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# Enabling capital investment by London local government: Full report

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# Contents

# 1. Introduction

## Background to the research

1.1 The ability of local government in London to use a variety of means to invest in local infrastructure projects could play a key role in sustaining the local economy in London and improving its prospects for emerging from the downturn sooner and in a stronger position. However, whilst local authority capital investment may be of increasing importance at this time, other factors such as the availability of government funding and capital receipts are having a significant impact upon the ability of local authorities to commit to large capital programmes.

1.2 The strategic relationship between capital and revenue finance is particularly important, given the expected significant reductions in revenue funding from 2011/12 and therefore the scope to support the revenue implications of capital borrowing. For London boroughs, this is a major constraint, in the context of around three-quarters of boroughs currently being on the revenue funding floor and the likelihood of their continuing to be in this position for the foreseeable future.

1.3 In this context, in May 2009, London Councils commissioned LG Futures Ltd. to undertake research into, 'Enabling capital investment by London local government.' The intention of the research was to develop a clearer understanding of the range of factors that may be preventing local authorities in London from planning and undertaking capital investment projects and what could be done to overcome these barriers.

1.4 This included consideration of the extent to which capital investment by London boroughs has been affected by the current economic climate and whether capital investment could potentially stimulate economic recovery. In addition, a range of case studies were explored, highlighting innovative means of financing capital projects by local authorities, with relevance to the London context.

1.5 This report summarises LG Futures' key findings arising from the research and is structured as follows:

Section 2 – Methodology

Section 3 – Trends in Capital Investment

Section 4 – Capital Need in London

Section 5 – Capital Investment Constraints

Section 6 – Legislative and Technical Barriers to Capital Investment

*Enabling Capital Investment:*

Section 7 – Scope for Better Asset Management

# 2. Methodology

## Introduction

2.1 LG Futures' research took place between May and September 2009 and involved the following key activities:

- **Desk-based research.** This involved the consideration of relevant literature and national data as background to the work.

- **Key expert interviews.** Interviews took place with a range of stakeholders with expert knowledge of capital investment issues; in particular, to explore a range of legislative and technical issues. The list of stakeholders consulted as part of the research is provided in Appendix A.

- **Benchmarking.** Analysis of more detailed trends in capital expenditure, comparing boroughs with other types of authority, and at individual borough level, took place over 2006/07-2008/09, the latest years for which individual local authority data was available.

- **London borough survey.** A survey was circulated to London boroughs, in order to explore a range of issues in relation to: capital need; key capital constraints; legislation, regulation and accounting practice; the effect of the economic downturn; prudential borrowing and Minimum Revenue Provision (MRP) approaches; and innovative means of capital investment. Responses were received from 25 of the 33 boroughs, with boroughs that responded to the survey being listed in Appendix B.

- **Case studies.** More detailed follow up also took place with a number of organisations and authorities to explore case studies of projects and initiatives which could potentially have relevance to the London borough context.

2.2 Following on from the completion of these activities, this report has been prepared, detailing LG Futures' key findings and conclusions from the research in relation to 'Enabling capital investment by London local government'.

# 3. Trends in Capital Investment

## Introduction

3.1 This chapter provides a brief explanation of the local government capital finance system and details of capital funding and expenditure trends across the public sector; in particular, within local government. More detailed analysis of capital spending has also been undertaken for London in comparison with other classes of authority, and at individual London borough level.

## Definition

3.2 In England and Wales, there are three primary routes by which expenditure can qualify as capital:

- Expenditure results in the acquisition, construction or enhancement of fixed assets (tangible and intangible) in accordance with "proper practices"
- Expenditure meets one of the definitions specified in regulations made under the Local Government Act 2003; for example, computer software
- The Secretary of State makes a direction that the expenditure can be treated as capital expenditure; for example, redundancy payments, equal pay awards

## Legislation

3.3 The current capital expenditure legislation under which local government operates has seen significant changes over the past 20 years. The Local Government Act 1989 introduced a number of complex regulations restricting local authority capital expenditure. The main aspect of these regulations constrained the level of borrowing by local authorities through the use of prescribed central government borrowing approvals - Basic and Supplementary Credit Approvals (BCAs and SCAs). The level of BCAs and SCAs received by authorities were determined by central government departments, with associated revenue support being provided through the local government finance system, to support borrowing incurred.

