North Essex Garden Communities

14th December 2016

Final Report

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1. Background

Context

Colchester Borough Council, Braintree District Council and Tendring District Council are in the process of updating their respective Local Plans to address projected demand for housing in the region. The process has identified a number of sites with potential to accommodate significant growth in residential units.

These local authorities, working in partnership with Essex County Council (together "the Councils") have agreed to take a long term, strategic approach to delivery of three particular major sites and want to drive delivery of these sites in accordance with "Garden City" principles1.

The Councils, with support from legal advisors (SNR Dentons), technical advisors (Garden Communities Partnerships, Aecom, and Cushman and Wakefield), the Homes and Communities Agency and Hyas Associates, have been working together over the past 12 months to progress a delivery approach. The Councils have developed a Heads of Terms to reflect the evolving delivery approach and to support engagement with stakeholders. Furthermore, the Councils have undertaken preliminary financial modelling to better understand the potential viability of each of the three key sites identified.

This Report

Colchester Borough Council (on behalf of the Councils) has appointed PwC to provide a high-level commercial review of the Councils' evolving commercial approach to delivering the three identified garden communities evolves:

- The proposed delivery arrangements (in so far as they have been developed);
- The initial financial modelling undertaken on each of the 3 identified sites; and,
- Potential funding and financing mechanisms that could be used to support delivery.

The remainder of this report sets out our findings under the following headings:

- Review of proposed delivery arrangements;
- Review of financial modelling;
- Potential funding and financing; and,
- Conclusions and recommendations.

The report is based upon information that was made available by the 25th October 2016, save for where explicitly identified in the text.

[1] Garden Cities are described by the Town and Country Planning Association as "holistically planned new settlements which enhance the natural environment and offer high-quality affordable housing and locally accessible work in beautiful, healthy and sociable communities" – as taken from the TCPA website, https://www.tcpa.org.uk/garden-city-principles

2. Review of proposed delivery arrangements

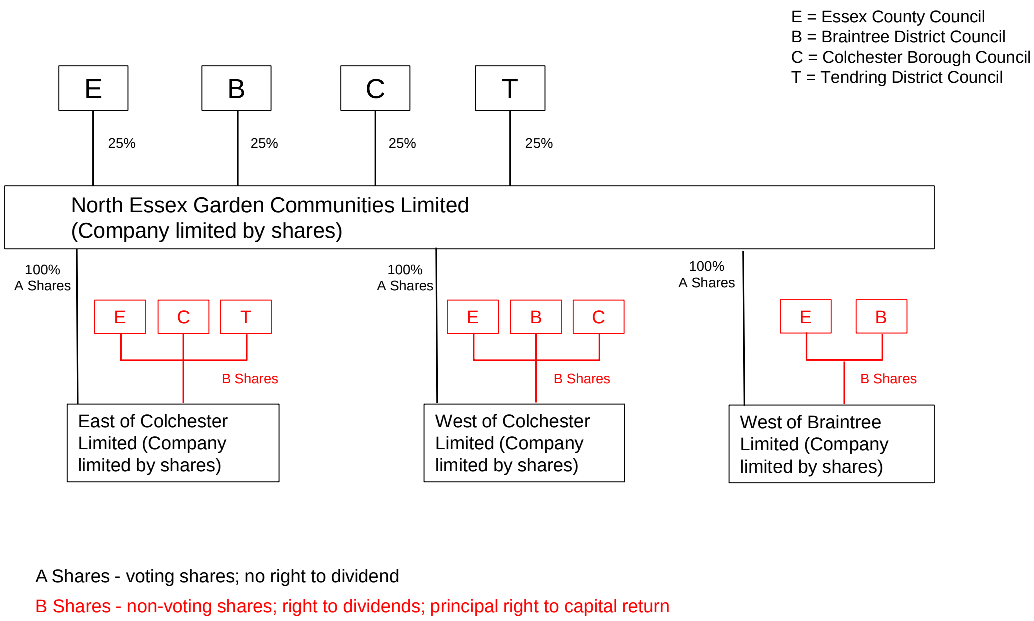
Overview

The Councils have undertaken a significant amount of work, supported by their advisors, to develop a proposed delivery structure that would link the four Councils together in delivery and provide dedicated delivery vehicles for each of the three major development sites identified. The two key tiers of the proposed delivery structure are:

- **North Essex Garden Communities Limited ("NEGC")** – a holding company owned in equal proportion by each of the four Councils, whose primary purpose is aligning stakeholder approach and interest via a single strategic body. The stated aims of that body are to agree masterplans and drive quality, consistency and standards of delivery. It may also have a role (as per the current Heads of Terms) in coordinating the funding of the Local Development Vehicles, although it is unclear based on current information how this role would work in practice; and,

- **Three Local Development Vehicles ("LDVs")** - shares in these vehicles will be owned by the NEGC and by those local authorities across whose administrative boundaries the sites sit. The primary purpose of each LDV is to facilitate the delivery of the Garden Communities. As such, they will have responsibility for the master planning, securing planning consents, delivering and financing infrastructure, and instructing landowners to sell serviced plots to realise value in accordance with a to-be-agreed phasing and delivery plan.

The diagram below summarises the relationship between these two tiers:



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As per the terms of our engagement, we have performed a high-level review of this delivery model, focussing on key commercial and financial considerations. Our observations can be summarised around the following key themes:

- Commercial appeal of structure;
- Risk, reward and value share; and,
- Clarity provided on commercially important processes.

"Commercial appeal" of structure

The Councils have sought to develop a delivery structure that recognises that the success of the project will require partnership working and buy-in from the private sector, including landowners and potential investors. This is particularly important for the sites being considered because the Councils (a) do not currently have an ownership interest in the sites and (b) do want to influence and have some control over how the sites are delivered. This creates a complex commercial relationship between the Councils and other stakeholders. As such, our high-level review focusses on the extent to which the proposed structure might appeal commercially to potential partners, including landowners and potential investors, with a particular focus on how risks and returns could be allocated and managed effectively.

