depend on the ability of local authorities and other agencies to retain and recycle funds.

Similarly, local authorities could do more with their surplus land and empty buildings, provided they are free to reinvest the receipts. Attitudes are changing and the government has relaxed some of the rules surrounding land designation and land sales. The Greater London Authority, for example, has already started using its surplus land for innovative public-private housing projects, and other local authorities are bringing forward more of their land for development as part of Private Finance Initiative housing schemes. Housing associations, meanwhile, will be free to reinvest receipts from properties sold under the government's new Homebuy scheme.

David Higgins, the chief executive of English Partnerships, demonstrates in his chapter how his organisation is working with the government and other partners on a range of land-based funding solutions to deliver timely investment to support sustainable communities. English Partnerships has piloted new ways of utilising public assets and cash flow for housing and regeneration – including using surplus NHS and Ministry of Defence sites for new housing. Higgins comments that many of English Partnerships' projects have used private-sector techniques fashioned to meet public-sector priorities. He argues that this new culture for policy intervention is the only way to close the major funding gaps.

Financing local regeneration

Local economic development has taken on greater significance in recent years, with most attention concentrated on supporting indigenous growth. With the introduction of greater local financial freedom and flexibility and a new, more prudential borrowing regime, local authorities are now asking what more they can do to generate additional funding for regeneration. Some authorities have formed joint ventures with housing associations and urban regeneration companies to lever in private investment, while others are establishing business improvement districts, where the local authority (with business consent) can levy a small charge on top of the business rate to reinvest locally.

On the tail wind of the government's review of local government finance and the decision to part-fund the London 2012 Olympics by way of a special council tax precept on Londoners, a debate has opened up on the use of similar precepts on the business rate. Jay Walder, at Transport for London, shows in his chapter how important transport is to city growth and asks what more can be done to boost investment locally. He calls for less reliance on central government and conventional financing arrangements, such as planning gain, and more devolution of transport decision making and funding. Walder argues for a supplementary business rate to fund major transport projects such as Crossrail.

Local authorities are also lobbying for new tax incentives, such as tax incremental financing. The Treasury remains cautious about breaking its public expenditure golden rule and increasing the public-sector borrowing requirement, but has recently introduced the local authority business growth incentives scheme, which allows authorities to retain a proportion of any increase in the business rate revenue (above an agreed limit).

The new prudential borrowing framework for local authorities offers the opportunity for bond financing of long-term capital investment. The municipal bond market in the USA is worth over £75 billion in new issues each year, covering everything from roads to public buildings. Ben Cashin, John Shinton and Jessica Castle, of Royal Bank of Canada, examine the potential for bond financing of housing and infrastructure and provide a useful insight into the workings of the capital markets – which have been criticised for failing to invest enough in housing and regeneration projects.

They look at the pros and cons of different types of bond financing and highlight the benefits of grouping together a number of infrastructure projects into a single, large bond programme. Royal Bank of Canada's experience suggests that bonds will play a bigger role in financing the Sustainable Communities Plan, with the capital markets developing more flexible and complex structures and instruments based on proven experience.

Public-private partnerships

The challenge for regeneration agencies is to attract additional, longer-term investment into local areas. One route for achieving this is for local authorities and other stakeholders to form public-private partnerships, or PPPs, which can complement business support initiatives.

Regeneration PPPs are relatively new and underdeveloped compared with those in other sectors, such as health and education. However, PricewaterhouseCoopers, the UK's leading adviser on PPPs, believes that the policy landscape is changing. It suggest that the new, indicative PPP models (such as PricewaterhouseCoopers' local regeneration partnership) will be better suited to area-based regeneration, especially where there is a need to capture and recycle development gains and to avoid cherry picking and piecemeal development. The partnership approach seeks to provide additional investment to drive forward regeneration by creating long-term funding arrangements and grouping together profitable and less profitable schemes.

According to Ray Mills and Mike Atherton at PricewaterhouseCoopers, PPPs are an emerging trend in regeneration and have the potential to generate significant additional funding. The experience so far suggests that they not only provide an effective means for levering in significant levels of private finance, but also offer additional benefits in terms of connecting local regeneration projects and building social capital and know-how.

The key, say Mills and Atherton, is effective and mutually rewarding participation in commercially viable regeneration projects. However, they claim there are still hurdles to overcome, including a lack of clear shared guidance that could provide local government with the tools to assess whether a PPP route is worth pursuing.

Planning gain and land value capture

One of the main delivery mechanisms for additional local funding for housing, regeneration and infrastructure is section 106 agreements between local authority and developer, which ensure that specified extra works related to the development, such as affordable housing or infrastructure, are undertaken for community benefit. The local benefits or safeguards are usually provided at the developer's expense and form part of a planning approval. In total these agreements are worth more than £1.5 billion a year, with most of the contributions funding social housing or local transport schemes. Housing associations and local authorities are especially keen to use section 106 arrangements where development land is scarce. Section 106 also makes an important contribution to mixed communities, funding around 3,000 affordable homes a year without public subsidy.

Although the section 106 system has been criticised for being slow and unpredictable, recent reforms to the system have encouraged more innovation, including the development of "strategic section 106" agreements to create pooled contributions. The so-called "roof tariff" strategic section 106 arrangement at Milton Keynes, for example, will allow more investment in local infrastructure when it is needed – in advance of developer section 106 contributions becoming due.

Gideon Amos of the Town & Country Planning Association suggests in his chapter that such strategic agreements could raise two to three times the amount gained from conventional section 106 deals. Although strategic section 106 agreements and tariff arrangements are not suited everywhere, their wider application could boost the value from planning gain England-wide to over £2.5 billion.

The government could raise stamp duty or introduce new property taxes, or else opt to fund the Sustainable Communities Plan by levying VAT on greenfield sites as suggested by the Urban Task Force. However, ministers are yet to be convinced that new taxes on land or property would be politically viable. Whitehall, meanwhile, is sceptical about the effectiveness of greenfield taxes and suspects they may deter housing investment.

However, mindful of the huge windfall profits made by some landowners, the government is considering the idea of a new planning gain supplement on the granting of planning permissions. Amos discusses the strengths and weaknesses of a planning gain supplement and other land taxes. He highlights the difficulties involved in any rapid implementation of such a system and wants to ensure that any new regime complements, rather than undermines, section 106 agreements.

Land trusts and endowment funding

Landowners, developers and property companies all stand to make large gains from area-based public investment. In the Thames Gateway, for example, residential land values could rise by as much as £15 billion. Some of that uplift will go to local authorities from higher rateable values and increased tax revenue, but the vast majority will be lost to the community. The challenge facing government is how best to capture land value increases without deterring new investment, and how to make sure the benefits are effectively redistributed.

The idea of capturing uplift in land values for the betterment of the local community is not new. The concept dates back over 100 years to the garden cities movement. Indeed, Amos argues that there are positive lessons to be learned from past experience with community land trusts and long-term (60-year) public loans for local infrastructure and the public realm.

Dr John Bridge and Euan Hall of the Land Restoration Trust take a fresh look at the way in which revenue funding from endowed land can provide long-term benefits to the local community. They show how endowment funding for parks and green spaces is more sustainable and represents better value for money over the longer term than conventional project funding. However, they conclude that there are unnecessary barriers to land restoration around the way in which green endowment projects and life-cycle funding are viewed by Whitehall. According to Bridge and Hall, "financing the future arguably demands a more thorough and extensive rethink about the way public investment for sustainable communities is evaluated, assessed, monitored and reviewed".

Funding affordable homes

The government aims to increase the supply of affordable housing and raise the level of home ownership. Spending on social housing has been increased and much more effort than before is being made to create an intermediate housing market. A partnership arrangement has been reached with the Council of Mortgage Lenders to offer new equity funding for low-cost shared-ownership homes, and real estate investment trusts are being introduced to encourage more equity investment in affordable homes. However, public investment levels are arguably insufficient to keep up with demand, let alone replace the huge loss of rented homes through the right-to-buy scheme.

Colin Blakey of house builder Bellway argues that the amount of affordable housing could be increased by the private sector. He shows how Bellway Housing Trust is working in partnership with local housing associations to provide new shared-equity homes without any direct public subsidy. Blakey comments that the government's emphasis on low-cost home-ownership will attract more private-sector investment.

However, he warns that if local authorities wish to encourage private finance in affordable housing they must be more flexible in regard to the section 106 conditions they place on the sale of equity-share homes on the open market. The new equity-share schemes that Bellway provides as part of a mixed-tenure community depend on future sales into the owner-occupier market.

The social housing sector has been at the forefront of borrowing against secured cash flows and assets. Housing associations have, for example, successfully secured over £30 billion of private finance for repairs and new building since the late 1980s. Despite this, Cashin, Shinton and Castle at Royal Bank of Canada argue that the true financial savings of housing associations are understated and under-utilised. The experience of Royal Bank of Canada with cash-flow-based bond financing for housing associations suggests that there is over £10 billion of hidden borrowing capacity across the sector.

Learning from abroad

International experience suggests that the key to unlocking more private finance is to create the right mix of financial tools, incentives and regulations. Greg Clark, who chairs the OECD's Forum of Cities & Regions, says that British cities and regions have traditionally been disadvantaged by the country's highly centralised public finance system. However, Clark shows that recent experience suggests the situation is changing and that the UK is catching up fast. But he warns against crudely adopting experience from abroad and calls for much closer international collaboration between financiers, policy makers and practitioners.

Conclusion

The government has made a strong commitment to creating sustainable communities and has introduced a comprehensive plan to deliver more housing in the South and more regeneration in the North. Ministers and civil servants are focused on delivery and meeting the targets they have set. But the demands on the public purse continue to grow and few believe that the government will be able substantially to increase public investment in housing and growth. Indeed, the ODPM budget is already being stretched by the Olympics and by extra funding demands from local authorities.

In the face of competing priorities and limited resources, the search will continue for new investment solutions. Part of the answer lies in getting more from public land and assets, and in investing more wisely. Efficiency savings also have a contribution to make, alongside reforms to open up public funding to greater competition, and a more positive approach by government towards land trusts and endowment funding.

Major funding opportunities also lie with new initiatives, such as public-private partnerships in housing and regeneration, a more innovative and strategic section 106 regime, public bonds, tax increment financing, business rate supplements, and new tax mechanisms to capture uplift in land values. But experience from the USA and Europe suggests that the transfer of new financial instruments and incentives to improve the supply of investment are only one side of the coin. Success comes from stimulating and sustaining a continuous level of good-quality demand so that the average cost of each deal can be reduced.

Moreover, to create a workable menu of options that can lever in more private finance requires greater flexibility in approach, clearer project appraisal systems and better governance arrangements. These factors help create more certainty and predictability, which in turn lowers the risk.

New funding instruments are central to the success of the Sustainable Communities Plan. However, financial innovation on its own will not deliver the results. The government must also help to create the opportunities for investment and ensure that its policies and funding streams are joined up, especially in regard to housing, regeneration and transport. This has implications for the way that departmental targets and budgets are set and demands more innovative working relationships between departments and delivery agencies.

In the past much of the investment in our communities was short-term and fragmented, with public and private finance often kept apart. That is now changing and, as the contributors to this monograph have collectively shown, there is now a strong appetite in both the public and private sectors to try and do things differently. It is that culture change that will make the difference and help provide the funding for the future.

Chapter 1

New solutions for sustainable investment

David Higgins, Chief Executive of English Partnerships

New solutions for sustainable investment
David Higgins

Sustainable places need good-quality homes, transport, local services, access to job opportunities and green spaces. We have been working for a while to achieve this joined-up approach, which is the hallmark of the government's Sustainable Communities Plan (launched in 2003) and its subsequent five-year housing plan (from 2005). But there is an on-going challenge regarding who should pay.

English Partnerships has been working with the ODPM and our other partners on a range of funding solutions to deliver the necessary and timely investment to support sustainable communities. Some of these ideas are mechanisms that bring forward the potential for private-sector investment and others are cleverer ways for the public sector to create value out of existing assets. I will discuss some of these ideas in this chapter.

Land supply

Before turning to delivery solutions, it is important to recognise the importance of land in making and regenerating places. Kate Barker's 2004 *Review of Housing Supply* stressed the importance of efficient land supply. Over the past 20 years residential land prices have risen 900%, nearly double the rate of house price inflation. Over the past four years, residential land values in England and Wales, excluding London, have risen by 75.7%. Yet mix-adjusted house prices in England and Wales rose at half that rate, by 41.6%, between April 2002 and January 2005 (Valuation Office *Property Market Report*, January 2005/ODPM housing statistics, June 2005).

There are many reasons for the inflation of residential land prices, but sufficient land supply and the more efficient use of that land (especially brownfield) are clearly policy priorities to help tackle this inflation, particularly as it reduces housing affordability. However, brownfield land is not easy to bring to the market. Our research shows that 64,130 hectares of brownfield land is vacant, derelict and potentially available for development. A significant proportion of this land is constrained by the planning system. More can be done to unlock it. That is why English Partnerships is producing a national brownfield strategy with the government, rolling out regional brownfield land plans and working with 14 local authorities to identify how to bring their priority brownfield sites to the market or to facilitate their renewal as local amenities.

There are strong signals that the brownfield-first policy is working. Planning and the greenfield direction have played their role, as have the long-term effects of regeneration policies such as the coalfields programme and the creation of urban regeneration companies. The stock of long-term derelict land has fallen by 32% in the past five years. Recent statistics show that over 70% of new homes are now being built on brownfield land, and density is up to 40 homes per hectare – a near doubling in 10 years.

Brownfield policy has to be even-handed. The public sector is sitting on a lot of brownfield land that needs releasing and English Partnerships was asked by the ODPM to help provide a solution. We assisted the government in setting up an interdepartmental forum for pooling surplus land and, more recently, a register of surplus public-sector land that we now run in partnership with the Office of Government Commerce. This register provides a single reference point for all participating public-sector organisations – in effect a snapshot of available national supply of surplus land. This helps to ensure that wider government objectives, including housing requirements and regional economic and housing strategies, are factored into all land disposal decisions by central government.

Once the disposing agency has provided English Partnerships with details of a site for inclusion on the register, there is a 40-day window for public-sector agencies and departments to identify new uses for this land. If the sites can be used beneficially elsewhere in the public sector, they may be transferred at market value. Gone are the days when departments spot the land of another department in an advert in *Estates Gazette* and then set about bidding for it against the private sector. Nearly 30 public-sector agencies to date have supplied site details for the register and it lists more than 700 sites, totalling more than 3,600 hectares of land.

Public-sector bodies are under pressure to deliver a good return from their surplus assets to help offset operational costs. This is simply good practice, but it was missing the wider picture. There is a need for more affordable housing, particularly for key workers, so it would seem sensible that when a public asset is deemed surplus its potential for meeting wider government objectives is considered. The register of surplus public-sector land has provided government with the opportunity to make these strategic linkages.

For example, in April 2005 the Department of Health announced the transfer to English Partnerships of the first tranche of 67 surplus NHS sites, eventually to reach a total of 96 sites. We are dedicated to bringing these sites into beneficial use very quickly. The hospital sites programme could provide up to 15,000 new homes nationally, at least

5,000 of them affordable homes, and could create momentum in many growth and regeneration areas by creating confidence.