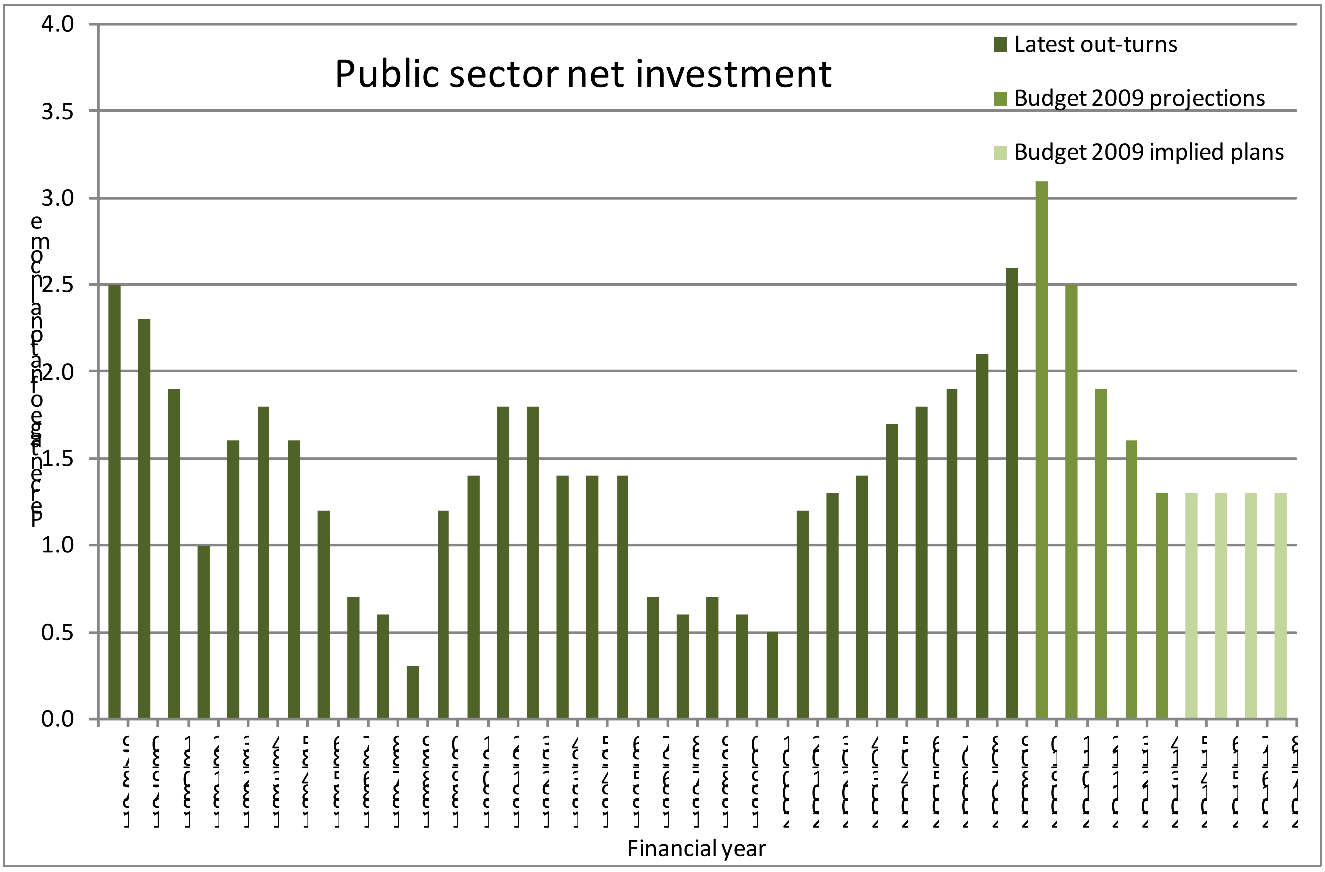
3.4 The introduction of the Single Capital Pot, in 2002/03, in theory, enabled local authorities to exercise greater freedom in relation to capital expenditure; when the restrictions that required local authorities to use BCAs at individual service level were lifted. However, the restriction on the overall amount that could be borrowed remained in place, and, in reality, authorities were concerned that deviation from notional service level allocations that were provided could have implications for future years' BCA allocations for that service.

3.5 The Local Government Act 2003 abolished central control of borrowing (and with it credit approvals), in favour of a system of self-regulation, with this 'prudential framework' becoming effective from 1 April 2004. Under this system, local authorities are free to borrow, as long as they consider that borrowing is affordable, prudent and sustainable, with this being determined by reference to a range of prudential indicators, as specified within CIPFA's Prudential Code for Capital Finance in Local Authorities. Any such borrowing does not, however, attract central government support for the costs of financing debt, and is therefore 'unsupported'.

## National capital investment levels

3.6 Figure 1 shows the proportion of capital investment as a share of national income since 1978/79 and what the latest Budget 2009 plans imply for spending through to 2017/18.

*Figure 1 – Public sector net investment 1978/79 to 2017/18*




*Source: Institute for Fiscal Studies*

3.7 The Comprehensive Spending Review (CSR) of October 2007 planned for investment spending to rise slightly, before stabilising at 2.3% of national income. However, these plans have changed in response to the prevailing economic conditions. As part of the fiscal stimulus set out in the Pre-Budget Report 2008, the government announced plans to bring forward £3bn of capital spending from 2010/11 into 2008/09 and 2009/10. This, coupled with the fact that national income is currently below forecast expectations, has led to a sharp increase in investment spending in 2009/10, with capital investment as a proportion of national income standing at 3.1%.

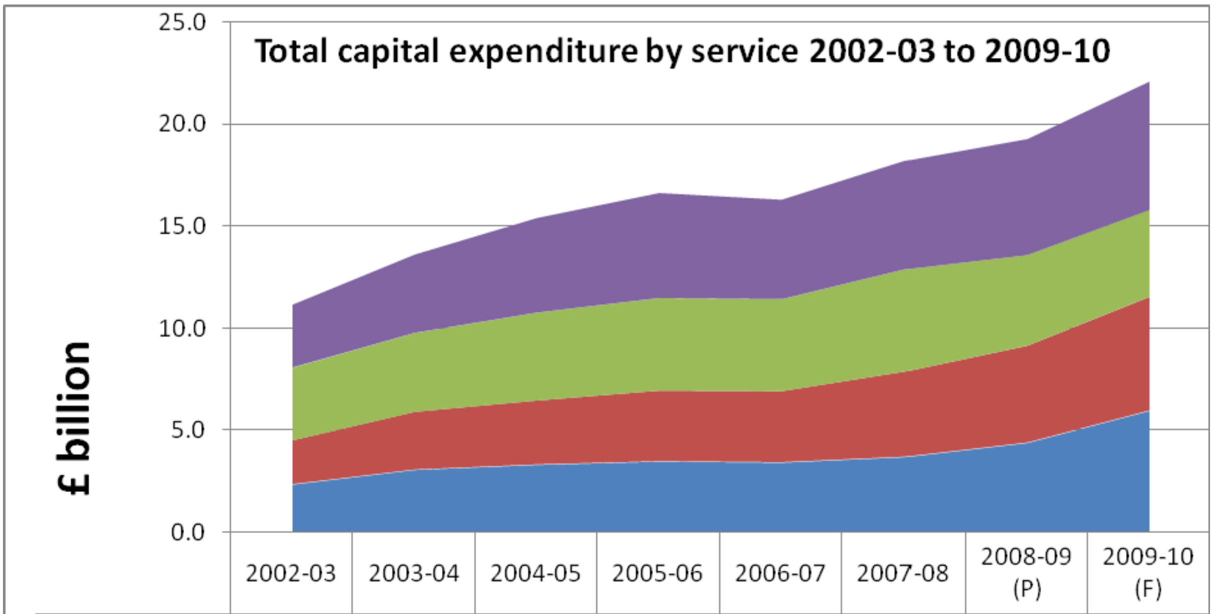
3.8 However, although public sector net investment should have stabilised at 2.3% of national income per annum, it is now planned to be cut back to 1.3% of national income by 2013/14, although the specific public services that will be affected will not be known until the next Comprehensive Spending Review is published.