Benefits

- The NEGC offers a range of benefits by virtue of providing a clear way for the Councils to engage with each other and to drive forward delivery in a consistent manner by establishing a common set of principles to underpin each development. On schemes of this size, scale and complexity, the private sector typically values having a single public sector interface that it can engage with. For example, the Mayfield regeneration scheme in Manchester adopted this approach in facilitating its three public sector partners – the Mayfield Partnership (Manchester City Council, Transport for Greater Manchester and London & Continental Railways) - to enter a deal with U&I plc for the £850m regeneration of 24 acres adjacent to Piccadilly train station (September 2016).
- The establishment of each individual LDV as a company limited by shares is typical for large scale, complex projects such as those envisaged here. It provides a means of managing the delivery risk of each site as well as providing clear accountability for delivery. Dedicated project delivery vehicles for specific scheme and groups of landowners provide a transparent way to invest and is likely to appeal to both landowners and investors. This use of scheme specific delivery vehicles is typical for development schemes such as those proposed here.

Potential challenges

The Councils do not own the sites to be developed and want to have control over scheme delivery. This creates challenges for delivery and the delivery structures proposed by the Councils.

- ***Appeal to the private sector*** – the appeal of the current proposals has been considered acknowledging the potential for a number of potential interfaces with the private sector, namely (i) current landowners, (ii) developers and (iii) prospective investors. Creating a delivery structure which is attractive to the private sector is important in the context of this project, particularly given that the LDVs do not own any of the land and given that there is a significant financing requirement, which may or may not be provided by the private sector

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- ***Role of NEGC and decision-making -*** the role of the NEGC, as currently stated, suggests it – and it alone - will approve and monitor the business plans of each LDV. Typically in projects of this scale and complexity, establishing effective governance frameworks for long term partnerships - to monitor and control activity and inform decision making - are essential. Further development of current proposals will be needed to provide additional clarity to potential support private sector landowners to better understand how this will work in practice. For example, a mechanism that allows business plans to be revised without appropriate involvement may not provide private sector partners with the level of control or certainty they require when choosing to allocate and / or invest their resources.

  It is noted that NEGC, a company limited by shares and can have independent directors. However, given it is owned entirely by the public sector, and funding is likely to be provided at LDV level, the potential role of the NEGC in influencing LDV delivery needs to be clear (and appropriate). Should NEGC's role extend beyond strategy and enabling support, landowners or 3rd party investors may be wary of the LDV's ability to deliver to plan without interference. In other words, private partners are more likely to accept decision making and influence from those investing in delivery (ie the public sector via its direct investment of funding into the LDVs) but are likely to be wary of influence exerted from NEGC (via a shares) that, without further definition of its role and remit, could impact upon the LDV's ability to fulfil its agreed business plan.

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- As viability of specific sites becomes clearer, the Council should keep the appropriateness of current delivery arrangements under review by considering the range of potential alternative options available and the relative impact they could deliver for the Councils. This approach is typical for such a large scale and complex project in its early stages of development. Some projects, for example Thurrock's £1bn regeneration of Purfleet, were taken to market "delivery structure blind", whereby the partner procurement process was used to shape the most effective way to deliver partners' outcomes.

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Summary

Overall, the Councils have proposed an initial framework to delivering the Garden Settlements that contains a number of key benefits that are likely to appeal to landowners. A key positive is the way in which it brings together the Councils to work in a coherent way to drive delivery across the three major areas. The proposed approach also offers land owners an attractive commercial proposition – an upfront price for land with potential for a substantial uplift following public sector investment.

If the LDV's role is to coordinate delivery of infrastructure and sell land (e.g. a land trading model) then the "commercial appeal" of the proposed structure may well be high with many landowners, but the Council's need to satisfy themselves as to whether it is appropriate to protect / manage its own investment risk. Further refinement of current proposals could be considered as part of that process.

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3. Review of financial model

Overview

To support their assessment of site viability and long term financial performance of each Local Development Vehicle ("LDV"), the Councils have developed detailed financial models for each site. Each financial model has been approached from the perspective of the LDVs and builds upon technical information on costs and values provided to the Councils by Aecom and Cushman and Wakefield.

We understand that each financial model is intended to serve as an ongoing tool that is updated to reflect the latest information available. Hyas Associates has been appointed to support the Councils in maintaining and managing the models accordingly.

Given the importance of the financial model to ongoing decision-making for the Councils, PwC has been requested to undertake a high-level review of the financial model, focused on:

- The model as a **technical tool**, including the extent to which it adheres to best practice, is internally consistent and demonstrates arithmetic accuracy; and,
- The model as a **commercial tool**, reflecting the reliance the Councils are placing on the model to assess each project as an investment proposition.

Based on discussions with the Councils and Hyas Associates, who confirmed that, structurally, the models were consistent, we have focused our review on one of the models only, namely that for the West of Colchester scheme[3]. Please note that the version of the model reviewed was dated 6th September 2016.

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Summary and recommendations

Based on our high-level review, we understand that the Councils have developed a financial modelling tool that has been helpful in informing its views on the potential viability of the prospective sites. This tool is broadly consistent with modelling best-practice, has been undertaken in a way which protects the integrity of the modelling in each worksheet.

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- Providing the Councils with the information they require to understand the potential capital and revenue impacts on the investments they may be asked to make;
- Developing a tool that accurately resembles the emerging deal terms in key commercial documentation such as the heads of terms. This will help the Councils to fully explore the range of positions they can take on key commercial issues and better inform decisions that impact on the Councils' risk position and ability to secure value for money from any investment.

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4. Review of potential financing options

Overview

Delivering the proposed Garden Settlements is anticipated to require significant upfront expenditure to develop the masterplans, obtain planning consents, and deliver the enabling and supporting infrastructure required to create serviced plots that can then be sold to the market. A central question for the Councils moving forward concerns what mechanism(s) could be established to bridge the gap between the expenditure and returns identified.

Amongst the broad principles that create the context for addressing this question are:

- **Project viability –** does the project generate sufficient funding (that is, revenues) to repay the financing, and the costs of that financing, that may be required to meet the level of expenditure anticipated?
- **Financing the LDVs –** assuming viability the LDV will need to consider what options for raising the initial investment required there are, and how can this be structured to utilise the funding available from the project in ways that are cost-effective and provide value for money to the public sector and other stakeholders involved in delivering the project.
- **Additional sources of funding –** where the current sources of funding and viability do not support the financing of the project (regardless of the source of that finance), are there additional sources of funding that can be identified and used to support the financing requirement of the project?

These principles and themes have been used as the basis for structuring our approach to providing a high-level review of the potential financing options for the scheme.