We are also growing active partnerships with other public-sector bodies to ensure that we can jointly identify land for development and regeneration. In November 2004, we signed a joint working agreement with Defence Estates to maximise the potential of surplus Ministry of Defence property. English Partnerships is now working closely with Defence Estates to analyse surplus MoD assets and assist in disposal strategies. We are in negotiation with them, for example, about our purchase of Oakington Barracks near Cambridge. The resulting new town, Northstowe, will be a sustainable new settlement in this growth area with a full range of transport and employment opportunities that will make it a balanced community.

Funding infrastructure

Land is only part of the picture. Infrastructure is also critical to making and regenerating places. The scale of the funding challenge looks daunting. A report earlier this year by Roger Tym & Partners on the funding required to support the growth agendas of the South East and the Eastern counties (Bedfordshire, Hertfordshire and Essex) to 2021 and 2026 respectively could amount to £55 billion, of which £10 billion might be levered from private developer contributions through the planning system.

There are also substantial public plans for the Midlands and the North, all of which require supporting infrastructure to realise plans for regeneration and market renewal. The long-term aspirations of the 21 urban regeneration companies alone require £1.7 billion of public-sector investment, which would directly lever in £8 billion from the private sector.

With regard to the private sector, there is an on-going debate about how best to get contributions to help pay for infrastructure. Options have largely centered on the planning system. The government's proposed reform of taxation on planning gain envisages a continuation of the section 106 system – whereby a developer undertakes to provide, for public benefit, specific extra works related to the development as part of the planning approval process – and offers a new opportunity to create pooled contributions. Until we know how the proposed planning gain supplement will work, it is going to be uncertain whether bills for infrastructure belong with local planning gain or with the hypothecation of any future proposed land tax.

While the new planning regime is a useful tool, I do not believe it is a panacea. We need to plan and form partnerships in order to provide the funding and deliver the infrastructure that the planning regime enables.

Whatever the planning system allows by way of pooled contributions or tax revenues, the dilemma is that all good communities need key infrastructure to be provided first, before homes are built and people move in. To make new housing sites attractive to families, we need new schools. To build new schools we are going to need contributions from developers, but they cannot be expected to pay until they are building the homes. So inevitably the new schools get built only once the homes are already built, putting pressure on the existing school system and discouraging families from buying the homes targeted at them. The following are examples of ways in which we have tried to escape from this vicious circle.

West Bedford

We have come up with an innovative approach in Bedford, which was recently announced by the Minister for Housing and Planning, Yvette Cooper, at the English Partnerships open meeting on 5 October 2005. Bedford lies within the Milton Keynes South Midland Growth Area and the sub-regional strategy sets out an ambitious policy for 19,500 new homes by 2021. Sufficient housing and employment land have been identified in the Bedford area to meet this growth, but there is a lack of capacity in the existing infrastructure and this has constrained Bedford's economic performance.

One opportunity for new housing development in Bedford is a collection of sites to the west of the town, which could accommodate a new settlement of around 2,250 homes and associated community infrastructure. However, in order to open up these sites for development, a road bypass to the west of Bedford needs to be built which cannot be funded by either the local authority or the Highways Agency. The new bypass will support the economic regeneration of Bedford.

Asked to provide a solution, English Partnerships brought together public partners, such as the county council as highways authority, and funders in the ODPM and the Department for Transport, as well as landowners, brokering a funding plan to construct the road in a partnership arrangement.

Because English Partnerships will be funding the road, adjacent landowners will have grounds to obtain planning consent to build new homes. On condition that the road is funded, we have agreed with these landowners that they will deliver the homes to an agreed timescale. With the ODPM, English Partnerships could make payments equivalent to the cost of the road funding in order to enable the council to contract to build it.

We have also agreed with the landowners that English Partnerships and the local authority will share in the resulting uplift in land values and negotiated payment from the land as it is sold for housing over a 10-year period. The landowners' obligations to pay will be secured by a legal charge over the land (or other security) in favour of English Partnerships.

What we are suggesting in Bedford is to create a cash flow mechanism to capture the resulting land value uplift that minimises the net public expenditure and even holds out the potential for net gain by the public sector alongside private landowners. The model could be transferred to other situations where public infrastructure unlocks private assets and contributions. This type of project could also potentially attract private finance in future.

Milton Keynes

Another brokerage role we have played to unlock payments for key infrastructure is in Milton Keynes, where a new local delivery vehicle, the Milton Keynes Partnership, (a sub-committee of English Partnerships) has been established. The partnership has been given planning powers to help facilitate growth in a defined urban development area. Within this area plans have been drawn up to guide development and this has enabled the partnership to cost up the infrastructure needed to support growth and to prepare the Milton Keynes prospectus.

This prospectus aims to establish a tariff arrangement for all section 106 planning obligations into which the partnership will enter in its capacity as local planning authority for the urban development area. The tariff, likely to be set at around £18,500 per new home with a similar contribution from employment development, will capture a share of the increased land value that good planning is creating. This will help pay for strategic infrastructure, such as highway and public transport improvements, as well as contribute to community infrastructure such as schools and new parks within the development area.

The framework has been developed by the Milton Keynes Partnership together with the local authority, the Highways Agency and the local primary care trust. Milton Keynes Forward, a body representing developers and landowners within the urban development area's eastern and western expansion zones, has also been involved throughout. The outcome is a funding plan for Milton Keynes' future growth that includes all public-sector partners in immediate commitments and long-term plans for investment in the city and which is supported by the private sector as an effective means of using contributions they will make under section 106.

This approach builds on the traditional section 106 system to create a more strategic mechanism for estimating and negotiating contributions. It makes the contributions by developers and landowners more equitable and relevant to the proposed development. In exchange the private sector gets certainty, knowing when and how the schools, roads and doctors' surgeries are going to be provided.

The Milton Keynes prospectus runs up to 2016 and not only is a business plan setting out targets and spending objectives, but also contains legal cover, using section 106 and supplementary planning approval to tackle implementation, risk and accountability.

Tariff contributions will be held by the Milton Keynes Partnership as the local planning authority, to be spent on a phased basis. Present proposals are for 75% of the funding requirements for infrastructure to be met through the tariff, with the remaining 25% to come from the local authority or other public-sector sources. The tariff will be phased, with an initial 25% payment on implementation of planning consent and the remaining 75% for each phase falling due on completion of the homes.

This approach allows English Partnerships to provide infrastructure when it is needed – in advance of developer section 106 contributions becoming due and in the certainty that we will get these contributions over time.

None of this thinking is new. Back in the 1980s Northampton tried to raise a road infrastructure tariff using the planning system and won the principle after a great deal of legal fees had been paid. Twenty years later we are, hopefully, realising that ambition in Milton Keynes. There remain problems, due to the lumpy nature and the timing of infrastructure investment, and it will take time for demand to match the new capacity.

There are also problems relating to the financial structure of the house-building industry. Commonly, house builders rely on turning over capital rapidly to generate a high rate of return on capital employed – which they cannot create if capital is tied up early in infrastructure investment.

Hattersley

The opportunity to maximise private investment is not exclusive to areas of economic and housing pressure in the South. There is the potential to attract private finance into many regeneration programmes, especially housing renewal. We learned as much when were invited to look at a stalled stock-transfer project in Hattersley, Tameside.

One of Manchester's overspill housing estates, of 3,300 homes, Hattersley overlooks spectacular Peak District countryside and is just a 30-minute train ride from Manchester city centre. Even so, this is not a desirable address, suffering from high unemployment, falling school attainment and a community lacking social mix, with 71% of homes being social rented and 29% private, much of it rented from remote landlords. Not surprisingly, there are 300 vacant properties.

Looking around the estate, we found that there was around 25 hectares of public land in the area that had not been included in the equation. English Partnerships purchased the land from the council, which is now using the capital to fund a gap in the stock transfer to the housing association. The funding from our land purchase will be used by the council and the housing association to bring the social housing up to decent standards, a condition set by the government for the stock transfer.

With the extra land added into the project, the area can now attract private development to diversify the housing mix, with around 900 homes to be built for private sale. This will bring in a new population with higher incomes as well as helping retain those who might otherwise have moved away. In addition, a new local shopping centre will be built on the land we have bought. At the end of the day, a more sustainable community will have been created. Before we got involved, private funding and land development had not been looked at together with the housing stock transfer.

Institutional finance

The 1999 report of Urban Task Force identified the need for further institutional investment in the urban renaissance. I believe there is still a lot more we can do to attract big City financial institutions into public policy fields like ours. The regeneration index we have produced with Morley and Investment Property Databank since 2003 has consistently shown that regeneration property performs no worse than general property and is in many ways more resilient against market cycles.

To demonstrate that these statistics really do mean what they say, a few years ago we set up the English Cities Fund, with Legal & General and Amec Developments, as a private-sector vehicle underpinned by English Partnerships capital. The aim of the fund was to demonstrate to City institutions that it pays to invest in both development and investment activity. In the past investors have not ventured into risk taking in regeneration development, so developers have relied mainly on bank debt.

The £100 million English Cities Fund has been working on a number of mixed-use city fringe regeneration projects and recently announced the attraction of law firm Hill Dickinson to the St Paul's Square project in Liverpool, in the biggest commercial letting in that city for 20 years. Momentum has been started for the revival of Liverpool's business quarter.

We have had similar success with Priority Sites, our joint venture with Royal Bank of Scotland, which has been building factories and other employment space in regeneration areas and coalfield community areas in which other private funders have not been willing to back property development. By summer 2006 Priority Sites will have delivered 330,000 square metres of floor space.

Years ago, the public sector would have used only one-off grants to encourage private-sector investment into priority areas. Equity-based investments like those we have made through Priority Sites offer long-term returns that can be recycled back into future programmes.

East Midlands Property Investment Fund (Blueprint)

Much regeneration investment by the public sector has tended in the past to leak away. This concern to capture value created by regeneration led to the creation of the East Midlands Property Investment Fund, officially launched as Blueprint in 2005 by the East Midlands Development Agency and English Partnerships. The purpose of Blueprint is to make existing and future regeneration assets sweat to provide a future stream of funding for further regeneration activity.

Blueprint is a 50:50 public-private partnership (technically in the private sector) that holds investment property and develops land and property. After a competition, Igloo Regeneration (Morley Fund Management) joined and helped establish an investment and development fund. The fund supports existing industrial property we have dedicated to the venture and seeks out and invests in new mixed-use land opportunities in priority urban areas, initially in Leicester, Derby and Nottingham. These sites are existing East Midlands Development Agency and English Partnerships land holdings that have been dedicated to Blueprint rather than sold or developed independently.

The distinct feature of Blueprint is that it will hold and manage the investment portfolio and will carry out development activity aligned to meeting agreed objectives of English Partnerships and the East Midlands Development Agency. The development agency is guaranteed a payment of 75% of the agreed open market value of the contributed properties. It will leave in the partnership the remaining 25% of value, in return for a 25% equity interest in Blueprint. English Partnerships will invest cash or assets as partnership equity with a value equivalent to the development agency's equity stake. Igloo will then match the combined equity commitment of the two public-sector partners.

English Partnerships and East Midlands Development Agency will share between them 50% of the net income from the investment properties. Igloo will inject cash, equivalent to the open market value of the total public-sector stake, as partnership equity to obtain a 50% stake in Blueprint and provide working capital for development assets. It will commit this cash at the outset, although it may be drawn down in the initial years of the partnership.

In future years, Blueprint would use the profits generated to acquire and invest in further development opportunities in these regeneration priority areas, thereby continuing the cycle. It sounds complex, but the principle is fairly simple – recycle regeneration investment to benefit the next generation.

Conclusion

I hope I have illustrated that there are ample mechanisms and models for attracting more private finance into our policies and programmes. These arrangements are not uniquely the domain of English Partnerships, but we have provided a few benchmarks. As someone with a long history in the private sector now working in the public sector, I recognise that we need to share skills and experience between the two sectors better than before.

Many of English Partnerships' projects have used private-sector techniques fashioned to meet public-sector priorities. Balancing the two perspectives to create a new culture for policy intervention is what I think we are now starting to achieve. This new approach to investment is the only way that major funding gaps are going to be filled, in order to meet the major policy challenges ahead of us.

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Chapter 2

Funding the public realm – lessons from the Land Restoration Trust

Dr John Bridge, Chairman, and Euan Hall, Chief Executive,
The Land Restoration Trusts

Funding the public realm – lessons from the Land Restoration Trust

Dr John Bridge and Euan Hall

In this chapter we highlight the importance of the public realm in creating sustainable communities and show how alternative funding organisations, like the Land Restoration Trust, can provide both sustainable outcomes and better value for money over the longer term. We believe that the experience of the Land Restoration Trust demonstrates the need for a radical change in the financial appraisal system for public investment in green spaces and the public realm.

The Land Restoration Trust

Launched by the Deputy Prime Minister in 2004, the Land Restoration Trust operates as an independent company limited by guarantee, with a board membership including English Partnerships, the Environment Agency, the Forestry Commission and Groundwork. The trust, which is at present financially accountable to English Partnerships, aims to restore derelict, neglected or underused sites and maintain them for the community in the form of publicly accessible green space.

The work of the trust is centred on the use of endowments, which if accurately structured can provide site maintenance in perpetuity. Indeed, the unique feature of the Land Restoration Trust is that it seeks to create and maintain community-led land restoration projects over the long term by utilising endowment funding schemes. In its initial three-year pilot period the trust will seek to secure the restoration and management of some 1,500 hectares of brownfield land. Within 10 years it hopes to expand its portfolio of sites to some 10,000 hectares – an area the size of Coventry.

The post-industrial landscape

Interest in new approaches to land reclamation and restoration began to emerge in the aftermath of the widespread collapse of manufacturing in the 1980s and early 1990s. Groundwork, for example, published in 1996 a major report by Professor John Handley entitled *The Post Industrial Landscape* which showed that without a change in policy (and given the rate of brownfield land creation and reclamation) it would take around 200 years to address the problem.

The Handley report (and later reports by the House of Commons environment, transport and regional affairs select committee) highlighted the fact that there was little, if any, funding available to take care of the post-industrial landscape. In addition, the research showed that governments had consistently underestimated the social, environmental and economic benefits of investing in parks, urban commons, public gardens and nature trails.

The Handley report called upon the Conservative government to set up a "UK [t]rust for the restoration of derelict land … which would act for the nation in the acquisition of land at the end of its economic life and … hold such land as trustees, working with the community to restore it to health and manage it for public benefit, in perpetuity". Unfortunately, at the time the so-called "liveability" agenda was low on the government's priority list.

Labour has shown a strong commitment to sustainable development and has increased investment in land reclamation. The *Urban White Paper* in 2000, the report of the Urban Green Spaces Task Force in the same year, and the Sustainable Communities Plan in 2003 also echoed the recommendations of the Handley report in respect of alternative approaches to funding the public realm.

For the first time in decades there was a recognition that, despite the perceived lack of direct commercial value attributed to many derelict sites, community-led regeneration of neglected or underused land can contribute to the economic, social and health prospects of a community. Indeed, in developing the Land Restoration Trust, the Deputy Prime Minister stressed that sustainable regeneration means doing more to improve the environmental quality and social capital of a community, as well as its economic well-being.