3.9 As identified in the Introduction, expectations of potentially significant reductions in local authority revenue funding from 2011/12 exacerbate these reductions in capital investment levels, through constraining the ability that authorities have to support the revenue consequences of capital investment, particularly for authorities on the funding floor.

## Overall local authority capital expenditure

3.10 Over the last decade, local authority capital expenditure has increased significantly, with total capital investment by local authorities rising from £6.7bn in 1998/99 to £18.3bn in 2007/08 (HMT 2008 Pre-Budget Report). More recent trends in local government capital expenditure for major services for the period 2002/03 to 2009/10 are shown in Figure 2 below, including provisional 2008/09 and forecast 2009/10 figures.

*Figure 2 - Local government capital expenditure by major service 2002/03 to 2009/10*




| | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 (P) | 2009-10 (F) |
|---|---|---|---|---|---|---|---|---|
| Other Services | 3.081 | 3.842 | 4.639 | 5.154 | 4.879 | 5.324 | 5.694 | 6.303 |
| Housing | 3.562 | 3.865 | 4.304 | 4.534 | 4.507 | 5.008 | 4.440 | 4.255 |
| Transport | 2.150 | 2.830 | 3.136 | 3.461 | 3.480 | 4.168 | 4.749 | 5.568 |
| Education | 2.364 | 3.083 | 3.333 | 3.492 | 3.442 | 3.711 | 4.405 | 5.983 |

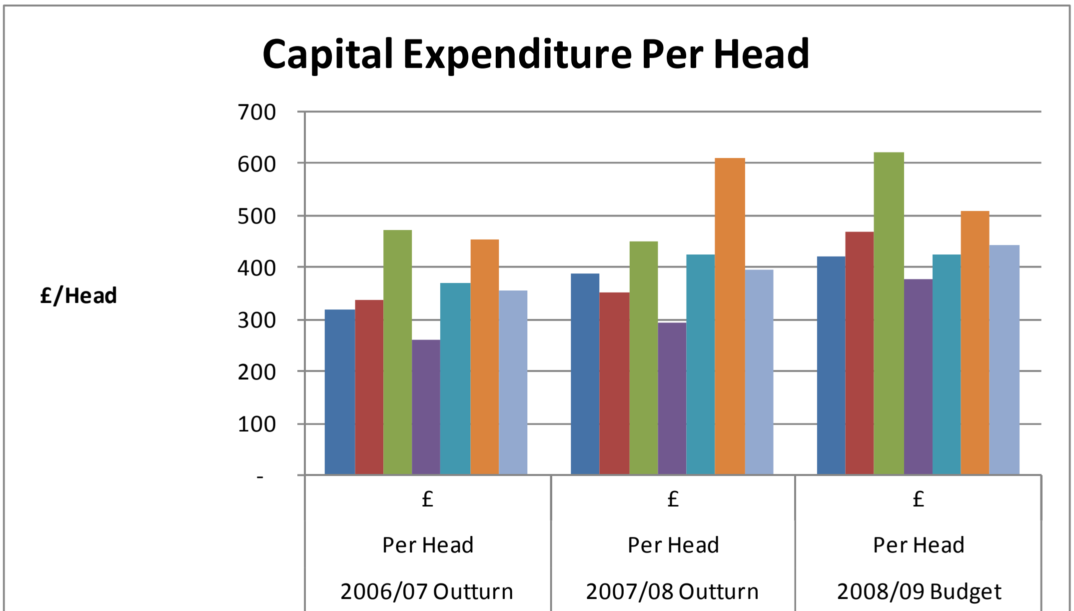
*Source: Local Government Financial Statistics England No. 19 2009*

3.11 The graph shows the extent to which capital investment in Transport and Education, in particular, has increased, whilst Housing has experienced much slower increases in capital investment levels.

## London capital expenditure

3.12 More detailed trends in capital expenditure per head over the last three years for which data is available at a more detailed level (2006/07 and 2007/08 outturn and 2008/09 budget) have been shown in Figure 3 below. This compares London with the average for England, metropolitan districts and the core cities[1]. Core cities are a useful comparison group, given their similar characteristics to London.

*Figure 3 – Capital expenditure per head 2006/07-2008/09 by class of authority*




| | £ Per Head 2006/07 Outturn | £ Per Head 2007/08 Outturn | £ Per Head 2008/09 Budget |
|---|---|---|---|
| England | 317 | 388 | 420 |
| London boroughs | 336 | 349 | 465 |
| Inner London | 471 | 449 | 620 |
| Outer London | 258 | 290 | 374 |
| Metropolitan districts | 368 | 424 | 423 |
| Core Cities | 453 | 607 | 507 |
| London Plus Mets | 355 | 393 | 440 |

*Source: DCLG Capital Outturn Returns (COR) and Capital Estimates Returns (CER)*

[1] Core Cities are: Birmingham; Bristol; Leeds; Liverpool; Manchester; Newcastle; Nottingham; and Sheffield.

3.13 Figure 3 shows that capital spending in London per head was only just above the average for England in 2006/07 and 2008/09 and was below the average in 2007/08. There is also a stark contrast between inner and outer London: collectively, inner London boroughs spend 16-49% above the national average, but outer London boroughs spend some 11-25% below the average. Core cities spend around 21-57% above the national average. In outer London, there are major differences in 'need', with some very affluent boroughs and others with similar needs to inner London.

3.14 We have used ranges here because spending levels fluctuate from year to year. There is also some evidence that the credit crunch started to bite in 2008/09, but that its effects (initially at least) have been more severe in the core cities. Planned spending in London was up 15% in 2008/09, but down 3% in the metropolitan districts and down 9% in the core cities. Within these totals, there are very different pictures, however, at borough level and this is illustrated in Appendix C, which shows differences in capital spending per head for London boroughs compared to the national average (based on three-year averages).