In practice, the financing considerations for large-scale development projects such as these are complex. The purpose of the analysis set out in this paper is to support the Councils to focus on the key issues that will need to be tackled between now and any investment decisions being taken. There is time to work through these issues, but the complexity and challenges should not be understated.

For example, and with reference to the findings of the high-level commercial review, it is anticipated that the financing and funding solutions for each project are likely to be different, may draw upon a cocktail of different approaches and sources of finance and funding, and will ultimately need to be structured in a way that provides each Council with appropriate risk-adjusted returns, in line with their respective risk appetite and role in delivery, and overall value for money.

Project viability

This sub-section is structured as follows:

- **Project overviews** - summarises key financial information for each of the LDVs based on information provided by the Councils to support an initial view on project and commercial viability; and,
- **More detailed analysis** – of one of the LDVs in particular, analysing some of the key investment characteristics of that LDV. This is on the understanding that the broad picture for that LDV is replicated across the other LDVs.

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- [redacted] and without further work being undertaken to more fully understand and improve the overall viability.

High-level approaches to financing the LDVs

Subject to viability, LDVs could be financed with a combination of equity finance and debt finance, and each is considered in further detail below. The emphasis of the high-level review undertaken is however on the approach to the debt component of the capital structure, given this is how the financial model and heads of terms are currently drafted. It is however highlighted that Councils should consider the extent to which additional equity

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investment may be required and how this may impact the investment decisions they may be asked to make in the future.

This section is therefore structured as follows:

- **Equity** – provides an overview of a number of the key considerations from an equity perspective, particularly with regard to factors that may mean additional equity is required by the LDVs;

- **Debt finance** – summarises two approaches to the LDVs accessing debt finance including (a) Council borrowing and on-lending, and (b) the Councils providing a guarantee to support the LDV to access private finance. For each approach, detail on the pros, cons and additional considerations are provided.

Equity

As a broader commercial point, it is noted that in the documentation and modelling developed by the Councils to date, an overriding principle is that there will be minimal levels of equity in the LDVs, which will be predominantly (in the model this is 100%, for example) debt financed. This approach potentially raises a number of important legal and commercial issues, including:

- **State Aid** – given the interfaces that the LDV will have with the market, and the benefit that may derive to the private sector as a result of the public sector's role in the LDV, the state aid implications of the arrangement may need to be considered further. With regard to the capital structure proposed, the level of gearing may be important in this context given that (a) debt is typically priced more cheaply than equity to reflect the respective risks of those instruments, and (b) if the LDV has a greater level of debt than equivalent market participants and is in effect passing on the benefit of more, low cost finance, then this could create a state aid risk. To the extent that it has not already been considered, we recommend that further advice is sought from your legal advisors, and the outcome of that advice reflected in an updated financial model and heads of terms;

- **Taxation** – from a tax perspective, with loans provided to the LDV by a connected party, the deductibility of the interest expense will be subject to an arm's length test by HMRC. This will consider whether the terms of the debt are consistent with the terms on which a commercial lender would be prepared to lend and may impact on the level of corporation tax payable. It is recommended that the financial model includes this functionality given the material impact it can have on the project as an investment proposition. More detailed information is provided by the Council's tax workstream.

With regard to equity investors, the default position in the term sheets is for each LDV to issue nominal equity to NEGC and those Councils within whose administrative boundaries the particular schemes sit. Flexibility exists in those term sheets for equity to be issued (a) to the other Councils and (b) to other third parties, which may include landowners or other investors.

It is anticipated that an equity investor would have a return expectation from the LDV. This return expectation would typically be in excess of the return to debt investors given the different levels of risk being taken. Given the approach taken to financial modelling and the assumptions around capital structure to date it is not clear what level of equity return investors would currently be projected to receive – and how this might compare to their return requirements. Subject to further analysis being undertaken, this may create further questions around the viability of the scheme and its ability to appeal to potential investors.

Debt finance

For the reasons outlined above and in the high-level review of the financial model, there remain a number of factors that need to be worked through before the Councils can take a definitive approach to how the LDVs are financed. As such, the purpose of this subsection is to provide some initial thoughts on the type of approaches that the Councils might consider with regard to debt financing.

Two broad approaches are considered, namely:

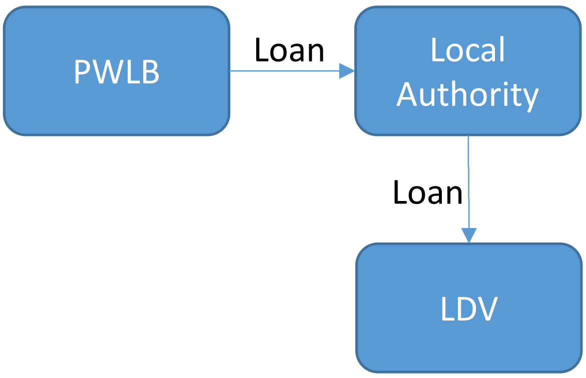
- The Councils borrowing, either from the Public Works Loan Board or another source (for example, municipal bonds), and then on-lending to the LDVs;
- The LDVs raising private finance, potentially from institutional investors, banks, and other financial institutions, potentially with the support of a financial guarantee from the Councils.

These two approaches, the pros, cons and further considerations for each, and the potential impacts on the Councils' capital and revenue accounts are presented below.

At this stage, particularly given the observations around broader viability and deal structuring set out earlier in this section, the Councils are not yet in a position to "set the course" of any particular funding and financing strategy. The information that is presented below is intended to summarise the key issues for consideration. These can then be used to support the Councils' thinking around a strategy once a fuller understanding of the underlying deals has been developed.

Councils providing finance to the LDVs

One model for financing the LDVs is for one or more combination of the Councils borrowing from the Prudential Works Loan Board (or issuing a municipal bond, or other source of finance secured against its revenues and assets) and on-lending to the LDV. This approach is illustrated in the following diagram:



Based on the above, there are two key aspects of that proposed transaction that need to be considered. Firstly, the key considerations in relation to the Council sourcing the finance in the first place, and secondly, the key considerations in relation to the on-lending of those amounts to the LDV.