Pilot phase

In the first three years, its pilot phase, the Land Restoration Trust aims to secure endowment funding of approximately £25 million. This dedicated funding will provide in-perpetuity maintenance of public-sector and private-sector sites around the country. Around half the sites (some 750 hectares) in the early years will come from English Partnerships' national coalfield programme, where the individual sites are owned either by English Partnerships or by a regional development agency and where endowments are available.

The basic process involves the regional development agency or English Partnerships transferring the site into the trust's ownership at zero cost (with the assumption that the land has been sufficiently remediated not to leave any residual costs to the trust) together with an endowment sufficient to secure in-perpetuity maintenance of the site. In effect, the Land Restoration Trust secures financial resources ahead of use, which are then invested to provide annual income streams that are sufficient to maintain the site for a wide range of public uses.

Endowment funding

Since the demise of derelict land grants in the 1990s most public-agency land reclamation initiatives have tended to concentrate on releasing land for hard end-use, notably for housing. The amount of brownfield land being brought back into use in this way has increased, and English Partnerships and other, local agencies have developed new approaches to funding housing-led regeneration.

However, as a result of this activity the amount of land reclamation to promote overall soft end-use such as green space has been in relative decline. The situation is compounded by the fact that such sites often pose a future maintenance liability, and in conventional public-sector output terms (as at present measured) produce little reportable impact. Their public investment value is thus seen as considerably lower than comparative investment in hard end-use, although the long-term outcomes may be significantly better.

Part of the problem is that grant regimes to date have typically provided a capital grant for site development, but little for maintenance. The long-term maintenance of a site then falls on the public-sector owner to cover, often a very difficult task when there are competing claims on scarce resources (or the funding for maintenance is separated from the capital investment). All too frequently the total capital injection is insufficient to secure the long-term benefit required. The end result is a slowly deteriorating urban fabric, which carries a high social and economic cost later on.

A typical example of this capital-revenue investment problem is the Liverpool Garden Festival site, which received over £20 million of public investment. When the year-long festival closed there was no long-term maintenance programme in place. The scheme thus failed to continue to provide the quality of open space required. The improvements were short-lived and the land fell back into disrepair. In effect, the capital expenditure was wasted, as no mechanism existed to secure the long-term benefits from the initial investment. The festival itself was a success, but this was not capitalised on.

In contrast, endowment funding is focused on ensuring the long-term sustainability of projects. The guiding principles are straightforward. For example, if a site in the ownership of a regional development agency or English Partnerships is transferred to the Land

Restoration Trust at zero cost (the site is deemed to have no economic value) then the trust calculates an endowment that will allow it to maintain that site in perpetuity. Such a calculation will have to take into account factors such as routine site maintenance, cyclical site up-keep (fences, access points, tree maintenance, for instance), site management and longer-term capital works (roads, car parks, bridges and walls).

As an example, a 200-hectare site, part of the national coalfields portfolio, could be maintained in perpetuity through an endowment of around £8 million. The Land Restoration Trust, on receipt of such an endowment, would have the responsibility to invest this money to yield an annual return consistent with the calculated overall maintenance costs and to include a management fee to cover the trust's core costs. From a public-expenditure point of view, the endowment route requires an up-front capital sum sufficient to generate lifetime income streams to provide in perpetuity maintenance of secured sites.

There are, however, potentially two problems with this approach. The first is that the full impact of the life-cycle maintenance falls into year one, as the capital sum is transferred. In this case there must be clear assurances that the endowment model provides value for money in the long term. On a crude financial measure the full benefit of the endowment model, compared with an annual revenue payment, will not fully show up for probably 20 years. However, if there were to be discontinuities in revenue funding (for example, due to competing demands on scare resources at local authority level) the endowment model would show benefits much earlier. This was the case with the Liverpool Garden Festival, where a further £8 million to £10 million of capital is now required to return it to its post-restoration state – a condition that a dowry of around £2 million in 1984 could have sustained in perpetuity.

The second problem concerns how the benefits are calculated, which in turn affects target setting and funding allocation decisions. Hard outputs in terms of houses, jobs, training places and the like are relatively easy to calculate. The benefits of open space are much harder to evaluate, especially in terms of present methodologies for public investment appraisal.

Recognising the benefits

Understanding the benefits of well-managed and well-maintained public open space is vital to helping create sustainable communities. We are all aware of the mistakes that were made in the post-war era when many of the new housing estates were built with little consideration of the public realm and how the homes would be maintained for generations to come. Many of the soulless estates built in the 1960s have been outlived by homes built a century before. Little thought was given to the long-term future and sustainability of these communities.

To learn from the past means giving greater attention and value early on to green spaces and the public realm: identifying an area not just by its housing and employment provision, but also by the quality of the local environment and the community facilities available. According to the Urban Green Spaces Task Force in 2002: "The quality of parks and green spaces provides a quick and highly visible indicator of whether an area is an attractive place for people to live and for business to locate."

The New Deal and neighbourhood renewal programmes have already shown that the generation, improvement and maintenance of urban green spaces can create new training and employment opportunities. Establishing local volunteer organisations can, as Groundwork has demonstrated, also build social cohesion and provide new routes to community stewardship of local environments. Research by CABE Space in 2004 and 2005, meanwhile, has shown that green spaces increase property values and help prevent antisocial behaviour.

Establishing new green amenities can also result in real benefits for public health. Recent research by Land Use Consultants (in 2004) demonstrated that a 1% reduction in premature death caused by chronic heart disease in Scotland would save the NHS £85 million a year. A similar reduction in England could save almost £1 billion. In part this can be achieved through encouraging healthier lifestyles, including more exercise – which itself depends to some extent on access to well-managed and well-maintained safe open spaces. According to research by Bristol University from 2002, green space also helps reduce stress – one of the major causes of lost days at work.

Similarly, at a time when climate change is one of the principal challenges facing the world there is insufficient recognition in appraisal terms of the environmental benefits of green space. One hectare of woodland, for example, can absorb the carbon-dioxide emissions from 100 family cars. Green landscaping can also absorb up to three-and-a-half times as much water as hard landscaping, thereby helping prevent floods.

Clearly, much more needs to be done to capture fully the benefits of well-maintained and well-managed open space. In particular, there is a need to review appraisal methodologies in order to allow the commitment of long-term funding for maintenance to be identified, allocated and set aside with capital for projects and programmes at day one. Perhaps instead of targeting 100 restoration projects, of which – optimistically – maybe 50% will survive 10 years due to shortage of annual revenue, only 75 funding projects should be delivered. The funding that would have gone to the other 25 could then be set aside as endowment funds to secure the sustainability of the 75 projects.

Conclusion

Failure to evaluate the full benefits of endowment investment will continue to undermine government efforts to create sustainable communities. The experience of the Land Restoration Trust shows what can be achieved, but fully to utilise endowment funding necessitates a more comprehensive approach to project development, where the emphasis is on full life-cycle costing and sustainability over the longer term. A rigid project-appraisal process that fails to take full account of the social, environmental and related quality-of-life indicators will merely exacerbate the culture of short-termism and ultimately prove more costly.

The concept of endowment financing to benefit communities is not in itself new – it has been operating successfully for the National Trust for over 100 years. Previous governments have, however, chosen to ignore this and have continued to adopt a short-term approach to public investment. In sharp contrast, Labour has made significant reforms to the public finance system and has championed new approaches to public-private funding.

The Land Restoration Trust has benefited from these changes and welcomes the chance to show what can be achieved by way of endowment funding. However, financing the future arguably demands a more thorough and extensive rethink about the way that public investment for sustainable communities is evaluated, assessed, monitored and reviewed.

Previous generations understood that well-managed green space – the lungs of our cities – creates a sense of place, well-being and community. The lessons are there from the past, if we are prepared to learn them. Arguably, there is sufficient public funding available to achieve this requirement already. What we must do is more appropriately target that money and utilise it better in order to create sustainable outcomes, not just short-term fixes.

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Chapter 3

Private investment and planning gain – can we do more?

Gideon Amos, Director of the Town & Country
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Private investment and planning gain – can we do more?
Gideon Amos

Financing the future in ways that encourage private investment for public gain is central to the government's Sustainable Communities Plan. Public funding is a major driver for delivering the housing and regeneration targets in the plan, but the private finance levered in from planning gain will make an ever more important contribution – not least to the provision of affordable housing and local infrastructure. The challenge facing central government and local authorities is how much more they can expect from planning gain, and whether there are viable alternatives worthy of consideration, such as land trusts and land taxes.

Planning for sustainability
The majority of our citizens benefit today from a rich inheritance of assets built by our Victorian forefathers. As Tristram Hunt put it in his excellent 2004 study of Victorian cities, *Building Jerusalem*: "For each time we step into our streets, we re-enter the Victorian urban world. From the Gothic spires of the Houses of Parliament to the neoclassicism of Liverpool's St George's Hall; from the Clydeside docks to Middlesbrough's gloomy chapels; from the Manchester Art Gallery to Leeds Town Hall; from Birmingham's Bournville to Bradford's Heaton Park, the Victorian city is with us."

These investments made more than 150 years ago have helped the more recent revitalisation of our towns and cities. The Victorian canals, warehouses and public buildings have been the centrepiece of the recent urban renaissance. In this respect sustainability could have been the watchword of previous generations. The question today is whether in the future we can invest as wisely as they did.

As in the past, we face the challenge of concentrating new housing and growth into well-planned towns and cities – turning the tide on sprawl and urban decay. But today's planners and developers must achieve all this in ways that promote social cohesion and are environmentally sustainable. We need not just better-quality homes but energy-efficient homes, not just roads but public transport and reduced commuting, and not just neighbourhoods but mixed communities with civic pride. Moreover, we need to plan for responsible growth.

The planning system is more readily associated with home extensions and the control of development. However, the planners of today who are mapping out the new growth areas in the wider South East, such as Milton Keynes and the Thames Gateway, are making a critical contribution to the financing of sustainable communities.

Planning provides the essential framework that enables pension funds, landowners and developers to invest in commercial, residential and other developments. Without plans and masterplans there is no certainty, and without certainty there is little or no investment. Creating a truly sustainable community – replete with schools, hospitals, open spaces, public transport, roads, water supply, drains and so on – without the support of a robust masterplan would surely be an expensive and risky business. It falls to good planning by professionals and civic leaders alike to ensure that the development is sustainable, commercially viable and beneficial to the community.

Capturing land value

Getting the balance right to ensure sustainable development is never easy. The power of planning, for example, to realise land values can make fortunes for landowners overnight. Agricultural sites in the South East today can rise in value from £1,200 per acre to £1.3 million per acre with the stroke of the district planning officer's pen on the notice that grants planning permission for housing development. Even ministerial policy announcements concerning new housing developments can lead to a sudden rise in land values in the places concerned. It is hard to think of any other area where local and national government can have such leverage on the market.

Kate Barker's *Review of Housing Supply* in 2004 identified the enormous potential for windfall gains from planning permission. These gains are publicly created and as such the wider community should appropriate a share of the value. As Barker observed: "Land, like most other assets, is already taxed through the capital gains tax regime. However, the existing system, which aims to incentivise and promote the efficient use of productive capital, does not sufficiently capture windfall development gains. There is, therefore, a case for extending the taxation of development gain resulting from land sales through different methods."

Section 106 agreements

The principal method of capturing land value is through section 106 agreements, whereby the local planning authority requires developers to provide certain extra works related to their developments, or so-called "planning gain". Although there are no accurate figures, it is estimated that section 106 raises about £1.5 billion a year. The vast majority of this funds affordable housing and off-site capital works such as highway improvements, although it can also fund green space, extra school places, public art and myriad other services. The track record of section 106 nevertheless remains mixed, with a lot depending on the capability of the local authority and the type of development (with commercial developments usually providing more planning gain than residential).

It is widely recognised that the section 106 system works because contributions are locally agreed and collected, and, crucially, locally reinvested. Since the legal tests require that section 106 contributions be both relevant and proportionate to the development, all parties concerned know the local authority is legally bound to spend the money on the agreed provision, which in the majority of cases will be provided in the vicinity of the development site. Funds are also gathered either up-front or within three to five years of planning permission being granted. Thereby as well as being local, section 106 contributions can also be invested at the outset of a development project.

There is no doubt that section 106 makes a major contribution to overall social housing provision. Nearly half of all affordable homes completed in 2002/03 received some form of contribution from section 106 investment. And the ODPM said earlier this year that "with tougher negotiations, clearer policy and better guidance, we might expect over 3,000 affordable units a year without public subsidy and without a detrimental impact on housing supply".

However, some local authorities fear that imposing section 106 obligations at too high a rate in order to fund affordable housing can risk deterring development. Developers meanwhile complain about unnecessary costs and delays in the system. Despite these concerns, the ODPM this year concluded that section 106 agreements have "encouraged developers and registered social landlords … to be more creative and to foster positive images of affordable housing schemes".

Section 106 agreements can go beyond what is either relevant or proportionate to a development. Such so-called "strategic section 106" agreements can provide useful extra funding for local infrastructure. The central feature of such agreements is the pooling of contributions and the joint commitment to deliver key elements of infrastructure (a vital bus link or road junction, for example) by an agreed date in return for the additional funds being contributed from the ultimate source of the rising land value.

In Milton Keynes, as first outlined in *Town & Country Planning* in 2004, strategic section 106 land and infrastructure contracts are now being agreed that could raise two to three times the amount gained from individual conventional section 106 contributions. Although strategic section 106 agreements are not appropriate everywhere, wider application could boost the value from planning gain England-wide to perhaps more than £2.5 billion.

Extra funds from land taxes

But should the government go further and tax a percentage of land value super-profits? Kate Barker has stated that she is not convinced that "blunt" land taxes are the way forward. In her contribution to the 2004 Smith Institute monograph *Building Sustainable Communities* she states that: "using land value tax to encourage bringing land into development is not the main problem constraining UK housing supply (rather, it is a range of difficulties around planning and local politics) … there are significant disadvantages to charging VAT on new-build developments – it would reduce the incentive to develop for landowners in the North more than the South and there are doubts whether EU law would permit the operation of differential VAT rates on greenfield and brownfield land".

Land taxes are certainly not new. David Lloyd George, as Chancellor of the Exchequer, introduced in 1909, as part of the first Planning Act, a levy of 50% of the betterment in land values arising from development. Labour governments have introduced various development gains taxes since: a development charge in 1947, a betterment levy in 1967 and a development land tax in 1976. Each one was ultimately repealed by an incoming Conservative government. In 1985, the development land tax (then operating at 40% of land value increases) was abolished and replaced with capital gains tax.

Whatever the political pressure for reform at the time, it is hard to see why a levy under development land tax should be unacceptable while capital gains tax is apparently acceptable. The main difference appears to be that capital gains tax offers more reliefs and greater scope for offsetting other costs. It also is arguably more suited to tax avoidance.

Many landowners and their agents are united in opposing any form of land tax and suggest that levies of this kind would stifle the very development we need for homes and sustainable communities. However, there is little evidence to suggest that the development land tax significantly held back the property market in the mid-1980s. It is questionable whether a levy of 25% to 35% on land value uplift would really prevent a development from going ahead. Much would depend on the extent to which the levy could be targeted and enforced, and of course on the continued rise in land values.

A planning gain supplement

The Barker review recommended that the government should impose a planning gain supplement on the granting of planning permission so that development gains can be increased. Government ministers are seemingly attracted to the idea and a consultation document is expected shortly.