3.15 Core cities spend at a similar level to inner London. Their spend appears to be more consistent: only Bristol spends below the England average and only Newcastle spends more than 50% above the average. Thus, where inner London boroughs are able to spend, they are spending considerably more than the core cities.

3.16 There are a number of arguments why capital spending might be higher in inner London than the core cities. The Relative Needs Formulae (RNF) per head is higher for most services, and there is an Area Cost Adjustment, which uplifts revenue funding in London by between 15-25%. As far as we know, there has been no similar exercise to estimate the differences in local cost for capital spending in London.

3.17 Capacity appears to be a constraint for some boroughs, with slippage averaging around 14% for 2007/08 for boroughs. Appendix D shows percentage capital programme delivery rates at individual borough and class of authority level for 2007/08.

3.18 The data suggests that London has not delivered its planned capital spending to the extent that other classes of authority have been able to. Whilst nationally, the average percentage of the capital programme delivered in 2007/08 was 98%, only 86% was delivered in London as a whole. Only 3 inner London boroughs delivered more than 90% of their capital programme, whilst 10 outer London boroughs delivered more than 90%.

## Capital expenditure for individual services

3.19 More detailed analysis of capital spending for the main local government services on a per head basis has also been undertaken, with this information being presented in Appendix E for 2006/07-2008/09. Based upon 2008/09 budgets, spending per head on education, housing and highways is roughly equal for England as a whole (at between £90 and £100 per head). The average for other capital expenditure is actually marginally higher, £111 per head. Spending is much lower for social services (£7 per head) and sports & recreation (£17 per head).

3.20 Spending on **education** is relatively similar across all the classes of authority considered. The similarity in the level of spending perhaps reflects the fact that this service is heavily driven by direct funding from central government. High slippage rates, of some 20%, possibly reflect anecdotal evidence about the difficulty that local authorities have had in delivering these complex education partnerships.

3.21 A significant amount of capital spending on **highways** in London falls to the Greater London Authority. Spending appears to be significantly higher in London than elsewhere in the country. Slippage is very low for the highways service.

3.22 Inner London consistently has the highest level of capital investment per head in **housing**. The core cities have levels of investment that are almost as high. We would expect these levels of investment, given the proportion of residents in these local authority areas that live in local authority housing. Investment per head in outer London is only just above the average for England as a whole, which possibly is explained again by the proportion of residents living in local authority housing. Making comparisons for investment in housing, however, is complicated by whether local authorities continue to own and maintain their housing stock. In those areas where stock has transferred to a registered social landlord, the capital investment on those properties will not appear in these figures.

3.23 Spending on **social services** is consistent across all classes of authority and slippage is relatively low for this area.

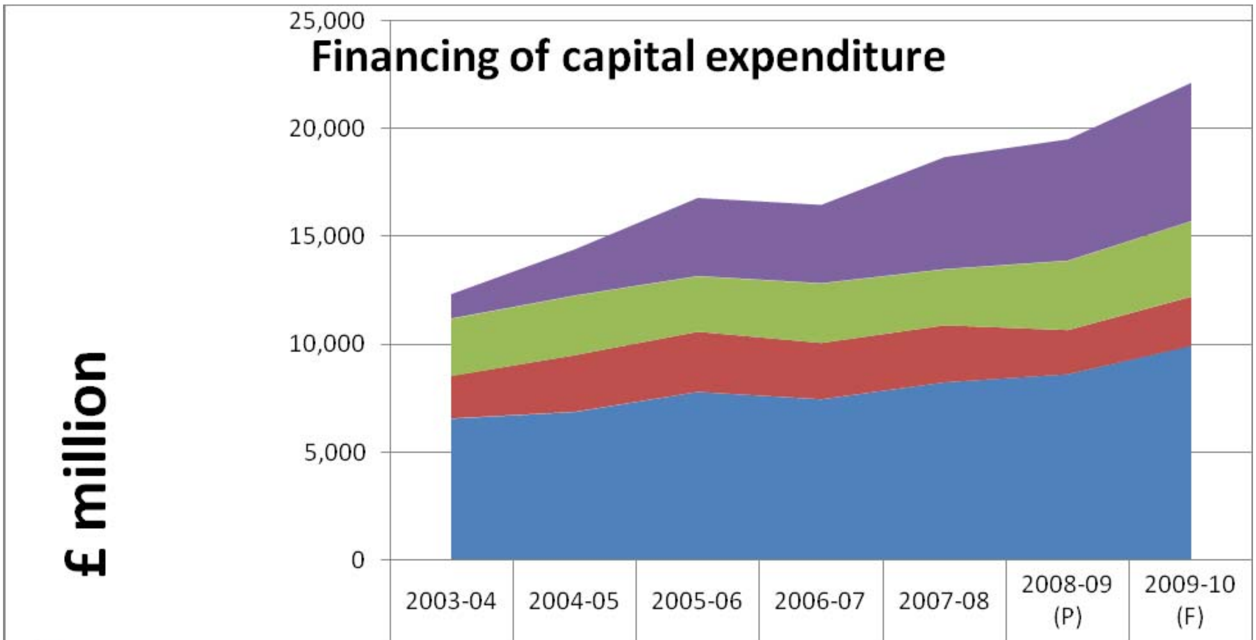
3.24 Planned investment in **sports & recreation** is very varied. This is probably because investment in these services is driven to a very great degree by policy choice and by the distribution of assets (e.g. where swimming pools are located) and whether leisure is provided through alternative service delivery models e.g. through Trust arrangements. Inner London consistently has the highest level of investment, however. Outer London has investment that is below the England average in 2006/07 and 2007/08, but is marginally above average in 2008/09.

3.25 Outer London boroughs consistently have the lowest level of investment in **other services**. Inner London is below the England average in 2006/07 and 2007/08, but the highest in 2008/09. Metropolitan districts as a whole are consistently below average, but core cities are above average. Considering individual London boroughs and metropolitan districts, it appears that the councils with the greater ‘city leadership’ roles tend to spend more on other capital expenditure: core cities spend more than metropolitan councils, and inner London spends more than outer London.