Council accessing finance – pros, cons, and further considerations

- Typically Councils are able to access low-cost finance from the prudential works loan board to finance capital projects. Alternatives to PWLB do exist including, for example, issuing a municipal bond. Note, these alternatives may require further processes to be completed (for example, obtaining a credit rating) and may attract additional costs;
- As the Councils will note, while PWLB does have some flexibility over repayment options and interest rates, this flexibility is limited. Additionally, all repayment options currently require interest to be paid. This may have implications for the Council where the LDV is not generating revenues; and,
- Where the Councils finance the projects entirely they are unable to benefit from the due diligence that may be undertaken by a third party lender. The onus will therefore be on the Councils to perform due diligence to the level required to provide them with comfort around their investments.

In addition, from a treasury management perspective, it is understood that the Councils are considering what scope there might be for a series of shorter term lending and subsequent refinancing over the life of the Garden Settlement developments. While this approach does introduce a refinancing risk to the project (which the Councils may have to accept ownership for) it may also provide the opportunity for the Councils to borrow at low rates and provide the opportunity for more regular reviews of the potential to leverage in private finance as part of the refinancing strategy. As such, the overall debt structure of the LDVs could change over time.

Council on-lending – considerations

- **Pricing, terms and security** – the Councils will need to price the loans made to the LDV in accordance with state aid requirements.

  As a guide to pricing, the European Commission's Reference Rate Methodology sets out how state aid compliant loans might be priced with reference to a 12 month LIBOR rate and a margin priced in accordance with the creditworthiness of the counterparty and the level of security (collateralisation) relative to the loan exposure. This approach, and the key underlying principles, underpin the pricing that the Homes and Communities Agency has adopted in relation to loans that it makes, as well as a number of other local authorities who have created their own wholly-owned housing companies and created on-lending facilities to provide the required development finance.

  In terms of application, by way of example based on the information available, given the LDVs will be newly-formed SPVs with no trading history and the level of security they are able to offer could be low, the initial margin applied could be up to 1000 basis points (10%) per annum (or equivalent to what the market would be willing to lend to the SPV at if lower). The provision of a parent company guarantee (for example, from one or more of the Councils) could help to significantly reduce this rate (that is, the creditworthiness assessment would typically focus on that of the guarantor), although the risks associated with this for the guarantor(s) would need to be more fully considered.

  In addition, it is also worth noting that as the LDVs develop a trading history and potentially do create assets that can be offered as security to lenders then there may be scope for the interest rates to reduce.

  Overall, it is recommended that the Councils consider the pricing of potential loans in the context of the state aid advice it is procuring from its legal advisors, particularly as there may or may not be state aid exemptions for specific elements of the infrastructure being provided. Nevertheless, in this instance the Councils should remain mindful of the risks inherent in the project and should develop a firmer understanding of what the risk-adjusted pricing for any investment could be.

- **Minimum Revenue Provision** – Where the Councils have undertaken additional borrowing to fund capital expenditure or investment, they would normally be required to set aside some of their revenues as provision for repaying that debt. The broad aim of the Minimum Revenue Provision ("MRP") is to ensure that the cost of the debt is provided for over a period that is reasonably commensurate with that over which the capital expenditure is benefiting the Councils.

  Whilst we would expect the Councils to set aside an appropriate annual MRP for the borrowing of the LDC loan we are aware of a precedent whereby there may be no requirement for such a provision.[11] This has been successfully argued on the basis that the net assets of the LDV (or equivalent) are sufficient to repay this balance through the eventual sale of the land.

  The Councils must satisfy themselves that such an MRP policy is prudent and consult their external auditors before it is adopted. The DCLG Guidance on MRP of February 2012 states that "Authorities are

[11] For example, Basildon Borough Council proposed (December 2014) to revise its Debt Repayment Policy as part of its investment of loan and equity into its wholly-owned company. This was on the basis that, because the Council was expecting the repayment of the loan and redemption of the equity in full, there was no requirement to make a provision for repayment of the loans that the Council funds these investments with. In the event that it became apparent that the Council would not receive repayment of such a loan in full or the value of equity is at risk then a provision for impairment may be made.

to have regard to such guidance" explaining that this is the same duty as compliance with other statutory regulations. The prudent provision of MRP by local authorities may, "in some cases consider that a more individually designed MRP approach is justified". Any significant departures from the guidance - of which potentially not providing MRP is such - must be discussed with external auditors.

When required, the MRP accounting entries impact the Movement in Reserves Statement: essentially reducing the General Fund Reserve and increasing the Capital Adjustment Account by an amount equal to the MRP on an annual basis. The Capital Adjustment Account is non-distributable.

- **Limited cash available at LDV level to pay interest costs** – based on the modelling undertaken by the Councils to date, the LDVs do not generate net cash flows before financing that can be used to pay interest and service debt.

  As such, any Council providing a loan to the LDV will need to consider the extent to which it is comfortable with the risks that it will essentially be increasing its credit exposure to the LDV until such time that it can begin to repay the loan finance provided. From a cash perspective, this may have implications on the Councils' own ability to make repayments on the debt that it may have taken out to finance its on-lending. The wider treasury management implications of this arrangement will need to be assessed by each Council as and when the model is evolved and further information on individual Council impacts is more fully understood.

Potential Capital and Revenue implications

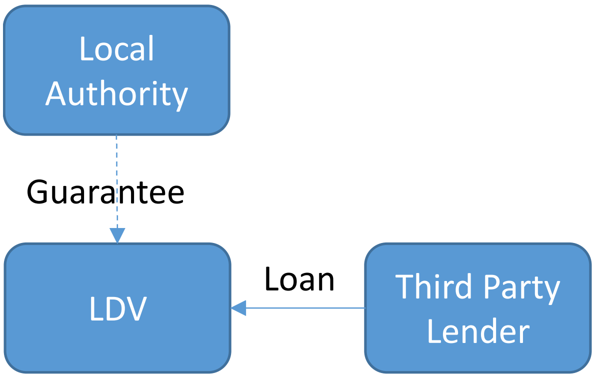
- Capital
  - Each year Councils are required to total their capital expenditure (capitalised amounts and REFCUS) and determine the extent to which this expenditure is to be financed from capital resources – capital grants, capital contributions and capital receipts. Any excess serves to increase the Capital Financing Requirement (CFR). The CFR records the historical capital expenditure that has been incurred by the Councils that has yet to be financed. It represents the underlying need to borrow for capital purposes, although the amount of actual borrowing taken out by a Council will depend on whether it has surpluses of cash arising from revenue balances, unused capital receipts, unapplied capital grants, etc. The CFR is reduced by setting aside revenue resources, either by lump-sum set-asides or by the annual charge of MRP.
  - Hence, a key consideration for the loan to the LDV is to assess any impact on the Councils' capital financing requirement ('CFR'), and hence the need to set aside capital resources (i.e. MRP, capital receipts etc.) to finance any CFR increases or where there is a decrease in the CFR, identify any over financing.
  - It is assumed the loan to the LDV is considered as capital expenditure on account of how, if the expenditure was incurred by the Councils, it would be treated as capital expenditure.
  - As such, appropriate entries will then have to be made to reflect the application of capital receipt or direct revenue financing in the usual way.
  - The loan to the LDV would be treated as a long-term debtor from the perspective of the Council.
  - Where there are any changes to the value of loan given, then it would have a corresponding effect on the CFR.
- Revenue – the key revenue considerations for the Councils are:

- With regards to any Council borrowing, the level of interest payable and any MRP made as a result of increased Capital Financing Requirement may need to be funded through the Council's Revenue budgets; and,

- Any interest payable on the loans to the LDVs can be allocated to the Councils' revenue accounts.

Councils providing guarantees to leverage private finance

A second approach for financing the LDV could be for the LDV itself to approach the market and seek to raise private finance. To support it in this endeavour, and mindful of the risks that have been identified above, it is anticipated that, at least in the early stages of the project, the Councils may have to provide a guarantee to the LDV. One way for structuring this approach is illustrated in the following diagram:



Leveraging private finance – pros, cons, and further considerations

- Providers of private finance will typically undertake extensive due diligence on the proposed investment opportunity. This can result in more robust propositions being created. The public sector can benefit from the rigour provided by third parties in this instance;

- In addition, there are a range of products available in the private finance market, with product choice in relation to the terms of investment, maturity, pricing, and drawdown and repayment profiles;

- However, it is likely that private finance will come at a premium to what the Councils can lend to the LDVs at (subject to state aid and value for money considerations). In this instance the Councils will need to consider the relative costs and benefits of alternative options;

One option available to the Council to reduce the costs of this finance is to provide a guarantee to potential investors. It should be noted that investors are likely to require this guarantee as a condition of their investment, particularly in the earlier years of the LDV's business plan where the greatest uncertainty exists. Through providing a guarantee, the Councils are at risk of having to meet the LDV's liabilities should it default. This exposure would need to be carefully monitored, and the probabilities and costs of it materializing reviewed. They would also need to be factored into the fee payable by the LDV to the Councils for providing the guarantee.

Further considerations of the guarantee

From the perspective of the Councils, there are a number of further considerations, particularly in relation to the guarantee, including:

- **State Aid –** in exchange for providing a credit enhancement to the LDVs the Councils will need to seek State Aid advice in relation to an acceptable form and terms of the guarantee, particularly as it allows the LDV to access funds at a cheaper rate than it would likely otherwise be able to.

- **Pricing guarantees –** partly linked to State Aid and partly a commercial issue in its own right, the Councils will need to consider what an appropriate risk-adjusted fee to charge the LDV is for the guarantees that it provides. The pricing would need to be informed by risk-based modelling to understand what an appropriate premium would be given the probability of the guarantee being called and for how much.
- **Managing potential risk exposure –** it is recommended that the Councils consider how they would respond to a guarantee being called. For example, the guarantee could cover a large and material amount of money. Upon the calling of the guarantee the Council will be obliged to cover this exposure from its own resources. This could have significant capital and revenue impacts, the implications of which would need to be fully assessed ahead of signing off the guarantee and continually monitored over the life of the guarantee.

Potential Capital and Revenue implications

- From an accounting perspective, the details of the guarantee will need to be reviewed to confirm its effect on the Councils. The following considerations will need to be further explored at the next stage:
    - The guarantees to provide credit enhancement confirms that the Councils have an interest in the LDV, which results in the Councils being exposed to variability of returns from the performance of the LDV. Such guarantees are included as part of the consideration to what extent the Council has control or joint control of, or significant influence over, the LDV.
    - Councils sometimes give financial guarantees that require them to make specified payments to reimburse the holder of a debt if the debtor fails to make payment when due in accordance with the terms of the contract. The Councils may decide to opt to charge a fee for accepting the risk involved in giving such guarantees, which as a result would be recognised as revenue receipts.
    - The financial guarantee contract shall be initially recognised at fair value. If the contract was issued in an orderly transaction between market participants, its fair value at inception will be the premium received unless there is evidence that this is not a reliable estimate of fair value. If no premium is received the fair value of the financial guarantee contract at inception shall be estimated by considering the probability of the guarantee being called and the likely amount payable under the guarantee.
    - Subsequently a financial guarantee shall be measured at the higher of the amount recognised initially and the amount determined in accordance with *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* less when appropriate cumulative amortisation. Therefore, the carrying amount of the financial guarantee would remain at the original amount estimated at inception (less cumulative amortisation) unless payment under the guarantee becomes probable, at which point the amount of the liability shall be determined in accordance with IAS 37.
    - The entries on initial recognition would be to recognise the liability by crediting Financial Guarantee Liabilities and to charge the loss to Surplus or Deficit on the Provision of Services. If the amount determined in accordance with IAS 37 becomes greater than the carrying amount, the carrying amount should be increased to this amount. The movements in the carrying amount of the financial guarantee after initial recognition whether from subsequent re-measurement in accordance with IAS 37 or from amortisation of the liability in accordance with IAS 39 shall be debited or credited to Surplus or Deficit on the Provision of Services. Any consideration received for granting the financial guarantee should be credited to Surplus or Deficit on the Provision of Services.

Options for funding and securing further value

The key source of funding that the Councils have identified to repay the financing required to deliver the scheme is uplifts in land value as a result of the improvement works and changing planning status of the sites before they are sold to third party developers.

The main recommendation of this high-level review of financing options is for the Councils to undertake further financial modelling and analysis to enable them to fully understand the overall viability of the scheme given the costs of the various sources of finance that could be leveraged to deliver the scheme. This may identify a funding gap that needs to be addressed.