However, even among supporters of a planning gain supplement there are concerns about making sure that the levy is high enough to make a difference in terms of generating extra revenues, and that it is flexible and cost-effective enough to be worth the political effort. There are also concerns about transitional arrangements, landowners possibly withholding land as a form of protest, and the impact on section 106 agreements.

There are other, more philosophical objections to a planning gain supplement, including from some advocates of full-scale land value taxation, who sometimes appear to overlook the similarities between the two systems. There are undeniably attractions to a land value tax in that the tax would be more constantly collected, rather than applied at the point of development as with a planning gain supplement. However, it does not follow that because development is desirable it should attract no taxation whatsoever. We do not take this approach to personal incomes, nor should we with development.

Barker suggests that a planning gain supplement would mean scaling back the existing section 106 regime. The rationale is that there would be no room on the balance sheet for a tax measure and section 106. If that proved to be the case, the legal test limiting contributions to impacts that are related and proportionate to a development would need to be more stringently applied. Careful consideration would also have to be given to the balance between providing for affordable housing and contributions towards local infrastructure. Certainly, divorcing the extra funding for affordable homes from private housing provision altogether would put the government's commitment to mixed-income and mixed-tenure communities at risk.

The question of whether such a tax should be a local one or a central tax would also need resolution. Since the Valuation Office Agency is already established and equipped with the required valuation skills and abilities, it might be advisable for a planning gain supplement to be collected centrally. As with section 106 contributions, however, a sufficient proportion of the revenue must be retained and spent locally, to help ensure a degree of support for the measure from those paying. A smaller percentage would rightly be due to the Exchequer, enabling an element of redistribution to regions where investment is most needed.

The Town & Country Planning Association welcomes the debate on a planning gain supplement as a means of financing the future and believes that there is a strong case for doing much more to capture the development gain accruing to landowners. However, a key feature of any new tax measure or planning gain supplement should be a complementary commitment from government to provide investment in those sites that are uneconomic to develop, such as contaminated or abandoned sites. Sir Peter Hall, president of the Town & Country Planning Association, has called for a 30-year clean-up programme for all contaminated land, to be managed and underwritten by the government. Whether through tax credits or grants, some funding to bring forward more brownfield land must accompany the introduction of any planning gain supplement.

Land trusts and loans

It is also important that the government does not lock itself too tightly into arguments about a planning gain supplement or nothing. The Town & Country Planning Association has long argued that there are alternative and complementary routes to securing additional funding. For example, if the community owns the land from day one then it can recoup the value increases accruing to it, enabling investment in infrastructure today financed on future returns. The planners of the new towns knew this, and the Treasury in a spirit of public-sector enterprise funded the new towns with interest-earning loans over 60 years.

According to the seminal 1969 work on new towns by Osborn and Whittick: "For the new towns the capital was provided by the government in the form of loans repayable over 60 years. Interest and repayments were chargeable from the start. During the period before revenues arose these charges were met in the main by borrowings. After a few years, however, revenues materialised, and in most of the first batch of new towns in England and Wales they have already overtaken the current loan charges on the whole of the capital invested, including the accumulated deficiencies of earlier years."

Whether the 30-odd new towns as a whole finally turned in a profit to the Exchequer or not (the Town & Country Planning Association believes that they did) has been debated ad nauseam. What cannot be contradicted is the spectacular economic success for planners at some of the new towns. Milton Keynes, for example, now experiences one of the highest rates of economic growth anywhere in the country and as a result attracts a net inflow of commuting workers each day. Without the acquisition of land at an early stage in Milton Keynes much of this success, and much of today's expansion of that city, would not have been possible.

Often in the past it was trusts that acquired land and created towns and communities on it, by recycling the profits to fund community infrastructure. Joseph Rowntree's developments at York, George Cadbury's Bournville in Birmingham and the garden cities at Letchworth and Welwyn were all created on this voluntary trust approach to land acquisition. Each used the trusts to capture rising land values and recycle revenues back into the community. A more recent example is the Milton Keynes Parks Trust, which was endowed with a commercial property portfolio that today generates income of around £2.7 million a year. The assets generate enough income to maintain local parks and green spaces.

Perhaps the housing associations could play a similar role in acquiring and bringing forward development today? The interest they have in mixed-tenure housing is in perpetuity, which makes them better placed than many to do the job. Alternatively, special-purpose delivery vehicles, such as urban development corporations or urban regeneration companies, could be given public-sector land stakes as an asset base to fund new infrastructure. Such investments would feed through into higher land values and higher land sale receipts later on.

Conclusion

Funding sustainable communities requires a huge effort by the public, voluntary and private sectors. The planning system can play its part, not least through a more innovative section 106 regime (including strategic section 106 agreements and borrowing against future developer contributions). In high-demand areas where the super-profits are made on the back of the community's decision to award planning permission, a planning gain supplement or similar levy system is an attractive option, provided it can recycle sufficient funds fairly and effectively.

Land acquisition and innovative trust schemes also offer great potential to play a bigger role in funding and maintaining new development. Regeneration agencies, such as English Partnerships, are already showing what can be achieved by acquiring surplus public land for new housing. There is also more scope for the pooling of public and private land in joint ventures in order to share the uplift in land values. These schemes can complement section 106 agreements and other local revenue-raising initiatives, such as the new local authority business growth incentives scheme, which allows local authorities to retain a proportion of business rate revenues for local economic development.

There are genuine uncertainties about new land taxes and a planning gain supplement, as well as complex issues surrounding the use of brownfield and greenfield sites and the scope for value uplift in different parts of the country. There are also real issues about alternative financial mechanisms offering value for money as against direct investment by the public sector.

Whatever the difficulties to be overcome, the focus must be on securing extra funding for affordable homes and infrastructure, and not simply substituting public expenditure with income from section 106 and new measures such as a planning gain supplement. The challenge is to ensure that both private developer and public authority can build those parts of the new sustainable communities they are best at. Financing the future means giving each of them the tools and incentives they need to get on with the job.

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Chapter 4

Alternative approaches to financing affordable housing

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Alternative approaches to financing affordable housing
Colin Blakey

Providing more affordable homes to rent and buy is vital to the success of the government's plans to create balanced and sustainable communities. Supporting new low-cost home-ownership schemes is also essential to meeting the government's target to expand the number of new home-owners by a further million over the next five years. But properly to finance more social housing and to help more people into home-ownership demands continued reform of the funding regimes, greater incentives for private investment and support for new, market-led approaches to shared ownership, which require no public subsidy.

Financing social housing
Until 1988 practically all funding for new social and affordable housing came from the public purse, delivered through registered social landlords. The cash comprised social housing grant and a residual loan serviced by low "fair rents" set by the rent officer. On average 90% was grant and 10% loan, and under Treasury rules it all counted as public borrowing.

Since the 1988 Housing Act, however, registered social landlords have raised more than £30 billion in private finance. About two-thirds of this money has gone into developing new homes, mainly to let at sub-market rents to those in need, with the remainder funding transfers of housing stock from local authorities and improvement of existing homes.

The 1988 act allowed the loan element of the finance to be funded by banks, building societies and the bond markets, and it no longer counted towards the public-sector borrowing requirement. Risk was transferred to the registered social landlords and to lenders. Fair rents were replaced by assured tenancies, which were subject to an inflation-linked cap on rent increases with the aim of achieving convergence between local authority rents and those of the registered social landlord sector. And until recently grant levels were being progressively cut, to around £52,000 per unit.

The contribution of the planning system
In parallel, an increasing proportion of affordable housing is now delivered through the planning system via section 106 planning agreements between local authorities and developers. According to research by the Joseph Rowntree Foundation published in 2005, between 2000/01 and 2002/03 the level of social housing built as a result of section 106

agreements increased from 30% to 47% – partly because registered social landlords have found it harder to acquire sites directly for housing.

However, it appears that grant costs per home are similar across the two methods of procurement, with contributions from private developers covering the higher costs of land in section 106 locations, thereby bringing grant requirement down to funding limits applying to non-section 106 sites. As a consequence, affordability is funded by either the landowner or the developer receiving a lower return than would otherwise apply, which often makes negotiation difficult and contentious.

Despite these fundamental changes, the provision of social and affordable housing has not kept pace with need. The number of newly built social homes for rent and sale fell from 42,700 in 1994/95 to around 21,000 in 2002/03 – compared with an estimated annual requirement of 48,000 units. However, the trend is being reversed and the present two-year programme of the Housing Corporation (worth £3.9 billion) is supporting the start of 67,500 homes – about 30% of which will be for low-cost home-ownership.

The challenge facing the government is how to maintain the increase in social rented housing, reduce costs and extend the opportunity for home-ownership to many more people. Part of the solution lies in supporting equity investment in social housing and opening up the affordable housing market to the private sector.

Equity investment in social housing

The provision of social rented accommodation continues to rely on the injection of public subsidy via social housing grant. However, the Housing Corporation is looking at how to convert grant to equity by investing up-front capital in schemes through special-purpose vehicles. The corporation would then benefit from a long-term return in equity growth that could be recycled into the provision of further affordable housing.

To date, little interest has been shown by private-sector institutions in equity investment in social housing. The main issue is the return. If such investments cannot improve on the return obtained from gilts, why should an investor consider an asset class with perceived risks and which typically generates a long-term low-yielding cash flow, with constrained opportunities for capital growth? Particularly if registered social landlords are reluctant to contemplate the separation of ownership from the management of assets, which is the case at present. This situation contrasts with the surge of private investment into the buy-to-let and general residential investment market in recent years.

Where there has been private-sector investment, the focus has been more closely directed towards the creation and use of new forms of low-cost home-ownership initiatives, although the resources available to registered social landlords have been limited by the pressures of providing social rented housing.

Investing in shared ownership

The main delivery vehicle for low-cost home-ownership on new developments by registered social landlords has been shared ownership. This has been supported through the Housing Corporation's annual investment strategy, which because of the lower rate of grant required enables a landlord to provide almost twice as many houses or flats for a given level of grant.

Under shared ownership a registered social landlord develops a home directly or purchases accommodation from a developer under a section 106 agreement. A potential home-owner then buys a share of the leasehold interest in the property, normally 50%, via a conventional mortgage and pays an index-linked rent to the landlord on the balance. The current industry-standard rent level is about 3% of unsold equity. Usually, the home-owner has the right to purchase further shares in the property, up to full ownership.

Procedures for funding shared ownership are based upon those used for social rented schemes and involve the application by the Housing Corporation of total cost indicators, which are designed to achieve value for money in return for grant and to ensure that the correct level of grant is paid. Grant rates represent the maximum proportion of scheme costs that will be funded by any form of public subsidy, including social housing grant. As there is no readjustment of grant on completion of sales, registered social landlords are free to sell tranches of equity and to make financial surpluses should the opportunity arise.

Although the Housing Corporation does review the levels of total cost indicators, they have become increasingly independent of movements in the market value of housing in recent years. As a result they can fall substantially below general house price levels, particularly in those areas that have experienced dramatic price up-lifts. The landlord gains when there is a divergence between the up-front cost and the market valuation of the property. Increased rents will also flow from the initial higher nominal level of unsold equity.

The Housing Corporation is currently reviewing the total cost indicator procedure and is also eager to reduce the level of grant funding provided to shared-ownership properties obtained through section 106 agreements.

Equity mortgages

The government has strengthened its commitment to promoting home-ownership (see *Extending Home Ownership*, HM Treasury, 2005) and has stated that it wants to develop new approaches that go beyond the conventional shared-ownership schemes. In particular, it plans to expand the Homebuy scheme.

With Homebuy, the purchaser – who is required to be an existing tenant of either a council or a registered social landlord – buys an approved property, which is part-funded by an interest-free equity loan provided by a registered social landlord. This is fixed at 25% of the value of the property and is 100% grant funded, normally by the Housing Corporation. The remaining 75% share is paid for with a conventional mortgage. The scheme can be used only to buy existing properties that meet certain criteria and cannot be used in the development of new property or for refurbishing property. When the property is sold, the purchaser retains 75% of the sale proceeds and the registered social landlord receives 25%, which is recycled to fund further Homebuy purchases.

This approach is now regarded as more straightforward and easy to understand than shared ownership, which relies on a lease structure. This adds a degree of complexity to the product and retains a management link between the purchaser and the landlord. Homebuy, on the other hand, has the advantage of simplicity by immediately offering full title to the property, subject to an interest-free equity mortgage. Additionally, there is no significant link back to the registered social landlord after the property is purchased.

Issues of affordability are also important. People who buy their home through the existing Homebuy scheme pay no charge on the share they do not own, whereas those who buy their home through shared-ownership schemes pay rent. This can mean that the monthly cost of owning 50% of a home under shared ownership is higher than the cost of owning 75% of the same home under Homebuy.

The government now intends to apply Homebuy more widely, through:

- Social Homebuy, to support social housing tenants buying a share in their existing homes;

- New Build Homebuy, to help key workers, social tenants or first-time buyers buy a new home; and
- Open Market Homebuy, to help these groups buy a share of a home on the open market.

Within these schemes, the government is keen to maintain the balance between affordability for purchaser and for provider. Initially two options were proposed, in the consultation paper *Homebuy – Expanding the Opportunity to Own* in April 2005. These were as follows:

- Option one – the buyer initially pays no rent on the developer's share where this is less than 25% of the equity, but pays an annual charge of a maximum of 3% (similar to social rent) on the rest of the developer's share. From year six, the buyer pays an annual charge of a maximum of 3% on all of the developer's share.
- Option two – the buyer would pay rent on the entire remaining share, from the outset. The buyer is responsible for all management and maintenance costs.

A broad spectrum of views on these products emerged during the consultation period. The National Housing Federation, for example, declared that New Build Homebuy option one is neither sustainable nor affordable, and after testing the government's proposals concluded that housing associations' financial viability would be critically undermined. The federation went on to recommend that the government adopt a revised model similar to option two, but where associations are allowed a more flexible approach to rent setting. Moreover, it suggested that greater choice be given to potential buyers by offering the possibility of equity stakes much lower than the average of 50% suggested by the government.

The Royal Town Planning Institute argued that the products represented a pretty poor deal for the purchaser, who has to pay only just below the current mortgage rate for the share in the property that they do not own. Conversely, it seemed a very good long-term deal for the provider.

Responding to these views, the government modified its proposals. In relation to New Build Homebuy, for example, the following will now apply:

- A maximum cap on rental charges of 3% on all remaining equity, chargeable from day one, will be introduced.

- A target average for rental charges of 2.75% will be set to inform funding decisions under the national affordable housing programme bidding round, but it is hoped that some providers may be able to reduce this further.
- A maximum limit on the annual increase of rental charges will be fixed at the level of the retail price index plus 0.5%.
- The minimum share to be purchased should be less than 50% to ensure that the offer remains affordable and accessible, particularly in high-value areas.

Public-private funding of equity loans

Ministers have also been in discussion with the Council of Mortgage Lenders and a range of lenders to look at ways in which it can promote joint public-private funding of equity loans, using a model similar to that of the Open Market Homebuy scheme.