## Financing of capital expenditure

3.26 Figure 4 below shows how local authorities financed capital expenditure between 2003/04 and 2009/10. The chart shows that revenue funding and capital receipts have remained relatively stable (although capital receipts fell from 2007/08 levels in both 2008/09 and 2009/10), whilst there has been a significant increase in funding from other sources (primarily relating to unsupported borrowing) and from central government grants.

*Figure 4 – Financing of local authority capital expenditure 2003/04-2009/10*

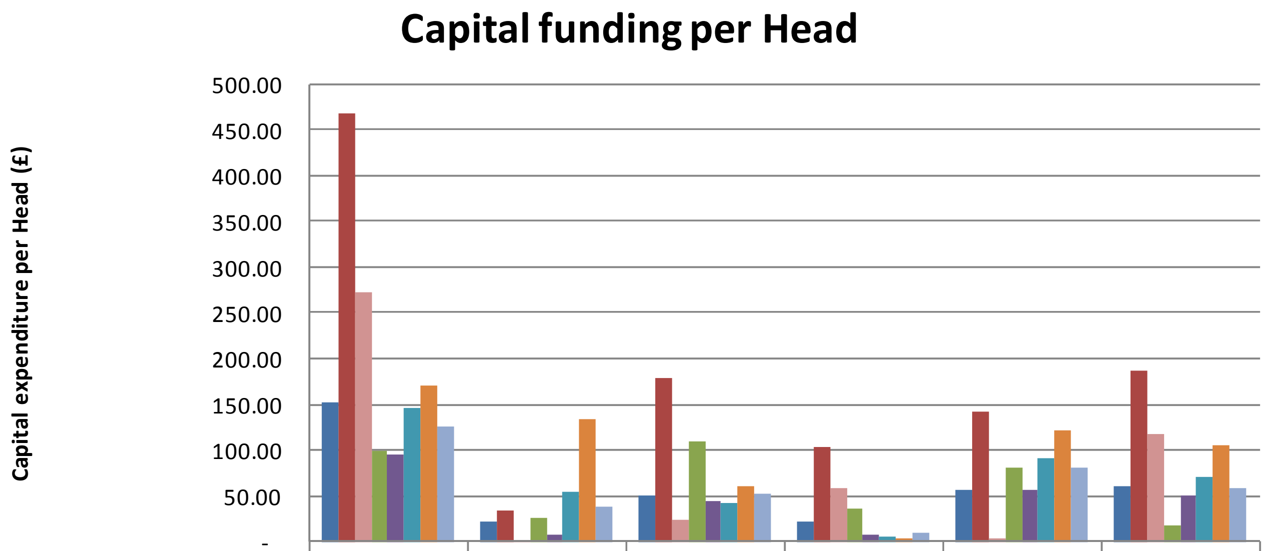



| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 (P) | 2009-10 (F) |
|---|---|---|---|---|---|---|---|
| Total other | 1,131 | 2,141 | 3,628 | 3,635 | 5,203 | 5,630 | 6,416 |
| Revenue | 2,655 | 2,757 | 2,569 | 2,763 | 2,593 | 3,212 | 3,496 |
| Use of usable capital receipts | 1,988 | 2,647 | 2,812 | 2,628 | 2,665 | 2,064 | 2,295 |
| Central government support | 6,551 | 6,859 | 7,788 | 7,446 | 8,233 | 8,611 | 9,935 |

*Source: Local Government Financial Statistics England No. 19 2009*

3.27 At a more detailed level, Figure 5 below shows the sources of capital expenditure for London and comparator classes of authority for 2007/08 actual expenditure.

*Figure 5 – 2007/08 sources of capital funding per head by class of authority*




| | Grants from Central Government 2007/08 | Contributions from Developers 2007/08 | Use of Capital Receipts 2007/08 | GF Revenue Funding 2007/08 | Single Capital Pot 2007/08 | Prudential Borrowing 2007/08 |
|---|---|---|---|---|---|---|
| England | 153.73 | 21.80 | 51.78 | 23.39 | 56.86 | 61.91 |
| London (incl GLA) | 469.40 | 35.30 | 178.91 | 104.49 | 143.21 | 187.25 |
| Greater London Authority | 273.89 | 1.21 | 23.45 | 58.87 | 3.95 | 117.18 |
| Inner London | 99.08 | 26.79 | 110.42 | 36.58 | 81.34 | 19.08 |
| Outer London | 96.42 | 7.30 | 45.03 | 9.04 | 57.92 | 50.99 |
| Metropolitan districts | 146.52 | 55.51 | 43.39 | 5.19 | 92.00 | 71.35 |
| Core Cities | 170.97 | 135.03 | 60.50 | 4.78 | 122.95 | 105.61 |
| London plus Mets | 126.49 | 38.78 | 53.89 | 10.90 | 81.62 | 58.25 |

*Source: DCLG Capital Outturn Returns (COR) and Capital Estimates Returns (CER)*

3.28 The graph shows that Inner London and Outer London received £31 and £57 per head less than the average national grant funding and supported borrowing per head, respectively, However, once the GLA is included, central government funding is more than three times as high per head.

3.29 Inner and Outer London boroughs generate developers' contributions which are only around three-quarters of the England average. Even inner London only receives around half the amount received by metropolitan districts and around one-fifth of the amount received by core cities. Based upon this analysis, the core cities appear to have been able to generate greater levels of funding from developers.

3.30 The British Urban Regeneration Association (BURA) undertook research for the London Assembly, "Who gains? The operation of section 106 planning agreements in London", which was published in March 2008. This report identified a range of issues in relation to developer contributions, including potential recommendations for improvement.

3.31 Inner London is particularly successful at obtaining capital receipts, drawing in more than twice per head the amount generated nationally or in the core cities. Outer London is around 10% below the national average.

3.32 Inner London tends to have relatively large amounts of revenue contributions to capital and undertakes very little prudential borrowing (the former is around 50% above the national average and the latter is a third of the average). Outer London, on the other hand, only contributes around a third of the national average level in terms of revenue funding, and undertakes more prudential borrowing than inner London.