Subject to the outcomes of this analysis, it is envisaged that the Councils may need to consider additional sources of funding that could be accessed to support the delivery of the scheme. Potential options could include, but are not limited to:

- **Business rates** – based on current estimates, the schemes are anticipated to deliver 220,872 square metres of commercial space. To the extent that the business that occupy this space contribute business rates, this may provide one source of funding that could be accessed to support the overall financial viability of the scheme. Amongst the potential benefits of this income is the fact that, depending on when the commercial space is delivered, it could be start to be generated reasonably early on in the scheme;
- **Community Infrastructure Levy on adjacent schemes** – the current proposals are for the LDVs to secure land value uplifts on the sites. Given that the investments being made may have positive impacts on other, adjacent sites and schemes, the Councils might consider the extent to which a levy might be applied on those developments to help provide contributions towards the initial costs; and,
- **Alternative sources of gap funding** – depending on the extent of the viability gap and the amount of funding that can be provided from a range of additional sources, the Councils may need to consider what options exist in relation to gap funding for the project (see below).

Potential "asks" of government

The Garden Settlement developments envisaged by the Councils have the potential to align closely with the Government's agenda, particularly with regard to accelerating the delivery of new homes and the broader move to greater devolution.

Given this, and in the context of the Government's imminent Housing White Paper (due January 2017), there could be a window of opportunity for the Councils to consider discussions around potential "asks" of government. These might include:

- **Retaining Stamp Duty Land Tax (and a range of other property taxes / fiscal devolution)** – this mechanism is not currently available to Councils but is one being considered/ sought by a number of other local authorities / devolved areas, as well as in London (via the Greater London Authority). Given the emphasis on incremental / additional residential development (i.e. there are currently no taxes being levied as the properties do not exist), there may be scope for the Councils to articulate a request to government that allows them to retain a proportion of SDLT receipts over the life of the proposed developments. Whilst it would require a major change from government (and therefore is unlikely to be an easy "ask to deliver") it could provide the LDVs with a reasonably regular flow of income that could be used to support the overall viability of the scheme. Further work would need to be undertaken to assess what this reform could yield and what benefit it could bring;
- **National Productivity Investment Fund –** the Government has identified housing as a key target for increasing national productivity. Of the £23 billion new spending announced in the Autumn Statement (2016), to be invested between 2017/18 and 2021/22, £7.2 billion has been allocated to support the construction of new homes. The primary purpose of this fund is to provide financial resources

to invest in infrastructure targeted at unlocking new private house building in areas where housing need is greatest. The overall aim is to support the delivery of 100,000 homes. Allocation of funds will be done via a competitive process. Given the alignment of interests between what the Government is trying to achieve and what the Councils are seeking to deliver, then subject to the supporting detail being worked up, the Councils could seek to prepare a strong case for investment ahead of what is likely to be a launch in April 2017;

- **New Homes Bonus –** New Homes Bonus has been one lever utilized by the Government to incentivize the delivery of new homes through providing match funding equivalent to six years of the Council Tax raised on each new home built. Reforms to the New Homes Bonus have been proposed, including reducing the period over which match funding will be provided (i.e. fewer than six years). While this could prove a useful tool "as is", there may be potential for the Councils to frame an "ask" to government which, given the extent of housing that could be delivered, seeks match funding equivalent to a longer time frame. In addition, if long term certainty over this source of funding could be provided over the life of the projects then this could provide a valuable source of income for the Councils;

- **Options around interest payments –** given the potential interest costs that the Councils could incur should the borrow to on-lend to the LDVs, options for managing this interest cost – and the impact it could have on their revenue budgets – would be of substantial help. This is an increasingly common, and complex, consideration for other local authorities undertaking similar large scale regeneration projects.

  Based on the information currently available, it is not possible to ascertain what the potential revenue costs for each Council might be. It is recommended that further modelling is undertaken to understand this more clearly. Once this position is more clearly understood, the Councils will be in a position to review their current Capitalisation of Interest policies to determine whether or not there is scope for them to use a lever already available to them to manage the potential revenue impacts associated with financing the deal. To the extent that this is not possible, there may be scope to engage with government around how an alternative revenue and / or accounting solution could be agreed such that this does not impact adversely on the Councils ability to bring forward these schemes.

The practicalities of delivering each of the above would need to be worked through in greater detail at the next stage as part of the broader discussion around project viability, risk allocation and return profiles. Clearly, options that require a change in policy, law and/or set a precedent for other Councils are likely to be challenging to secure, particularly in a timeframe to support upfront viability.

A strong evidence base underpinned by robust analysis will however help put the Councils in a position to articulate any "ask" of government in a way that can be framed as an "offer and ask" deal – i.e. government understands what it will receive in return for investment.

In terms of timeliness, the National Productivity Investment Fund is an option that the Councils may wish to consider and explore as a priority.

5. Conclusions

Conclusions

Based on the information provided it is clear that the Councils have made significant progress over the past twelve months to shape an approach to delivering three large scale, public sector-led residential development opportunities.

In accordance with the scope of the high-level review undertaken and the findings set out in this report, our conclusions and observations are summarized below:

- ***Proposed delivery structure –***
  - ***High-level commercial and financial review of framework***
    - ***Initial support -*** Considerable progress has been made in terms of aligning each of the Councils to a shared vision and set of underlying principles which will guide the delivery of the prospective Garden Settlements. This provides the Councils with a strong basis upon which to continue to develop their proposals and to engage with the market, and is consistent with the approach that others have taken for similar, multiple stakeholder schemes;
    - ***Delivery mechanism -*** A proposed "land trading" delivery mechanism has been articulated. This mechanism, through the creation of NEGC, recognizes the need of the public sector to provide confidence to the market for schemes of this magnitude. The proposal to create subsidiary LDVs which are limited by shares also provides an appropriate risk mitigation mechanism for the Councils. The attractiveness of the proposed mechanisms will however depend on the viability of the schemes and should additional private sector investment prove necessary, the proposed structure may need to be refined; and,
    - [redacted]
  - [redacted]
    - [redacted]

      [redacted]

[redacted]

- [redacted]

[redacted]

- *Project financial model -*

  - ***Functionality and key formulae*** – the model developed broadly adheres to best practice and the application of formulae exhibits the expected level of consistency within worksheets. However, a review of sample model formulae identified a number of calculation errors that will need to be updated in subsequent iterations of the modelling.