In this model, the borrower would take out a conventional mortgage to pay for a proportion of a property's value, say 75%. The mortgage provider would also extend an equity loan of 12.5% of the property's value, and the government (probably through a registered social landlord) would provide an equity loan for the remaining 12.5%. Sharing the equity stake with lenders in this way would allow the government to assist more households with the same level of public funding, but none the less public subsidy would be needed to underpin the product.

However, the response from the Council of Mortgage Lenders has not been encouraging. The conclusion reached is that it is necessary to charge an interest rate of 3-4% on the equity element of the loan to make a commercial product viable. If this rate is applied, then in the first year after buying, a household taking out a 50% interest-bearing equity loan would save 24% on mortgage out-goings, relative to a conventional market purchase. For a 25% equity loan the saving would be 12%.

Taking into account these factors and the protracted discussions with the government, the Council of Mortgage Lenders has recently announced that it is unsure that the scheme will ever "get off the ground".

Equity share without subsidy

Against this background, a few private-sector organisations, including Bellway, have been investigating methods of promoting shared-equity schemes without the use of public subsidy.

Bellway Housing Trust has been created to respond to these issues, and in particular to act as a housing landlord, holding affordable housing assets. It will not operate as a registered social landlord; rather, the allocation and management of the stock of properties created will be subcontracted to existing registered social landlords or other suitable organisations. It will seek to invest in affordable housing built by Bellway under section 106 agreements.

The overall aim is to provide new affordable accommodation, which does not require the injection of public subsidy, to first-time buyers and others who cannot afford to purchase on the open market. The company will work closely with Bellway's operating divisions, particularly within London, the South East, the South West and Eastern England, to develop a diversified portfolio of good-quality properties designed to provide growth in capital. Bellway Housing Trust, which will acquire properties at a price reflecting the limitation on value arising from planning requirements, is initially offering three products: Sharebuy, Homebuy and Easybuy.

- Sharebuy is based upon the conventional shared-ownership model operated by registered social landlords and will incorporate recent guidance adopted by the Housing Corporation, the Council of Mortgage Lenders and the National Housing Federation regarding the operation of a standard share-ownership lease. The entry purchase level will normally be 50% of the open market value of the property and subsidised rent will be paid on the outstanding equity. Further tranches of equity may be bought by the leaseholder (in bands of no less than 10%) as their financial situation improves.
- Homebuy is modelled on the government's scheme, offering a 25% equity loan. However, the Bellway Housing Trust scheme will extend the equity loan to, on average, 30% of the market price of a new dwelling. This means that up to 30% of the initial purchase cost will be met by the company and treated initially as an interest-free loan to the purchaser. Upon subsequent resale or staircasing (in 10% tranches), the company will be paid the relevant percentage of the current market value. To help purchasers adjust to the financial responsibilities of home-ownership, there will be no interest charge applied to the equity loan in the first year. In year two interest equivalent to 1% will be charged on the equity loan and this will rise to a maximum of 3% by year four. Unlike the equity-sharing schemes proposed by the government, the annual charge will not be increased over time by reference to the retail price index. From the company's viewpoint the retained equity will, over time, earn a return in the form of capital appreciation and will eventually be paid back and be available to recycle within the company to support other low-cost home-ownership projects.

- Easybuy combines the flexibility of shared ownership with the simplicity of the equity loan model. With Easybuy the customer buys 100% of the property via a 50% conventional mortgage and an equity mortgage on the remainder from Bellway Housing Trust. Unlike shared ownership, the buyer does not pay rent on the outstanding equity. Instead, interest equivalent to 2% is charged on the equity loan in the first two years and this is increased to a maximum of 3% in year three and thereafter. As with Homebuy, the interest charge is not increased by reference to the retail price index and buyers have the opportunity to reduce the company's equity interest and ultimately acquire 100% of the open market value of the property.

Bellway Housing Trust is pursuing a number of opportunities and is at present on site at Sovereign Court in South Woodford, Essex. This scheme, in a high-demand area on the outskirts of London, offers a Sharebuy model with the possibility of an initial subsidised rental period. This feature is particularly helpful to key workers, who may wish to rent for a short period before committing to home-ownership. Standard shared-ownership procedures for sale of a property are proposed in the event that an occupier wishes to sell.

A cascade approach has been adopted for the allocation of the affordable homes, beginning with nominations received from the local authority and depending upon interest extended to other key workers and wider areas of London. This process, together with on-going management, is being undertaken in conjunction with East Choice, the shared-ownership arm of East Thames Group, a major registered social landlord. Bellway Homes has made available its on-site sales and marketing personnel and show homes in order to support the early take-up of the affordable homes.

This scheme and other opportunities involving Sharebuy, Homebuy or Easybuy are reliant upon staircasing and future sales into the owner-occupier market to deliver an investment return. According to the Council of Mortgage Lenders, there are good grounds to expect equity loan staircasing rates to rise after a few years to 5-10% each year. However, if local authorities wish to encourage private investment in affordable housing then they will need to show flexibility in relation to any obligations they may wish to impose restricting the sale of the accommodation on the open market. Additionally, a greater understanding and appraisal of the demand for affordable and intermediate housing is required within housing market assessments.

Conclusion

Looking forward, it is anticipated that there will be greater investment interest both corporately and institutionally within this market. This may lead to the creation of specific property investment funds. The government is consulting on the introduction of real estate investment trusts, which allow investors to benefit from the advantages of direct and collective investment in property. Instead of transferring section 106 obligations to a registered social landlord, developers might sell their interest to a real estate investment trust, with the fund benefiting over time from the arbitrage presented by the difference between purchase price and market value.

From an underlying investor's perspective, shared-equity portfolios offer considerable attractions over conventional buy-to-let portfolios. They require less administration and are unlikely to experience significant vacancy rates. In addition, maintenance and repair costs will reflect the fact that the properties are newly built. Investors will also be comforted from the anticipated steady pattern of capital receipts over time, while experiencing the cash-flow benefits arising from regular payments of rent or interest over the life of the investment. Additionally, retail investors would be attracted to a real estate investment trust structure as it potentially offers a convenient, liquid and risk-diversified means of investing in the housing market.

The government has opened up an exciting agenda for further reform of the housing market, which will allow for innovation and new partnership working between house builders, developers, registered social landlords, local authorities and private investors. There is a willingness for change and a real opportunity to generate additional resources to meet the government's ambitious housing objectives.

Chapter 5

Financing urban regeneration – the case for public–private partnerships

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Financing urban regeneration – the case for public-private partnerships

Ray Mills and Mike Atherton

A central part of the government's delivery agenda is about levering in more private finance through public-private partnerships. According to the Treasury, these were worth over £34 billion between 1999 and 2004 – with the number of operational Private Finance Initiative facilities rising to over 600. However, research by PricewaterhouseCoopers shows that although the UK continues to widen its use of public-private partnerships, or PPPs, their application in urban regeneration is less developed than in other sectors such as health and education.

The case for regeneration PPPs

Regeneration PPPs in all forms are, nevertheless, continuing to develop due to the need for greater investment and a willingness in the financial and development community to invest over a longer period. There is a growing interest among funders and developers in integrated approaches to regeneration which demand financial arrangements that link public and private investment, rather than the conventional piecemeal, pump-priming approach that has characterised urban regeneration in the past. The new thinking around sustainable communities and masterplanning has also helped promote wider interest in regeneration PPPs, particularly among housing associations, house builders and local authorities.

There are now successful examples of PPPs in regeneration, such as the East Midlands Property Investment Fund, the Solihull/Bellway PPP, Priority Sites, the English Cities Fund, and One NorthEast's North East Property Partnership. Local authority-led partnerships in Bradford, Leeds, Newcastle, Sheffield and Liverpool are also actively considering regeneration PPP structures. PricewaterhouseCoopers envisages more interest in regeneration PPPs on the back of the government's proposals to promote home-ownership and mixed communities and to improve the economic performance of the UK's regions.

PPPs are proving particularly attractive where there is a shortfall in funding or where the investment requirements go beyond what can be met from a section 106 agreement between local planning authority and developer negotiated when project risks are at their highest, thereby limiting private-sector contributions. In addition, regeneration PPPs are suited to areas where the market is fragile and investor confidence is low, and where there is a need to control the phasing of regeneration programmes.

By bundling profitable and less profitable investment projects together to create scale and provide greater certainty of the supply of opportunities, PPPs can enable the private sector to take a longer-term view on potential increases in future value that may arise as the wider regeneration of an area is achieved. As a consequence, investors may be more willing to take a higher risk in the crucial early phases as their overall rate of return across the life of the project meets their investment criteria.

However, a coherent, planned, joined–up approach is needed that focuses on those aspects or projects where there is market failure. Any PPP structure therefore needs to avoid cherry picking of the most profitable opportunities and sole-supplier arrangements that deter wider market interest in an area.

There is no "one size fits all" solution, and each regeneration PPP has to be moulded to local circumstances. A typical PPP will centre on development assets, but can also accommodate investment or revenue-generating assets (which can improve the risk profile of the investment through the provision of an income stream against which to service borrowings and hence secure greater commitment from private-sector investors).

Public-private investment

Generally, the partnership structure of a PPP matches public-sector funding and surplus/development assets with funding and expertise from the private partner. This in effect provides substantial additional resources to undertake pump-priming investment, and therefore promotes faster delivery.

In order to attract private investment, the public sector must add value to the partnership by investing cash and assets:

- Cash investment – cash contributed by the local authority from its own resources or perhaps utilising cash allocated to an urban regeneration company or other local special-purpose vehicle. It is also possible to "invest" core funding from other public-sector partners, such as a regional development agency or English Partnerships.
  The key to maximising private investor interest is aligning the differing funding streams and governance arrangements between the various public-sector partners.
- Asset investment – investing development assets can be a valuable addition to the structure in that it is easier for the PPP to exert control over the timing and nature of

development if the PPP has a substantial asset or land holding in the regeneration area. Realising the value of non-operational assets can be identified from a review of the local authority's asset portfolio or as part of an asset management process. Investment assets can also be injected into the PPP, which improves the revenue generation potential and hence risk profile of the PPP.

Normally the private-sector partner will invest cash into the partnership as an equity stake. To date, this investment has generally been based on matching the public-sector contribution on a pound-for-pound basis. The partnership is then often grounded in the core principle of a "deadlock" arrangement in which neither partner can act without the express approval of the other. However, PricewaterhouseCoopers' experience suggests there is scope for structures in which the public sector takes a minority stake, enabling higher leverage of private finance.

In addition to equity investment, there is also the possibility of raising debt against the land and other assets held in the partnership. Injecting debt into a PPP structure must be carefully managed and needs to be considered against the partners' risk appetite, the level of certainty of the PPP cash flows, the realisation value of the asset portfolio and the ownership structure of the PPP. If prudently utilised, however, debt finance can provide additional resources to a PPP with which to drive regeneration investment. This can increase equity returns to the investors in the PPP and be non-recourse, thus reducing the risk exposure of individual partners.

Local regeneration partnerships

PricewaterhouseCoopers has been working closely with local authorities and delivery agencies (such as the urban regeneration companies, English Partnerships and the regional development agencies) on developing a new PPP structure – the local regeneration partnership. This new structure is based around the principles developed from PPPs in other sectors, most notably the NHS local improvement finance trust and the government's Building Schools for the Future programme.

The local regeneration partnership concentrates on the assembling of land and investment in associated infrastructure and the public realm. A commercial return is generated in the local regeneration partnership from the enhancements in land value in a regeneration area which can arise, for example, through change of use or improvements to the built environment in the shorter term or as a consequence of a longer-term income profile that the private sector can anticipate and factor in as future values increase. The financial returns are realised by disposing of the land acquired or, alternatively, by participating in specific development projects through using land holdings to enter into a joint venture or development agreement with third-party developers.

The local regeneration partnership would not therefore typically undertake any direct development role, and hence the majority of project risk rests with third-party developers alongside which the regeneration partnership invests its land. In this way the partnership does not replace the development market in an area, and indeed should improve the number and quality of projects coming forward by addressing the key up-front risks – such as by having a clear development platform or by helping with the timing of payment for land acquisition.

How the local regeneration partnership works

In any partnership structure, considerable focus needs to be given to the rules and procedures that underpin how the partners will work together, and which are encapsulated in the partnership agreement or equivalent. These rules and procedures will encompass the governance and control arrangements for the PPP, and as the case history for these structures develops then the process of agreeing suitable arrangements will become more standardised and straightforward. However, in the absence of such precedent or case history the emphasis is on the public sector to interpret the local regeneration partnership model against their own priorities and what the structure is trying to achieve.

Typically the local regeneration partnership will have an executive function that consists of representatives from the public and private sectors, in the relative ratio of their shareholding in the partnership. The executive team have the responsibility of creating a project portfolio that will comprise a phase of activity for the regeneration partnership and consist of an appropriate mix and scale of development to meet the regeneration objectives for the area. The executive team will undertake sufficient due diligence and verification to meet the appraisal priorities of investors from the public and private sectors.

A critical point for the local regeneration partnership is that this project portfolio must be agreed in advance by all partners before any investment activity can commence and before funding is drawn down or (public) assets are contributed. This joint "gateway" programme approval process provides the key control over the scale and nature of project activity. Following approval, the regeneration partnership is tasked with implementing the investment programme with any material variations in the approved project portfolio requiring further approval by the partners in advance of implementation.

The benefits of this approach are:

- The project investment programmes are required to make an acceptable commercial return only in aggregation and therefore it is possible to mix more profitable projects with marginal or non-profitable projects, securing delivery of investment that otherwise may not happen.
- The public sector participates in development gains that can be recycled into additional investment in regeneration.
- The public sector participates in assembling and approving the project portfolio. This offers public-sector partners protection against cherry picking the best investment opportunities and undermining the chances of achieving a sustainable regeneration solution through balanced investment.
- Investment into the PPP is applied to regeneration projects and therefore public-sector cash and assets are clearly linked to project outcomes. The public sector does not therefore speculatively invest in the local regeneration partnership.
- The portfolio is more likely to be of a scale to make an impact on the area and to influence market perceptions positively – thus encouraging further investment.

Once approval for an investment project programme has been given, the local regeneration partnership is tasked with delivery. There is no loss of control as the public sector participates in the executive function of the partnership and has a right, protected in the shareholder agreement, to receive such information on project monitoring as it reasonably requires to meet its various obligations around reporting, best value and accountability.

Barriers to the PPP approach

Any regeneration PPP will need to address the key requirement of value for money and demonstrate whether it can deliver tangible benefits over and above other approaches. This demonstration of benefit also needs to recognise the potential costs and timetable for implementing or procuring a PPP against what can be tight project timetables. Approval for a PPP therefore requires the consideration of a business case and an initial investment from the public sector, with an acceptance that the PPP route merits consideration alongside more traditional routes in regeneration.

This requirement for up-front investment from the public sector is not just in financial terms. Potentially extensive approvals are needed from both the public sector's own boards and central government. This can give rise to concerns about delays to project activity and over issues of reputation associated with pursuing a procurement route that is less well understood.

In order to exploit the full potential of PPPs in regeneration, it is therefore necessary to encourage an environment in which the benefits of PPPs can be demonstrated and a forum created in which some of the concerns or barriers outlined above can be explored, with a view to reaching a robust conclusion. Central government can have a key role to play in this respect through positive intervention and a clear policy statement that PPPs are a solution that is encouraged.