# 4. Capital Need in London

## Introduction

4.1 One of the fundamental issues that the research sought to address was whether, and the extent to which, there is unmet capital investment need within London boroughs. As part of the research, therefore, the following survey questions were explored with boroughs:

- Is there is a need to increase the level of capital investment within your borough over and above existing levels?
- If so, approximately what total level of capital resources do you estimate your borough would need to fully deliver its capital priorities/needs, and over what period?
- What are the key services/areas where greater capital investment is required, quantifying where possible, and identifying the anticipated procurement approach to address these needs?

4.2 As might be expected, all boroughs who responded identified additional levels of capital need, with this being quantified by 19 of the boroughs responding. Clearly, such figures should be treated with a degree of caution, given that some boroughs had provided broader brush estimates and not all boroughs will have identified all need, only that which could be specifically quantified.

4.3 However, in overall terms, Figure 6 below shows the average annual funding 'gap' between existing capital resources and resources required to fully deliver boroughs' capital priorities/needs. The average annual funding need identified was £34m. Although it should be recognised that the level of capital need will not be consistent across all boroughs, in order to provide a sense of scale, simple extrapolation of this figure across all 33 boroughs equates to annual capital need over and above existing resources of around £1.1bn.

4.4 A number of boroughs also identified that they had needed to deliberately constrain their capital investment programme; for example, only using capital receipts to fund capital projects; using prudential borrowing for invest to save schemes only; and securing capital resources through inward private sector investment e.g. for regeneration. Other boroughs identified that the level of unmet capital demand can be hidden, as an annual capital bidding round is no longer in place, due to the limited funds available or with the capital programme only consisting of 'unavoidable items capital'.

*Figure 6 – Boroughs' projected average annual funding gap*

| Annual Funding Gap | Number of boroughs | Percentage |
|---|---|---|
| £5m-£10m | 3 | 16% |
| £11m-£15m | 1 | 5% |
| £16m-£20m | 2 | 10% |
| £21m-£25m | 3 | 16% |
| £26m-£30m | 2 | 10% |
| £31m-£35m | 1 | 5% |
| £36m-£40m | 1 | 5% |
| £41m-£45m | 0 | 0 |
| £46m-£50m | 3 | 16% |
| £51m-£55m | 0 | 0 |
| £56m-£60m | 0 | 0 |
| £61m-£65m | 2 | 10% |
| £66m + | 1 | 5% |
| **Total** | **19** | **100%** |

*Source: London Councils Capital Investment Survey (September 2009)*

4.5 Key issues identified in relation to individual service areas have been highlighted below.

4.6 **Education.** The level of capital investment need in schools generally ran into tens of millions of pounds for boroughs responding to the survey, with this largely being delivered through the Building Schools for the Future programme via Local Education Partnerships (public-private partnerships developed to ensure the building of the schools), with the BSF programme leading to more strategic procurement of infrastructure projects. Subject to the outcome of the next Comprehensive Spending Review, funding for future BSF projects looks more secure than for other areas, as it is a national priority area. The procurement arrangements are, however, complex and this is an area where having access to expertise from boroughs that have already gone through or who are further ahead in the process appears particularly relevant.

4.7 **Housing.** Significant gaps (over £100m for some individual boroughs) were identified in bringing homes up to the Decent Homes Standard, with it not always being clear how this will be financed. The consultation paper on reform of the housing subsidy system may allow greater financial freedoms and the redistribution of housing debt might favour larger housing authorities such as those in London, although the precise detail of such proposals are not currently fully clear. Additional PFI credits have been issued for social housing schemes and this will make a contribution to addressing needs; however, such resources will spread across England and London may receive a comparatively small proportion.

4.8 A number of boroughs also expressed significant concerns over expected Decent Homes funding being withdrawn, with this being ‘switched’ to build new affordable housing, as part of announcements made in, “Building Britain's Future”, which was published in April 2009. More widely, innovative development of housing companies is on the agenda and have been considered further under section 10 in relation to capital receipts and asset leverage, although, following the fall in housing values brought on by the recession, the business cases for these models have become more difficult to deliver.

4.9 **Transport.** Transport issues were explored with Transport for London (TfL) directly. Whilst TfL is a local authority, unlike other local authorities, the majority of its operations are carried out through trading subsidiaries such as London Underground Limited and it operates akin to a private sector group structure. When it was formed, TfL had a low borrowing base, as most of its capital spending had been financed by grant and there was limited external borrowing. Consequently, at its inception, there was scope for more on balance sheet borrowing and additional public private partnerships.

4.10 In 2007, TfL secured a 10-year funding settlement with the GLA, amounting to £39.2bn over the 10-year period 2008/09 to 2017/18. The settlement represents an effective limit on TfL’s spending during this period, even though, as an entity with significant income generating potential, its scope for additional prudential borrowing schemes is very significant. Whilst core borrowing could therefore potentially be substantially increased, with the £39.2bn limit having no legal force, once the settlement is set, as a convention, it is complied with.

4.11 This settlement covers funding for Crossrail, support for the Tube line upgrades and the remainder of TfL’s operations. However, funding for operational services is constrained, so TfL has launched a major efficiency programme to maximise the effectiveness of its expenditure. The Crossrail project is expected to be the beneficiary of Business Rate Supplement (BRS) funding under new legislation. The Act states that BRS for Crossrail will not be subject to a vote, unlike other BRS schemes. This business rate income is therefore effectively a hypothecated income stream, dedicated to the Crossrail development.

4.12 **Other services.** Less need was explicitly identified e.g. for areas such as cultural assets; social services; leisure; regeneration; community safety; ICT, than for the core services considered above. A number of boroughs also identified that office accommodation/rationalisation schemes were in place, some of which were linked to wider regeneration initiatives.

4.13 Waste disposal did not feature highly in the survey responses. However, Defra was given a further £2bn of funding through PFI credits in the Comprehensive Spending Review 2007, which is available to English local authorities to invest in sustainable waste management options. The PFI credits available rise from £280m in 2007/08 to: £600m in 2008/09; £700m in 2009/10 and £700m in 2010/11. We are aware that London has benefited from these additional resources; for example, the South London Waste Partnership was awarded £112.9m of PFI credits in March 2009.