  - ***Commercial review of the model*** – the model produced does provide some information that it is useful for the Councils to consider from a commercial perspective. For example, information on peak funding requirements, and payback periods are included.

    However, given the magnitude and complexity of the investment that is required for this project, further work is required on better defining the peak funding requirement, the project IRRs, the structuring of debt and equity and respective returns, and taxation impacts. The latter two in particular are completely absent from the model and will need to be incorporated as the project develops and further decisions around potential investment are made.

  - ***Identifying "pinch points"*** – a number of pinch-points in the business plan have been identified, including that significant upfront funding is required, the projects do not reach a cash positive position for an extended period of time, and that there is considerable uncertainty around the quantum and timing of all cash flows. The model is not currently developed in a way that is conducive to extensive sensitivity analysis to test these key pinch points. Such sensitivities may include the impact of cost overruns, revenue shortfalls, and delays to the progamme.

  - [redacted]

- *Potential financing and funding options -*

- [redacted]

- It is understood that each Council is currently in the process of securing an "agreement in principle" to be a long term funder for the project. This approach recognizes that the Councils are likely to have some role in funding / financing the deal, at least in the early years of each scheme, to help de-risk them with a view to potentially leveraging in private finance at a later date.

- ***Potential approaches to financing -*** to support the Councils in understanding how each scheme could be financed this report has identified and considered two broad approaches – (i) the Councils borrowing (either via PWLB, municipal bonds, or other source) and on-lending to the LDV in a state aid compliant manner and (ii) the Councils providing a guarantee to the LDVs to allow them to leverage in private finance directly.

- ***Potential asks of government*** – drawing upon experience elsewhere, and particularly in the context of devolution deals and the imminent Housing White Paper, a number of potential asks of government have been identified, including retention of SDLT (and other property taxes), the National Productivity Fund, and New Homes Bonus. Further work is required by the Councils to articulate any "ask" that is made of government. This "ask" must be able to demonstrate a "something for something" that is both credible and deliverable, and supported by robust analysis and a strong evidence-base.

Overall, the Councils have undertaken a significant amount of work to create a strong basis upon which to continue to develop their proposition and engage with the market. The conclusions drawn above acknowledge this work, and the usefulness of the tools and approaches used to arrive at the current position, whilst recognizing that the Councils are now entering a phase which requires further detail to be developed and a robust evidence base that can inform the future direction of the deal – including engagement with landowners, understanding the financial implications of the deal for all parties, and framing potential asks for government – to be created.

[12] It is noted that the Councils are considering the broader non-financial benefits that the scheme could deliver, with a view to factoring this into a broader value for money assessment of the proposed deal, as necessary.

6. Next steps

Next steps

To deliver successful outcomes the Councils will need to:

- Fully understand the objectives, risk appetite, constraints and level of financial and non-financial resources each Council is able to commit to the scheme;

- Undertake more detailed viability assessment supported, where appropriate, by due diligence on key assumptions. Such analysis should be supported by a financial model for the scheme that provides greater flexibility to test risk and should also provide individual Councils with a clearer view of what their individual investment and risk exposure is expected to be. This more detailed analysis will also support further development of potential structuring and financing solution(s) for the deals as well as underpinning any potential asks to government; and,

- Engage with the market to understand further (informed by a more detailed understanding of viability and Councils investment appetite) the extent to which current delivery and risk / reward sharing arrangements are appropriate for a) landowners and b) any potential third party investors that are to be targeted; and,

- Consider the implications of the above steps on the delivery of each individual scheme.

Building on the progress made to date, and with the above next steps, we believe the Councils can move forward with the objectives of:

- **building stakeholder confidence, clarity and support;**

- **refining and testing delivery proposals to demonstrate deliverability; and**

- **Building momentum into delivery.**

To support you to meet these objectives we have set out more specific suggestions around next steps under the following headings:

- **Further market engagement and testing with key stakeholders;**
- **Understanding of viability and overall deliverability; and**
- [redacted]

Further market engagement and testing with key stakeholders

- **Target outcome** – understanding what each party is seeking to achieve from the deal, what they are able to commit, and for what level of risk and return. Having this understanding, early on in the process, is regarded as best practice for all complex transactions.

- It is noted that each local authority is seeking approval for an “agreement in principle” to be a long term funder for the project, subject to further analysis. As part of that further analysis, it is recommended that the following key themes are explored with each Council, both individually and collectively:

    - **Affordability** - what can each stakeholder make available to the project and over what period;

    - **Returns** – what level of return does each stakeholder require, and how does it need that return to be extracted from the deal (e.g. as capital or revenue);

- **Risk** - what level of risk is each stakeholder prepared to accept as part of its investment;
- **"Red lines"** – does the stakeholder have any "must haves" and "must nots" that could be deal-breakers for the proposed transaction (note these could be financial or non-financial); and,
- **Value for Money and Options Assessment** - what analysis does each stakeholder need to be provided to support its business case development and demonstrate that the proposed investment is an appropriate use of public funds etc.

- [redacted]
    - [redacted]
    - [redacted]

Understanding of viability and overall deliverability

Target outcome – provide the Councils with greater confidence in the viability, deliverability and risks involved with potential schemes and a clearer understanding of their own investment and risk commitment. Key to providing that analysis will be development of robust financial analysis that accurately reflect the emerging details of the schemes and proposed transactions. This work will support:

- **Understanding viability** – based on current projections provided by the Councils the schemes may have viability challenges. The extent of any viability challenges need to be more fully understood and supported by accurate calculations and best practice financial modelling;
- **Developing a robust evidence base** – the Councils have started work to collate assumptions. However, a more formalized assumptions book should be created so that each and every assumption used is logged and explained, with a view given as to the likely levels of robustness and sensitivity. Due diligence on key assumptions should then be undertaken;
- **Transparency around financing cash flows** – given the level of investment that is potentially being requested, much greater transparency around financing cash flows, for a range of financial instruments, for a range of potential investors, is required. Only once this information is available will it be possible to understand the extent to which the schemes are deliverable in the context of the outcomes from the further engagement identified above;
- **Risk assessment** – the financial model should be developed in such a way that a range of risks (including cost overruns, revenue shortfalls, and delays) can be modelled accurately and reliably. The level of analysis that can be provided will support the Councils in building confidence in the proposed schemes;
- **Readiness to fully explore financing options** –having a robust financial model that provides a detailed level of understanding of the LDV's financing cash flows and how those cash flows perform under a range of risk scenarios will provide the Councils with a much stronger set of information with which to more accurately appraise the costs and benefits of a range of potential financing options, as well as support it more broadly in negotiations with those potential providers of finance; and,
- **Councils' positions (Capital and Revenue implications)** – from the Councils' perspectives it will be necessary to understand what the potential capital and revenue

implications for each Council of the proposed deals could be. This will support the Councils in building the confidence of their internal stakeholders also.