At a more practical level it should then be possible to share and create best practice, which would assist procuring authorities. This best practice should cover areas such as partner selection criteria, how to exert appropriate control, and key benchmarks on aspects such as pricing, governance and assessing value for money. In due course this practice could then become more codified and specific guidance provided on implementing a regeneration PPP – as we have already seen for other PPPs in education and health.

The other principal barrier is the challenge of aligning public-sector interests for an area and presenting a single, unified offer to the private sector. It could be argued that this difficulty applies to the regeneration theme as a whole. However, it is more acutely relevant to PPPs because an alignment of public interest must manifest in real commitment and contribution of value to the partnership – since the private sector is being similarly asked to make a long-term commitment. Private investors have clearly stated that they are willing to invest in regeneration areas, but greater certainty is required if a longer-term view on overall returns is required.

Those public-sector partners that can communicate clearly their regeneration plans and back this up with transparent commitment for the long term will be attractive to investors and developers. PPPs can be a way of promoting a more rigorous approach to programming regeneration projects, but will be effective only through buy-in across government departments.

Next steps

PPPs for regeneration are at a relatively early stage in their development and the PPP structures that have been successfully established to date have addressed a relatively narrow definition of regeneration, focusing on real estate, housing and an element of investment in transport infrastructure. However, as the experience base builds and a greater track record can be demonstrated, reappraisal will become possible of what can be achieved through a more joined-up approach that links the core regeneration agenda with other elements such as health, education and business investment to promote a more complete, sustainable solution. An alignment of government funding streams in these areas (helped by the new local area agreements, which enable a pooling of programme funding) should have a greater multiplier effect and hence a greater economic and social impact.

The benefits of closer alignment and better masterplanning could help improve private investors' perceptions of a location – for example, how much more attractive an area would be for housing if there was to be major investment in new or improved schools. PricewaterhouseCoopers' experience in giving financial advice suggests that there is the potential to generate financial efficiencies through more joined-up investment that is area-based rather than sector-based.

Closer alignment of the various funding streams is a key challenge for PPPs and could lead to further innovation in partnership structures. The local regeneration partnership example may help in this regard, given that it is based on other PPP structures and therefore combining these into a single strategic framework may be an achievable goal. There has been some discussion on this subject at local and central government levels and it is one that PricewaterhouseCoopers is committed to pursuing in the future. Clearly, some major obstacles will need to be overcome – not least the need not to undermine the deliverability of present structures and the problems of joining in existing partnering agreements – but the prospects look promising.

Conclusion

PPPs are an emerging trend in regeneration and have the potential to combine with other government-sponsored initiatives, such as the new local authority business growth incentives and pooled section 106 agreements. The experience so far suggests that they may provide an effective means for levering in significant levels of private finance and may offer benefits in terms of connecting local regeneration projects and building social capital and know-how.

PricewaterhouseCoopers believes that the ODPM's recent five-year plans, Sustainable

Communities: Homes for All and Sustainable Communities: People, Places and Prosperity, have given a fresh impetus to PPPs for sustainable regeneration. Indeed, the work PricewaterhouseCoopers is undertaking in many of the UK's cities suggests that the mutual benefits of PPPs are becoming clearer as a track record of successful deals is established. There are still hurdles to overcome – not least the lack of clear shared guidance that could provide local government with the tools to assess whether a PPP route is worth pursuing – but the tide is turning.

Chapter 6

Bond financing for housing and infrastructure

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Bond financing for housing and infrastructure

Ben Cashin, John Shinton and Jessica Castle

The capital markets offer the potential to help fund the government's housing and growth strategy. In this chapter we illustrate this by providing a positive perspective on the way in which the capital markets approach bond financing for housing and infrastructure. We show how the markets operate and what the history and experience of such financing arrangements has been to date. Moreover, by drawing on our own work at Royal Bank of Canada in London we highlight the opportunities for developing a wider range of bonds for public-private projects.

Financing social housing

The injection of private finance to expand housing association activity in the late 1980s was the first major example of combining private and public finance to fund a major public service – namely social housing. This initiative has now grown to a market of over £30 billion of private finance, supplementing public support in the form of over £25 billion of grant and assets transferred from local authorities. It remains the simplest and in many respects the most efficient example of the Private Finance Initiative.

Private finance has been provided in two main ways. Initially it has happened through mixed-funded schemes, whereby housing associations acquire existing housing stock for rehabilitation or build new units to be let on sub-market rents to those in housing need. Public social housing grant bridges the gap between what the net rent can service by way of a private loan and the capital cost of providing the housing. Grant may represent between 45% and 70% of the capital cost, dependent on location. In effect it funds the diminution in the open market value of the property when it is let at a sub-market rent level.

In the second route for private finance, homes in need of investment have been transferred voluntarily from local authorities to registered social landlords – mostly housing associations. In this instance there is no grant, but the assets are transferred from the public sector at a very low price – calculated by discounting the net cash flow from the housing stock over a 30-year period. The net cash flow takes into account all expenditure that potentially might be incurred to bring the housing up to full social housing standards in as short a time as possible. As a result the transfer values are very low – for example, £10,000 per unit for stock that might have a vacant possession value of £80,000 and a tenanted value of £40,000. While all finance is provided through loans from the private sector, the public-sector "subsidy" is reflected in the inherent long-term value of the asset being transferred at little or no consideration.

Both arrangements have been highly successful in delivering a large amount of private finance to support a very significant level of investment in social housing in a manner that has kept public-sector capital investment within acceptable levels. The capital subsidies (through low transfer values and grant) have ensured that the rents required to service loans are 30-50% below market rents. Quite separately, the system of housing benefit ensures that the rent is paid for those tenants unable to pay even this low level of rent because of low or no income. While this is a very important revenue subsidy, it is more one for the tenant than the housing project.

Once the development of the unit has been completed or the investment in the run-down local authority housing stock has been undertaken, then in most instances what is left is relatively attractive, well-maintained housing, sustainable into the long term. However, in many respects this is where the inefficiency creeps in.

The great advantage for the public sector in these arrangements is that the assets remain for all time within quasi-public-sector ownership in a regulated not-for-profit sector. The value that accumulates, particularly once the initial investment is completed, is therefore not lost by the assets being traded or refinanced to produce an equity return to a private-sector investor. However, at present the housing industry is not necessarily recognising (and therefore not utilising) this gain.

Bond financing at Sunderland Housing Group

One or two housing associations – exceptions to the rule – are beginning to exploit their true potential. A notable example is Sunderland Housing Group, which was formed to take the transfer of 36,000 housing units from Sunderland City Council in 2001. The funding of this entity was unusual in that it was structured from day one to exploit both bond and banking markets. This approach led to a new evaluation of the financial capacity of this type of entity.

Virtually all transfers of local authority stock up until this point had been funded from day one in the banking market. They were funded as though they were large-scale capital projects, the investment in which would pay down over a given franchise period. In the case of transfers, the investment required to bring the properties up to modern social housing standards was the initial capital project; the 25- to 30-year funding term was the equivalent of the franchise period, at the end of which all debt was repaid. This contrasts with other Private Finance Initiative schemes, such as a hospital or school that might need to be rebuilt after 30 years. With housing the asset is generally still there and probably performs into perpetuity, and yet is still held within the not-for-profit/quasi-public sector. By evaluating and funding such transfers as projects that were required to start paying down debt as soon as net cash flows turned positive, the banking market was limiting the financial potential of housing associations.

Sunderland Housing Group approached the market in 2000 for between £450 million and £480 million of finance (£225 million for the transfer price of £6,300 per unit and the balance for its 10-year investment programme). The banking market's initial response to this – the largest transfer funding requirement by that point – was to suggest that premium pricing could be required for such a significant call on the project-funding appetite of the banking market.

Cash-flow-based financing

Royal Bank of Canada took a different view. We suggested this was an opportunity to utilise a more appropriate funding methodology – one that evaluated the long-term business cash flows and their capacity to service debt over a longer period. This approach was derived from cash-flow-based funding techniques developed by Royal Bank of Canada for the housing association bond market.

The most significant initial result was that the initial transfer price – Sunderland Housing Group's core long-term debt – was in effect funded through the bond market by issuing a £240 million, 40-year cash-flow-structured bond. The balance of the funding – less than half what the banking market was expecting – was viewed more as a long-term working capital facility, part of which was likely to be refinanced by a £75 million European Investment Bank loan on very preferential terms. The result of the more limited call on the banking market was keener pricing of the banking facilities.

Of even greater significance was the emergence of a set of performance covenants for the business which were not based on the standard 30-year project ratios and annual approval of variations in these ratios – the hallmark of all project-financed transfers to that point. Such project ratios simply reflect the day-one business plan assumptions demonstrating that the project can be debt-free within a 25- to 30-year period. This crudely shows "negative" cash flows during the investment period (interest cover therefore less than 1 times) to positive cash flows seven to 10 years on (interest cover rising exponentially as debt is repaid)! It is unhelpful to covenant a dynamic business to meet these ratios over the 30-year period, and they are equally unhelpful from a funder's perspective in assessing objectively the true debt service capacity of the business in the first seven to 10 years.

For Sunderland Housing Group these variable project ratios were replaced with fixed minimum cash-flow performance ratios to demonstrate that all outstanding debt could be fully serviced from day one to maturity. This required a sub-analysis of the cash flow to distinguish between those elements of expenditure that were essential in maintaining the gross income flowing at its current level and expenditure that was of a more optional nature and might, if the chips were down, be deferred, restricted or foregone. In addition, it excluded expenditure that could be capitalised and therefore reflected in an enhanced valuation.

This approach – developed within the bond market but capable of application within banking loan terms – evaluates the true core operational income of the business, in other words the income that can be relied on to service debt as a priority before other expenditure of a more optional nature. It does not assume or drive the business to being debt-free in 30 years and progressively recognises the value of cash flows that generally flow into perpetuity.

Maximising the opportunities

The consequences of this more sophisticated "bond up" analysis for Sunderland Housing Group was eventually to allow the negotiation of an increase in facilities of 30% – from £450 million to £600 million – only two years after transfer. This was on the same security basis of the originally transferred units, where an increase in value of over 40% was derived from this more detailed categorisation of expenditure flowing from the stock condition survey – an exercise that had not previously been undertaken in the transfer sector.

In contrast to Sunderland Housing Group, the true operational surpluses of housing associations generally are in effect hidden in the standard financial reporting of the not-for-profit sector. As a result their true financial capacity is understated and under-utilised. If the Sunderland Housing Group exercise were to be repeated across the industry it could imply an additional £10 billion borrowing capacity on existing industry cash flows and asset base. Some might regard even this figure as an underestimate.

Bond financing infrastructure

Unlike for social housing, bond financing for infrastructure has a long history. For over 200 years the international bond market has been a source of funding for major UK infrastructure projects, from the railways in the 19th century to power stations in the 20th. It has offered very long-term debt at fixed interest rates, with the private-sector investor bearing substantial project risks. However, in the UK over the last 60 years, major capital projects have been funded on balance sheet by the public sector, with the taxpayer taking most of the construction and operating risk.

More recently balance sheet constraints and the failure of traditional procurement methods have led to a review of this model and the launch of the Private Finance Initiative, or PFI. As a result, private-sector capital, including bond finance, has been used as an instrument to price and allocate risk to the parties, whether public or private, best able to manage it efficiently.

Bond funding has become increasingly viable over this period as investor appetite has increased, and the cost of this type of capital has therefore fallen (while pension fund deficits have resulted in a rethink of asset allocation away from equities into the bond market). High-quality cash flows generated by long-term infrastructure assets are particularly attractive for asset liability matching. Thus supply and demand fundamentals have led to a renaissance in the bond market as a source of funding for infrastructure and essential assets.

Gilts and PFI bonds

Publicly procured infrastructure has traditionally been funded by public debt. Government debt issued in the gilt market is the cheapest source of funds as investors consider it risk-free. At the time of writing, the government borrows for 30 years in the gilt market at approximately 4.30%, and this rate is fixed even if base rates go up. However, the disconnection between funding and procurement has been less than optimal for the public purse: a long line of publicly procured infrastructure projects resulting in delays, significant cost overspends and backlog maintenance problems far outweighs the saving on debt service costs.

PFI and other forms of public-private partnership have been one way of linking procurement and operations to funding in order to drive efficiency. Projects procured under the initiative demonstrate that this is a successful, proven alternative to direct public-sector procurement. The vital element of PFI for this purpose is that the private-sector partners, including the funders, have no direct recourse to the government and rely on the successful performance of the project in order to be paid.

A significant number of large PFI projects have been funded through the bond markets. The transfer of project risks to the private sector results in the cost of debt increasing. However, the underlying high quality of the cash flows generated by the provision of an important public service means that there is competition to invest in these projects; as a result the financial markets have found ways of ameliorating this cost.

As an example, one common method (also used widely by US municipalities) has been to purchase a financial guarantee from specialist "monoline" insurance companies. These guarantors are independently assessed as very low-risk entities (and given an AAA/Aaa credit rating – the same as the UK government). They provide a guarantee to investors for the timely repayment of principal and interest, which reduces the overall cost of financing. However, despite their credit rating, the non-sovereign nature of monolines means that the cost of financing remains higher than the gilt rate. From a financing perspective, this is the price of the risk transfer achieved through PFI schemes.

Government guaranteed bonds

There are other instances where alternative approaches have been taken. Typically these have been where the size or nature of the infrastructure being procured has meant that although the project is financially viable (in the sense that it is expected to pay back the debt) the costs of the risk transfer are recognised as being prohibitive in the capital markets. In these cases, the public sector has sought to introduce efficiency through risk-sharing mechanisms with contractors and transferring operations to a private company while funding the project with the benefit of a government guarantee.

Government guaranteed bonds, for example, were issued by London & Continental Railways as part of the finance for both section one and section two of the Channel Tunnel Rail Link. The guarantee both increased the pool of investors willing to buy such bonds and reduced the costs. These bonds at present carry a return of around 0.15% above the gilt rate. This small premium is charged because the bonds are less liquid (that is, they are not as easy to buy and sell) than a gilt.

Credit guarantee finance

As noted above, looked at in isolation, the cost of funding infrastructure through PFI schemes is more costly than through public debt. HM Treasury has responded to this by launching a small number of pilot schemes using a new facility, credit guarantee financing. The premise behind credit guarantee financing is simple. The project structure, including the risk transfer, is the same as for a standard PFI project, with a monoline insurer or bank guaranteeing the repayment of the financing. But instead of the cash being advanced by the financial markets, it is provided by HM Treasury through the gilt market.

Credit guarantee financing offers some distinct advantages, achieving the same degree of risk transfer as a standard PFI project while the funding is at the risk-free rate. However, it is not expected to account for a large proportion of PFI investment as the government wishes to maintain a range of competing funding sources and limit its exposure to bank and monoline credit risk.

The future of bond financing

Opening up the infrastructure market to the private sector is a great achievement, which will result in numerous models for the government to chose from, within and around the principles of PFI. To date, £6.5 billion of bonds have been used to fund one-off PFI projects (versus £35 billion from the bank market). One drawback is that they have been seen as inflexible – a fetter on the public and private sector responding to changing needs over time. To date, there has been little incentive to be more creative as projects have been relatively small and heterogeneous.