4.14 Given the overall scale of capital investment need identified by boroughs, the research went on to consider key constraints in relation to enabling (and increasing, where appropriate) the level of capital investment within London and ways in which boroughs could potentially overcome such constraints.

4.15 Section 5 of this report highlights boroughs' views on general constraints that they are currently facing in relation to capital investment, with section 6 considering more specific technical constraints e.g. legislative and accounting, in further detail.

# 5. Capital Investment Constraints

## Introduction

5.1 As part of the research, boroughs were asked to identify the particular constraints that they currently face in relation to capital investment, including providing a 'ranking' of the top 3 constraints. Figure 7 presents a summary of boroughs' views. To provide a sense of scale, this is based upon a reverse points score, as follows:

- Most important constraint - 4 points
- Second most important constraint - 3 points
- Third most important constraint - 2 points
- Identified as an issue (although not ranked in the top 3) - 1 point

*Figure 7 – Key capital constraints identified by boroughs, based upon rankings*

| Constraint | Total points |
|---|---|
| Decreasing levels of capital receipts | 72 |
| Limited availability of revenue budget resources to contribute to capital | 59 |
| Falling property prices | 32 |
| Reducing levels of capital grant | 22 |
| Reducing private sector contributions | 21 |
| Barriers in relation to legislation, regulations or accounting practice | 19 |
| Desire not to exceed maximum levels of debt | 19 |
| Lack of internal capacity/skills | 16 |
| Inability to deliver capital projects due to slippage in the programme | 16 |

| Constraint | Total points |
|---|---|
| Complexity of procurement arrangements | 13 |
| Difficulties in closing PFI, PPP or BSF deals | 13 |
| Reduced availability of capital financing from lenders | 8 |
| VAT partial exemptions limit | 1 |

*Source: London Councils Capital Investment Survey (September 2009)*

5.2 This information can also be presented based upon the percentage of boroughs that considered each of the constraints to be an issue to some degree, as shown in Figure 8.

*Figure 8 – Key capital constraints identified by boroughs, based upon the percentage of boroughs identifying each constraint as an issue*

| Constraints | Percentage |
|---|---|
| Decreasing levels of capital receipts | 100% |
| Limited availability of revenue budget resources to contribute to capital | 96% |
| Falling property prices | 91% |
| Reducing private sector contributions | 78% |
| Reducing levels of capital grant | 74% |
| Inability to deliver capital projects due to slippage in the programme | 61% |
| Barriers in relation to legislation, regulations or accounting practice | 61% |
| Desire not to exceed maximum levels of debt | 61% |

| **Constraints** | **Percentage** |
| --- | --- |
| Complexity of procurement arrangements | 57% |
| Lack of internal capacity/skills | 52% |
| Difficulties in closing PFI, PPP or BSF deals | 48% |
| Reduced availability of capital financing from lenders | 35% |
| VAT partial exemptions limit | 4% |

*Source: London Councils Capital Investment Survey (September 2009)*

5.3 It can be seen that, in both cases, the 'top 5' constraints identified (in order of priority) related to:

(i) Decreasing levels of capital receipts

(ii) Limited availability of revenue budget resources to contribute to capital

(iii) Falling property prices

(iv) Reducing levels of capital grant

(v) Reducing private sector contributions

5.4 Clearly, the first and third issues above could also potentially be interlinked, if reducing property prices mean that assets have not been sold, as their previous value would not be realised, thereby reducing capital receipts levels.

5.5 The limited availability of revenue budget resources to contribute to capital has been identified as a major issue by boroughs at the time of our research. Clearly, this is before any expected further pressures on local authority funding occur, from 2011/12 onwards. This will therefore become of even greater significance in future, as a major constraint upon local authorities' ability to invest in capital.

5.6 Expected reductions in the level of capital grant have already been highlighted, in the context of overall reductions in capital investment. Reducing private sector contributions is an issue which appears to have affected London boroughs, in particular. The British Urban Regeneration Association (BURA) has undertaken research for the London Assembly, "Who gains? The operation of section 106 planning agreements in London", published in March 2008, which contains a range of recommendations in relation to this area.

## Effect of the economic downturn

5.7 The effect of the economic downturn as a specific constraint was also explored in further detail with boroughs, in order to identify whether the downturn had had any effect, and the extent of any such effect, on capital investment plans. The significant majority of boroughs identified that the economic climate had affected their capital planning adversely, with key issues identified being summarised in Figure 9 below, including the number of boroughs who raised each issue as a concern.

5.8 A number of these issues will link directly back to the constraints identified above e.g. reduced value of capital receipts, although some e.g. reduced income receipts, will have an indirect impact, through reducing revenue budget availability to support capital investment. Illustrations of comments made by individual boroughs have also been provided overleaf.

5.9 More widely, on 13 August 2009, Capital Ambition published, “Responding to recession: An innovation and good practice guide”, which aims to share best practice from London boroughs who are keen to share information about what can be done to most effectively assist residents and businesses experiencing financial difficulties as a result of the recession.

*Figure 9 – Issues raised and comments provided by boroughs in relation to the effect of the economic downturn*

| Issue | Number of boroughs | Comments made |
|---|---|---|
| Reduced value of capital receipts/inability to dispose of assets as planned | 20 | Wider regeneration schemes are more difficult in the downturn, due to lack of developer interest (difficulties in obtaining finance, and falling property prices).<br><br>As a result of the difficult economic conditions, it proved impossible to sell a number of planned disposals in 2008/09 - these planned disposals had a total projected receipts value of £6m. Reduced disposals may lead to increased borrowing and subsequent pressure on revenue budgets or may lead to a reduced capital investment programme. A number of regeneration and housing schemes have been deferred as a result of private sector partners revising their financial position. As a result of revised projections for disposal receipts, the Council reviewed and amended plans to redevelop civic accommodation.<br><br>Land disposals programme of approximately £50m over 5 years has reduced to nearly zero on current projections.<br><br>We have had to reduce our target for General Fund capital receipts in 2009/10 from £6.25m to £3.25m with the funding replaced by a revenue contribution<br><br>Three significant disposals have been indefinitely delayed due to a reduction in the amount developers are willing to pay; in some cases developers have been renegotiating previously agreed values, resulting in no sale (an example being one site, initial offer £8m, revised offer £2.5m),. This has reduced receipts by approximately £18m. Some major projects have been indefinitely delayed, an example – major redevelopment of part of Town Centre.<br><br>Our Right to Buy sales in 2008/09 were down 88% on 2007/08. We have had to revise downwards |