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]

Appendix A. - Scope of services

A.1. Scope of services

The following is an extract taken from our Engagement Letter with Colchester Borough Council that sets out the agreed scope of services.

- A high-level review of the proposed delivery structure. Our services will include:
    - Attending a half day meeting with you and your legal advisors to understand the key details of how the Local Delivery Vehicles ("LDVs") are being established and how they are proposed to interact with landowners and other potential counterparties to the deals;
    - Performing an initial high-level commercial and financial review of the framework and key principles covered by the Heads of Terms that your legal advisors have prepared and which landowners have provided initial feedback on; and,
    - Support you in identifying the key commercial and financial risks and implications of the proposed approach, including viability considerations, as well as propose a number of potential mitigations that you may wish to consider to help manage those risks.
- A high-level commercial review of the project model that you have prepared. Our services will include:
    - A high-level review of the model's functionality, including a check of key formulae in the model for arithmetic accuracy and internal model consistency;
    - Undertaking a commercial review of the model output with a view to providing advice on the extent to which it provides the information required to support an investment decision. For example, such information might include details on peak funding requirement, structuring of debt and equity and respective returns, taxation, and payback periods;
    - Working with you to identify funding "pinch points" in the business plans – that is, aspects in those financial plans where there may be risks around the amount of financing required and / or the level and timing of receipts to the Local Development Vehicles or Councils. In addition, we will work with you to suggest a range of sensitivities to be performed by you to assist you to understand the potential impacts of key risk factors; and,
    - Working with you to identify other key financial and commercial risks based on the information provided in the project model.
- High-level review of potential financing and funding options. We will work with you to:
    - Identify and agree with a shortlist of potential financing and funding options for the Councils and / or the vehicle;
    - For each option, present high-level analysis in relation to the relative advantages and disadvantages, as well as relevant wider commercial considerations. Details on quantum of financing required will be drawn from your financial model;
    - Consider, at a high-level, the key capital and revenue implications of each option from a local government financing perspective;
    - Hold a half day workshop to discuss the outcome from the tasks set out above with the Councils to understand the respective appetites towards these financing options, as well as the suitability given the specifics of each site; and,

- Based on the above, identify and describe, at a high level, what, if any, changes to current local authority financing conditions might be required to support the delivery of your proposed Garden Settlements (that is, what might the “financing ask” of HM Treasury be).

- You will be responsible for providing timely access to key stakeholders and any documentation required for us to complete our proposed services.

Deliverables

- We will provide you with a short report which collates and summarises our conclusions from the above scope of services.

Services outside the scope of this letter

We are not providing any services other than the services set out above.

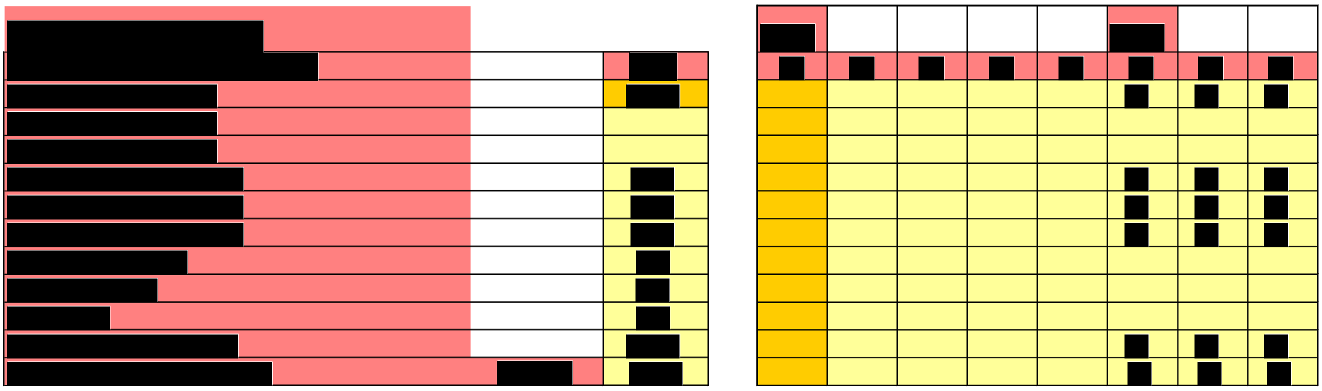
Appendix B. - Financial model review

B.1. Extract from financial model review

To test the extent to which the model demonstrates internal consistency and “integrity”, as well as has been constructed in accordance with principles of best practice, we have used specialist spreadsheet analysis software (Operis Analysis Kit) to help identify the following in the model:

- Any inconsistencies in formulae replication across worksheets;
- Hidden assumptions which are embedded as hard codes within formulas;
- Unused or redundant inputs; and,
- Cells with potential formula errors.

The illustration below shows an example of the analysis we have conducted on the model, which shows results from our high-level review of the “7. Baseline Appraisal” sheet in the model. This sheet consolidates the LDV’s total cash inflows and outflows to calculate the project’s internal rate of return and net present values, and the screen grab bellows reflects the total land sale and returns of the LDV component of that worksheet:



A well-constructed model should exhibit the pattern of colours seen above, namely where each unique formulae (dark yellow colour code) is copied in one or two directions (in light yellow colour coding), and there are no anomalies throughout the calculations (purple or pink colour codes, which denotes numbers or text respectively).

We have tested each worksheet accordingly and can confirm that, based on this high-level review, each exhibits a similar pattern. As such, we have not noted any inconsistencies in formula replication across worksheets.

We have also reviewed the model structure to understand the interdependencies between the inputs, calculation sheets, and the output sheets of the model. It appears that the model seems to be working correctly, that is, formulas in the calculation sheets are built upon inputs that have been entered manually into the model’s input sheets, and the output sheets consolidates the various calculations that have been done in the calculation sheets to reflect key financial indicators, such as project revenues and costs.