However, the announcement of major programmes such as Building Schools for the Future will stimulate more innovative, flexible and cost-effective structures, in particular allowing for large batches of schools to be bond-funded over time. Being able to aggregate a number of projects into a single, large bond programme (perhaps with several issues of different maturities) would mean that the individual projects would each benefit from economies of scale and from the highly competitive pricing available for large bond issues. Such solutions have been used for funding social housing and small utilities, and similar methods can be used for infrastructure.

The prudential borrowing regime offers another avenue through which local authorities can potentially access capital through the bond markets. The new regime allows authorities to borrow provided they can demonstrate that they are able to repay the borrowings, either from their existing resources or from revenues associated with the project. Theoretically this decentralisation will give local authorities much greater freedom to match the financing structure to their particular needs more effectively. However, it is unlikely that we will see a major use of the capital markets while the Public Works Loan

Board offers cheap funding, and given the ultimate balance sheet constraint.

At the other end of the scale, there are a number of very large infrastructure projects on the horizon. These include Crossrail and the Olympics. It is unlikely that either PFI as we know it or direct gilt financing will provide a solution. The size and complexity of the financing requirement for Crossrail is such that the price of the risk transfer associated with PFI would be prohibitive and a number of new financing techniques will need to be explored. One alternative form of financing is raising bond finance against specified increases in property or other community taxes levied on the areas benefiting from the new link.

Such techniques, such as tax incremental financing, have been used extensively in the USA, where tax incremental financing bonds (known as TIF bonds), transferring material development risk, are sold in the municipal bond market. Political acceptability aside, the amount and pricing of any such financing is likely to be influenced by the extent to which the taxes are either set at a fixed rate or linked to an unpredictable variable such as property valuations or new developments.

Conclusion

Bond financing will play an increasingly important part in financing infrastructure projects and affordable housing. The market will continue to evolve, with the development of more flexible structures to accommodate new risks, batches of small projects and very large, complex deals. The technology for these types of structures already exists in other markets and can be adapted for these purposes.

Nor will demand be a limiting factor. In an increasingly risk-averse environment with persistent pension deficits, institutional investors are keen to invest in relatively low-risk assets. Long-term projects with cash flows related to the provision of an essential service (albeit linked to the project's performance) provide a good fit for matching long-term liabilities. The capital markets offer an extremely deep pool for public-private projects at competitive rates, with bond investors seeking a relatively conservative premium over the gilt rate, rather than equity type returns.

Chapter 7

Funding transport infrastructure – enhancing the role of local government

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Funding transport infrastructure – enhancing the role of local government

Jay Walder

It is widely acknowledged that London's transport system is in need of investment. Indeed, one of the main hurdles in the bid to host the Olympics in 2012 was the need to convince the International Olympics Committee that London's transport system could handle the influx of competitors and spectators. Yet it was not always so: 50 years ago, London's transport system was the envy of the world. The lack of investment in the following decades led to a decline in the system from which, with recent investment, it is only now starting to recover.

However, that recent investment has been focused on bringing the system to a good state of repair. Attention now needs to focus not only on continuing repairs but also on expanding the system to meet changing demand patterns.

In this chapter I refer to some of the evidence concerning the positive effects of urban transport on the local economy and look at ways of tapping into these benefits. Local funding of transport can better match the sources of funding with the beneficiaries of transport. Thus, for example, when land and property prices rise as a result of transport investment, local taxes aimed at increases in land and property prices can raise larger revenues to pay for the investment.

In particular, I focus on the potential of a supplementary business rate, which could part-fund large projects such as London's Crossrail. Drawing on international experience, I have argued that the best place for much transport planning, funding and governance is at the regional level. For London, this would mean the mayor and the Greater London Authority, as they have the cross-London overview required for strategic transport planning.

Local benefits of transport projects

Academic research over the years demonstrates that the benefits of transport investment, particularly for rail-based transport that enables high population and employment densities, extends beyond the direct users of the system. There is overwhelming evidence to suggest that transport investment increases land and property prices, supports employment and housing, and raises productivity.

Several academic studies worldwide demonstrate a positive relationship between productivity and city size, with a 1% increase in city size leading to productivity increases of between 0.04% and 0.11%. This increased productivity is spread across the entire urban cluster rather than restricted to new employment. Recent studies for the Department for Transport in 2005 suggest a similar relationship for cities in the UK.

Other academic studies demonstrate a positive relationship between land and property prices and rail-based public transport improvements. One study in London in 2003 found that proximity to a Tube or rail station is a significant determinant of employers' location. Other studies by the same academics found that house prices depend on the accessibility and quality of transport. They also found that house prices increased by 9.3% more than average in areas that experienced rail transport improvements. Impact studies of the Jubilee Line extension undertaken in 2004 showed that land values at Canary Wharf and Southwark increased by approximately £3 billion as a result of the new line.

One of the key drivers of London's success over the last 10 years has been the competitive tension between the City and Docklands. The development of Docklands – where more than 75,000 people now work, more than in the heydays of the docks – has allowed growth in financial and business services which has driven the economy in London and the rest of the country. This has pushed down rents and facilitated the development of the large buildings required by banks and other firms. This could not have happened without the Jubilee Line extension. Cut off by the river on three sides and with limited highway access on the fourth, the only reasonable access to Canary Wharf is through public transport.

Despite this evidence for local benefits, the only means available to local and regional governments to fund transport has been a negotiated contribution for planning gain. However, this only allows for mitigation of any adverse impacts on the transport system of any proposed development.

Funding local transport projects

In many other countries, responsibility for transport investment rests with local or regional government, and it is matched with the tools for tapping into the total benefits the investment creates to contribute to its funding. Local and regional governments in these countries have the ability to levy taxes on property, payroll, petrol, hotels, airports and numerous other local services.

In Spain, for example, regional governments play a major role in transport funding and have largely replaced central government support. The central government now provides a relatively fixed level of support under multiyear agreements with the regions. The regions have substantial flexibility within their own tax sources to meet the needs of transport spending and to absorb the risks of operating the transport network.

This model of funding is clearly very different from the way public finances are organised in the UK, with its high level of centralisation. The only taxes with local characteristics in the UK – stamp duty, council tax and business rates – all have peculiar characteristics that make them difficult to use for devolved transport funding. However, it is not necessary to overturn the entire basis of public finances in the UK to devolve responsibility for transport funding. Sensible incremental steps can be taken to unlock some discrete major investment before assessing the value of a more devolved system of public finances.

Local control of investment also improves accountability and delivery. A good example is the congestion-charging scheme in central London. In this instance it is indisputable that responsibility – and visible accountability – rested with the mayor of London. Congestion charging was one of a small number of issues on which the success of the mayor's first term would be judged. Importantly, the enabling legislative framework that provided opportunity for congestion charging was set up by central government. Equally importantly, having set up the enabling framework, central government allowed decisions to be taken locally.

The wider implication of this experiment is also worth noting. Enabling local and regional governments to take decisions suitable to their environments leads to valuable experimentation with policies that would be more risky on a national scale. Such experimentation, both successful and otherwise, leads to wider lessons and adoption of policy – witness present moves to develop road pricing nationally. Even if different local areas choose different solutions this permits a better tailoring of a local solution to a local problem. Again, evidence from other countries shows the immense value of state and local government innovation with policy.

Another difference between congestion charging and the Jubilee Line extension was in the incentives for managing risk. In the Jubilee Line extension all financial risk flowed directly back to central government, with the local transport body having little ability to bear the risk. In congestion charging all responsibility for risk lay with the mayor. Linking the management of risk with political accountability at the local level provides a powerful incentive for successful delivery of a project.

In other countries this arrangement is often formalised. In the USA, for example, the federal government enters into so-called "full funding agreements" with state and local governments when funding capital expenditure. A full funding agreement is anything but "full" in that it sets out very clearly the limits to what the federal government will fund. All other costs – including the costs of mismanagement or unforeseen risks – lie with the state concerned and/or local government.

Tapping into local beneficiaries

In seeking to tap into the local beneficiaries of transport, we need to find a mechanism that satisfies three basic criteria. Any chosen mechanism must:

- provide an efficient means of collecting contributions and eliminate the likelihood of free riders;
- be equitable in collecting contributions from all beneficiaries;
- provide funds that are additional to the existing sources of funding.

The only means realistically available thus far to local authorities to tap into the local benefits of transport is through section 106 contributions from developers agreed as part of the planning approval process. However, the logic of section 106 derives not from the positive effects of transport but from the negative impacts of property development. Local authorities cannot therefore charge developers for improving transport. Instead, they can only seek contributions where there is a demonstrable need for some improvement in transport as a result of a development.

Under this mechanism the burden of evidence falls upon local authorities to demonstrate that a particular development leads to a need for transport investment, and then to negotiate a suitable contribution from the developer. Not surprisingly, section 106 agreements have had limited success only in funding small-scale, targeted transport improvements. As the transport benefits become more diffuse there are relatively few successful examples of section 106 application to transport. With a project such as Crossrail, for example, the challenge of negotiating contributions from developers multiplies to the point of impracticality when so many properties across a wide swathe of London are affected.

Section 106 contributions therefore fail the first of the three tests highlighted above. The challenge therefore is to find a mechanism that relies neither on negotiation nor on the need to demonstrate the impact of the transport improvement on each and every property that may be required to contribute. This can happen only using the powers of taxation.

Section 106 powers suffer from one additional shortcoming, which any proposed tax mechanism must seek to address. With its roots in planning powers, section 106 focuses only on new developments. The beneficiaries of transport, by contrast, consist of both existing and new properties. Both new and existing properties register similar uplifts in value, although the ability to develop additional built space often has a more pronounced effect on unused land. The need therefore is to find a tax instrument that covers both new and existing properties.

Taxes, transport and the business rate

There are three existing property tax instruments: council tax, business rates and stamp duty. Additionally, it is possible to devise new instruments, such as a land value tax to address any perceived shortcomings in the existing tax instruments. However, the creation of any new tax instruments is likely to result in an overly cumbersome process without any substantial benefits beyond those offered by the existing tax instruments.

We can therefore concentrate our attention on the three existing tax instruments. Each of these has some characteristics that make it more or less suitable for application to projects such as Crossrail.

Council tax is levied on residential properties and has only a weak link to property values. The last valuation of properties for council tax was conducted in 1992 and the next one is planned for 2007. Council tax is not strictly based on values and may be regressive. For all of these reasons it is difficult to capture uplifts in value through council tax. Council tax payers in London already pay a share of transport costs through the mayor's precept and also form the bulk of the users of the transport system who pay through fares.

Stamp duty, by contrast, has a very direct link to value in that it is payable on the transaction value of properties subject to sale or long leases. However, since stamp duty is payable only during a transaction, the benefits do not get realised until a sale.

Business rates have neither of the problems associated with council tax and stamp duty. They are charged on the assessed rental value of all non-residential properties at a uniform rate across all of England. Since 1990 the rental value of all such properties has been assessed every five years, with a tried and tested valuation and appeals process. All occupiers of business properties pay business rates at the same rate across all of England.

Business rates have one very curious feature, though. They are the only major tax where the yield is indexed to inflation (through the retail price index). Under existing legislation the total collection from business rates can increase only at the rate of the retail price index. In practice, this has meant that the rate has fallen substantially at revaluations, and will continue to fall at future revaluations if there is real growth in property prices.

This curious aspect of business rates means that as the value of properties increases the tax rate decreases – something that would be an anathema were it to be applied to, say, income tax. Linking funding of transport infrastructure to business rates would help in correcting this problem, although a fuller correction would require a more fundamental change in the way business rates work.

Given their robust history of regular revaluation, focus on employers and coverage of all properties with relatively few exclusions, business rates are a useful way of tapping into the benefits of transport investment. While there is more than one way to raise funds from business rates, a supplement – a straight percentage of rateable values – applied to all properties would be by far the simplest mechanism to raise funds equitably.

If a business rate supplement were to be introduced as a straight percentage of rateable value there might also be some merit in looking at the issue of development gains once again. A business rate supplement by itself would not address the particular windfall gains from developments close to Crossrail stations. Replacing section 106 contributions with a mandatory development tax would help in the process of securing contributions from developers around Crossrail stations, the most direct and visible beneficiaries of transport improvements.

Funding the Crossrail project

A practical example of how local funding could help deliver transport investment is the Crossrail project. Crossrail will be a significant addition to London's transport network and relieve the particular constraints of transporting increased numbers of people to the employment centres of the West End, the City of London and Canary Wharf. Various estimates show that Crossrail will enable an increase in employment in central London of between 20,000 and 35,000. Crossrail will also provide much-needed help for regeneration in the Thames Gateway and will support housing growth. The Department for Transport assesses that Crossrail will increase GDP by about £20 billion through additional employment in the high-productivity cluster of central London.

Work done by Cross London Rail Links, the joint venture company formed by the Department for Transport and Transport for London to promote the project, predicts an increase in land values of up to 6% around Crossrail stations as a result of the project. As with other rail projects, many of the benefits of Crossrail are concentrated around its route and particularly its stations. However, the benefits of Crossrail are also spread more widely by virtue of it being integrated with London Underground and the national rail network in London.

The cost of the project is assessed at £10.3 billion in 2002 prices, which after allowing for inflation in the construction industry would be expected to lead to final costs of between £15 billion and £16 billion. The size of the project makes looking at alternative funding sources not just a virtue but possibly a necessity. Building a funding plan for Crossrail requires that all of the beneficiaries of the project – passengers, London businesses and the government – share the cost. Reliance on passengers and the government alone, to the exclusion of other local beneficiaries, would result in a large burden on some beneficiaries and leave out others completely.

London businesses have broadly accepted that they benefit from Crossrail. They also broadly accept that without some support from them it is unlikely that Crossrail will be built. This is a somewhat rare position for businesses to take with respect to transport infrastructure.

A possible funding structure for Crossrail could include revenues from passenger fares, a contribution from the government, a business rate supplement for all of London and a mandatory mechanism to capture large development benefits around the stations (replacing section 106 contributions). The funding structure must look at passenger revenues first. Crossrail's passenger revenues are projected to provide a surplus above the operating and maintenance costs of the project. The remaining cost of the project needs to be shared between London businesses and government in a proportion acceptable to both.

However, the benefits to both businesses and the government are likely to be much larger than the remaining costs. The government has a large stream of tax revenues enabled by Crossrail. For £20 billion of additional GDP the tax potential is at least £8 billion.

The size of the business rate supplement can similarly be determined to suit funding needs. Each 1% increase in business rates could raise close to £1 billion, even after exempting small businesses (those with rateable value below £50,000, which would exempt nearly 90% of businesses while losing only 25% of possible revenues). These are significant numbers, even for a large project like Crossrail. Importantly, though, a supplement at this scale has a limited impact on businesses. Property-related costs are about 1% of turnover on average after excluding small businesses.

As with the federal government's so-called full funding agreements with state and local governments in the USA, it is possible for risk to be managed at the local level if contingent funding can be sourced locally. Under present arrangements, the only such source would be passenger fares. This source has some capacity to cover cost increases – perhaps as much as the equity layer in privately financed projects – but has clear limits. If other funding sources were controlled locally, more risk could be managed locally.

Conclusion

In many countries in the world, local and regional governments take the lead in delivering local transport infrastructure. They can balance local priorities and they have the fiscal means to manage the investment. A clear accountability for decisions taken at the local level has generally led to the provision of better infrastructure and better-maintained transport systems.

Devolution of greater responsibility to local and regional levels provides an opportunity to improve the provision of transport infrastructure. In London, a directly elected mayor has clear accountability for the transport system and has delivered radical change with the congestion charge and the improvement in bus services.

Local authorities now have the ability to finance their investment. Yet, without the ability to raise additional funding, this will have limited benefit. Tapping into the local beneficiaries of transport investment through reform of business rates would provide the opportunity for better provision of transport infrastructure and give local authorities the ability to manage the risks of investment themselves.

Crossrail is a practical example of where such an approach could deliver much-needed investment. There is a willingness on the part of local businesses to contribute which, coupled with the political accountability of a directly elected mayor, could demonstrate a new way forward in funding transport investment.

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Chapter 8

City and regional finance – learning from international experience

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City and regional finance – learning from international experience

Greg Clark

Cities and regions in the UK have, for many years, existed within a highly centralised public finance system. Indeed, compared with other OECD countries local and regional authorities in Britain are much more dependent on transfer payments from central government, and much more constrained in their ability to generate investment capital locally. Despite a beneficial macroeconomic climate for the past 10 years, this relatively weak investment framework has arguably put British cities and regions at a competitive disadvantage.

However, recent experience suggests things are changing and that the UK is starting to adapt many of the financing tools prevalent in other countries. In this chapter I try to capture a flavour of developments internationally and highlight some of the policies, tools and techniques that are capable of transfer and adaptation to the UK. We can learn from each other, but it is important to contextualise experience elsewhere and to reflect carefully on what mechanisms work best in the longer term.

Competitive cities and the territorial investment market

Since 1997 a fresh investment in financial instruments and frameworks has started to rebuild the UK's local investment tool kit. Business improvement districts – first invented in Canada, massively expanded in the USA, and now prevalent in South Africa, Australia and elsewhere – have finally arrived in the UK's town centres and commercial districts. Regional investment funds – first piloted in Germany, and spread through Netherlands, Belgium and beyond – are now here in the UK's regional development system too, and growing. New approaches to infrastructure levies and development fees, common in East and North Asia and in many other countries, are starting to be taken seriously. Tax incentives that improve returns for private financiers, and guarantee systems that reduce their risks, are with us too; the first a North American and the latter a European invention.

Properly appraised public borrowing at local and regional levels is no longer considered heresy. Using the tax system to provide a different incentive structure for place-based as well as issue-based investment has now become common in the UK. Addressing how public assets can be better used (or sweated) to generate private co-investment (rather than just sold for a once-only current-value price) is now the new mindset, and thinking about the organisational vehicles needed at local and regional levels to promote financial innovation has moved on.

All of this has been increasingly supported by a recognition that improved local and regional investment is not solely about the supply of finance (the amount of money available from all sources). It rests much more upon the quality of propositions that are developed, the robustness of their management, and the returns they can offer to private and public investors. Consequently, a renewed focus on generating better propositions ("stimulating good deal flow") and making the opportunities that are available better known to financiers ("brokering demand with supply") has become a key feature of local and regional endeavour.

Attracting investment

The encouragement of both public and private investment by cities and regions can have different purposes, and take different forms, including:

- tax-based incentives, credits and reinvestment mechanisms;
- participation of public funds in financial engineering and special funds;
- use of public assets to encourage investment;
- debt financing or other investment arrangements that are taken on by cities on their own account (within their own municipal balance sheet).

OECD states, and their city and regional governments, have embarked on a quest for effective means to encourage investors to view cities as good places to secure a return on investment. Bankers, fund managers and investment advisers are taking note and are becoming interested in the commercial performance of OECD cities and regions (see Standard & Poor's European cities listings). Investments that help city and regional economies to perform better can add value to other localised transactions, too – by providing a more competitive platform for business, raising local incomes and revenues, improving asset values, and creating further demand for financial services.

Mayors and regional leaders increasingly advocate planning and development strategies that seek to perform the role of investment prospectuses for their territories, demonstrating to financiers that they have the ability to grow in ways that can sustain borrowing to support economic expansion and provide an acceptable return on capital deployed. Put simply, increased private investment can help a city or region achieve more than public investment cycles alone can afford, especially in times of tight fiscal discipline.

It is therefore arguably a key task of city and regional development activity to make cities and regions both more "investable" and more "investment-ready". Investable in that they need to demonstrate clearly how good returns can be made on investments in their territory, and be ready to help make those deals attractive. Investment-ready in that they must become involved directly with measures to stimulate a strong deal flow of good-quality propositions for financiers to evaluate. Just as cities and regions still spend significant effort seeking to attract international corporate investments through foreign direct investment deals, they now need also to attract institutional and commercial investment into their locally focused financial instruments and assets.

The changes in global development over the past two decades have produced a different set of financing propositions at the local level from in the past. Economic development in cities and regions is now much less about roads, bridges and factories (which offer tangible collateral), and much more about soft infrastructure, reused brownfield land, high-tech business space, creativity hubs, science parks, supply chains, knowledge capital, small companies, joint promotion and community development. These offer less tangible collateral, and less well-tested investment returns. They also offer more variable revenue covenants.

Investing in these assets requires something new. The public sector, at any level, can use its resources flexibly to help the private sector find means to finance commercially this new generation of job and wealth creation activities. National assistance through tax relief and incentives can be coupled with more localised participation in financial instruments to improve returns, or to reduce risks and costs, for private co-investors.

In some places this is happening more quickly than in others: Catalan banks have played a major role in financing the redevelopment of Barcelona; in New York City the financial services sector has been an important investor in community development successes. Fast-growing smaller companies in Australia and New Zealand are seeing their growth supported by public and private venture-capital programmes.

In cities and regions in the UK municipal pension funds are now significant investors in capable small firms and urban regeneration, while banks are providing patient capital for disadvantaged entrepreneurs. Meanwhile social housing in poor neighbourhoods is regularly financed through private debentures, bonds and European Investment Bank lending, and community development organisations are starting to leverage bank lending for capitalisation projects.

We now know that investment opportunities that are principally territorial (localised) can be competitive for commercial finance when compared against other opportunities in business stocks and shares, government bonds or other traditional investment instruments. However, there are credibility and profitability gaps, issues of scale and risk, and matters of cost and confidence, which have to be addressed if cities and regions are to attract private investment over the long term.

For those promoting city and regional growth, private co-investment can add important ingredients that are otherwise absent. Development programmes are increasingly moving away from traditional attempts to compensate for the absence of private investment, and are now more concerned with explicit attempts to leverage private investment instead. Tackling market failure through market making is the focus.

Private finance is key to city and regional development because it:

- provides more capital than is otherwise available, more quickly, and more efficiently;
- helps to rebuild local investment markets and averts other disinvestment occurring;
- creates a greater commercial and professional discipline within city development policies and initiatives;
- attracts wider interest from other commercial players, giving confidence that something of value must be occurring that might merit their interest;
- builds a more sustainable finance strategy into city development initiatives, allowing public funds to be gradually unlocked for alternative actions;
- repositions good city development activity as an investment rather than an expenditure, in the modern economy.

Cities and regions are therefore increasingly in search of the best propositions and instruments to attract commercial investment. Equally, for private finance providers, participation in city development programmes can provide some important contributions to business strategy. It can, for example:

- utilise public-sector support to help develop new business and market sectors that would otherwise not be easily accessed, acting as R&D activity for future financial product lines;
- contribute to diversification of the asset classes over which investment is spread;
- contribute to achieving ethical and/or local investment priorities;
- provide some predictable returns in periods of instability;

- build relationships with a wider set of partners from which other business might evolve;
- strengthen local and regional economies in ways that can safeguard or improve other investments, or expand the market for other financial services.

City and regional governments want to be in business with private financiers, and many are now embarked on the task of learning together about how to do this more effectively.

Financial tools and frameworks – international variations

Financing tools for cities and regions are very different from one place to another. For example:

- Tax credits and incentives in the USA have tended to do the work that grant in aid does in the UK when it comes to urban redevelopment.
- Guarantee systems in Europe have tended to address the small business lending issues that, in the USA, are tackled through regulation.
- Town-centre investment mechanisms begun in Canada (and spread rapidly throughout the USA) through clear statutory frameworks have been achieved through voluntary partnerships, or chambers of commerce, in most of Europe.
- Foreign direct investment deals that are sweetened with tax abatements in one place are supported with direct subsidies in others.
- Public bonds are issued in some countries to support the activities that in other countries are the preserve of private fund managers.

Despite these kinds of differences, two basic forms of innovation are emerging. Firstly, there is a continued push by commercial intermediaries and investment institutions to create non-governmental approaches that define and develop new localised investment markets where it is clear that good returns can be made. Secondly, within government at various tiers, there are efforts to innovate with public finance in ways that will make it more flexible and sensitive to commercial thresholds, and thus leverage private investment more effectively.

There are substantial variations in the extent to which city and regional governments across OECD countries are empowered to borrow, invest, save, lend, incentivise and sweat their assets in the name of growth and development. This means that cities and regions across the OECD region have very different levers at their disposal to encourage private-sector investment in their development and growth efforts, and some have competitive advantages over others in their abilities and competencies to do so.

In addition to these distinctive variables, most countries have experience of heroic failure: cities that have gone bust because they have borrowed more than they can afford; regional and city leaders who have invested in grand projects that have become white elephants; loans to businesses and others that have never been repaid; and municipal speculations in stocks and shares that have failed to meet expectations.

However, this is not just an issue of what financial tools are in principle available. It is also quite clearly a matter of how well they are used, and whether they are being used to optimum effect. Cities and regions with apparently equivalent financing tools at their disposal tend to use some better than others. Ireland's tax incentives, Belgium's regional investment funds, Chicago's tax increment financing programme, New York's business improvement districts, North Rhine-Westphalia's venture capital programmes, Piedmont and Lombardy's investment institutions and bank foundations: all appear to be examples of a particular instrument being fully exploited for local development purposes, and more so than by neighbouring cities and regions who have the same set of tools at their disposal.

Comparisons between, say, Manchester, Chicago, Berlin, Toronto and Lyon show that these cities each have a very different set of financing tools to use to promote their development, and different governance arrangements. Berlin, for example, is a city state with significant freedoms over how much tax it raises and how much debt it issues. It has its own regional investment bank and considerable flexibility in how it deploys its assets in order to further economic development. Chicago is also a financially empowered city with substantial freedoms granted to it by the State of Illinois. It can levy and vary taxes, raise bonds, cut fiscal deals with investors, and set up special assessment and tax increment financing districts.

Manchester, Lyon and Toronto fare less well in financial empowerment terms, although Lyon has leveraged private investment effectively and borrowed to finance infrastructure. Toronto has a history of innovating financially, but has been highly constrained by its need for long-term investment in the context of provincial conservatism resistant to raising public capital. Manchester, meanwhile, is the most fiscally and financially constrained city of the group, but benefits from a national regime that encourages private investment in public goals outside public finance instruments.

Does this mean that Manchester or Toronto would be better off if they had the local financing instruments of Chicago and Berlin? It is tempting to say yes, but before doing so, we have to understand better how those instruments would work in a different context, and what consequences they might have.

Transferability of finance instruments

The issue of transferability of development finance tools within and between the cities and regions in OECD countries is key to financing the future. However, transferability of development finance tools is rarely undertaken in a considered manner. Costly mistakes have been made, most of them resulting in highly partial or sub-optimal performance of the initiatives taken.

Some things work well in the situation where they are established because they receive a lot of help from the local regime, which may not be present elsewhere. (For example, setting up local loan funds works best when banks have a real incentive to participate through the tax or regulatory system.) Equally, some approaches work in the local system where they are precisely because of particular weaknesses in that system that may not be present elsewhere. (Certain tax-based financing initiatives to encourage land redevelopment only work when the starting point is very low land values and minimal tax yields.) Willingness to participate in programmes that seek an additional levy for an additional activity will work better in governance cultures where taxes for specific purposes are not unusual.

Evaluation needs to differentiate the performance of such financing tools from the economic cycle and also be much more sensitive to identifying at which point in the economic cycle certain tools are likely to work better.

Borrowing and transferring financing tools and policies from one place to another can be wasteful. Rather than crude borrowing, it would be more productive for the focus to be on learning from best practice, and developing really useful learning interventions in which the policies and initiatives of others (particularly private financiers) can be carefully examined in a collaborative manner.

Learning from each other

In the UK we continue to try to borrow financing tools and techniques from cities and regions in other OECD countries. In general, the introduction of new tools is to be welcomed – having more options is usually good. However, we reflect too little about where the overall system of city and regional development finance is heading, and what will leverage most private investment in the long term.

Looking forward, it is possible to make some predictions with a reasonable amount of certainty. In the past five years the UK has made substantial progress towards introducing some new tools that do leverage institutional and commercial participation into various aspects of city development. These include:

- regional venture-capital funds;
- high-tech start-up funds;
- regeneration investment funds;
- community development financial institutions;
- community investment tax credits;
- business improvement districts.

The influences have been more US than European, but lessons have clearly been learned from successful European models involving SME investment (often involving the European Investment Bank as a partner). European best practices are more concentrated in long-term design and planning of city and regional development, and the regional cohesion of efforts made, combined with access to debt when necessary.

Each of the tools mentioned will take some time to bed down, and it will be a while before any real evaluation is possible. However, experience in North America and Europe raises a number of key issues. First, using special instruments and incentives to build the supply of investment capital is only one side of the coin. Diligent work has to be done to stimulate and sustain a continuous level of good-quality demand so that the average costs of each deal can be reduced. The scale of the opportunity will then grow, and scope for further investment will be created.

Second, achieving this kind of performance is only really possible with high-quality intermediaries (such as fund managers) who are really dedicated to making it work. Attention to building up the capacity of the intermediaries is key to making the instruments effective. Community investment tax credits without community development financial institutions are a non-starter, as are regional venture-capital funds without dedicated fund managers.

Third, the mechanisms must not be rigid; they must be capable of adaptation in different circumstances and at different points in the business cycle. For example, public-sector support may need to be calibrated to local investment climates. In some places, more public participation may be required to underpin the specific risks, costs and returns than may be needed in others.

Looking to the next wave of city and regional development finance transfer into the UK, and our unmet imperatives for private financial leverage, it is possible to make some informed predictions about what will come next. It appears that variations on the following development finance instruments are the most likely contenders:

- long-term structured borrowing, through bonds and debentures;
- tax increment financing/value capture finance;
- securitisation of small business loans and investments;
- real estate investment trusts (publicly quoted and tax enhanced);
- historic preservation incentives for older buildings;
- new organisational vehicles for stewarding public and private land holdings.

Conclusion

Given the pace of innovation in development finance in the past five years in the UK, the balance of the effort may now need to be placed in making what is already on the books work. Tax increment financing and other forms of value capture are probably the most likely short-term addition to our toolbox, especially for large redevelopment sites where there is latent demand for new uses (such as a strong housing market), but also where there are major infrastructure investment requirements. The latest view is that private investors feel that this may be quite a fair way to finance infrastructure.

Recent experience in the UK shows that we are borrowing financing tools for city and regional development from both North America and Europe, and we are not about to stop. This is a positive trend, but to maximise the benefits we must do more to promote international learning between financiers, policy makers and practitioners.