| Issue | Number of boroughs | Comments made |
|---|---|---|
| | | our RTB projections to 2014/15 by £18.6m and cut our Housing capital programme accordingly.<br><br>Decline in Right to Buy sales (approx. £5m per annum compared to 2007/08); other sales taking longer to achieve. |
| Reduced capital support from government | 9 | The Government has withdrawn its offer of £112m Decent Homes funding, which the council was due to receive once its ALMO achieved a two star rating<br><br>The floor issue (see para 6.9) means that borrowing allocations do not come with revenue support.<br><br>Yes – reduction in Growth Area Funding of £1.2m. |
| Increased demand on services | 7 | This reduces flexibility in terms of both revenue and capital.<br><br>Demand for temporary accommodation increasing, generating homelessness service pressures. Increased demand for school places leading to the need to build additional accommodation.<br><br>Both a significant increase in birth rate and proportion of birth cohort applying for primary school reception places (increased from 80% to 89% in past three years) requires 15 additional classes required by September 2011. Estimated capital cost £50m based on DCSF funding calculator (plus purchase of land for one new school). |
| Reduced income receipts | 6 | Impact will be on availability of revenue funding to support ongoing costs<br><br>£1m effect – some income is expected to be less than budgeted (e.g. parking income)<br><br>Shortfalls in income projections for land and property charges |

| Issue | Number of boroughs | Comments made |
|---|---|---|
| | | Examples of areas where income receipts are below expectations and the scale of these reductions include: building and development control £462k; trade waste income £383k; concert income £250k; leisure centres and hire of premises £140k; car parks £91k; open spaces sponsorship fees £75k.<br><br>Significant impacts from the slowdown include a reduction in Section 106 agreements, search fee income, planning and building control income. |
| Inability to secure financing | 5 | Yes - developers, rather than the council itself.<br><br>The revenue cost of borrowing is unaffordable by the Council. Borrowing to invest is becoming increasingly difficult to secure, due to the stricter levels of regulation.<br><br>Need government guarantees to support borrowing requirements.<br><br>Private sector can't raise finance to come in; they also foresee difficulties in selling houses, so delay starting. |
| Future increased pension contributions | 5 | Impact will be on availability of revenue funding to support ongoing costs.<br><br>Potentially significant at £4 to £5m in 3 years – increase in pension fund contributions. |
| Increased bad debts | 3 | Potential effects but unable to quantify currently.<br><br>Yes, to some extent (though not too much that we can quantify clearly) |
| Poorer value for money in PPP, PFI and BSF | 2 | BSF – The complicated company structure required to meet the criteria for this programme does |

| Issue | Number of boroughs | Comments made |
| --- | --- | --- |
| transactions/higher procurement costs | | not seem to deliver any real value when compared with other procurement options.<br><br>BSF is proving to be costly and the costs may not be sustainable |

*Source: London Councils Capital Investment Survey (September 2009)*

## Stimulating economic recovery

5.10 In addition to considering the impact of the economic downturn, the research also explored whether there were any measures in relation to capital investment that boroughs believed could potentially stimulate economic growth. There were a range of measures identified that had been put in place by boroughs, either specifically, or where an indirect consequence of investment would be to stimulate economic growth. These are explored in further detail below.

5.11 A number of projects to regenerate borough town centre locations were identified. The intended benefits of such schemes (funded through direct council resources or also including grant contributions from other bodies) were to encourage enterprise and employment in the area, delivering improvements such as high quality housing, new retail and leisure facilities and providing impetus for economic growth. One borough identified that, although it believed that a major regeneration scheme for its town centre would potentially stimulate the local area; in current market conditions, it was unlikely to be able to find finance for such regeneration.

5.12 Increased investment in public transport links was also identified as having significant potential to stimulate economic growth, by connecting relatively isolated commercial and residential areas. A specific example related to the 2012 Olympics, with regards to the Stratford City development, Olympic Park and opening up routes across docklands areas between DLR stations. In the longer term, the intention is to also achieve legacy benefits following on from the completion of the Olympic Games, in terms of future leisure use.

5.13 Olympic boroughs also have job brokerage schemes in place and have a role in monitoring economic development information in relation to Olympic works; for example, proportion of local companies undertaking work, value of contracts, numbers in employment etc. A number of borough planned capital schemes have also been brought forward, in order to take advantage of matched funding opportunities for the Olympics.

5.14 The Crossrail project for new transport links within London (which boroughs contribute funding to via the Business Rate Supplement to the GLA) was similarly identified as an area where it is expected that contribution to capital investment could stimulate economic growth within boroughs and across the capital more widely.

5.15 The provision of mortgages/guarantees to potential householders was identified by one borough as a potential stimulus to the market, although this was considered to be one element in an overall strategy of investment. Another borough, however, felt that the provision of mortgages/guarantees was not an area that local authorities should become involved in, as banks provide this activity on a commercial basis and, unlike local authorities, have developed the expertise in risk management to do. Alternative measures included low cost home ownership and intermediate housing, with RSL shared ownership schemes being identified as ‘drying up’ (as banks believe these to be high risk).

5.16 The bringing forward of capital funding, as a measure to increase capital works activity, was considered by some boroughs to have stimulated growth and employment. Examples provided included the government accelerating the Schools Modernisation Capital Programme and the Homes and Communities Agency bringing forward funding from 2010/11 to 2009/10.

5.17 One borough also considered that developments within local government to consider creating local banks could be important, as these bodies could be in a much better position to fund longer term investment in infrastructure than the prevailing banking system.

# 6. Legislative and Technical Barriers to Capital Investment

## Introduction

6.1 Technical and legal issues can often become barriers to enabling capital expenditure. In this section of the report, we have sought to identify issues where the rules, whether in statute or non-statutory proper practice, could potentially be changed to either provide more flexibility, more resources or more choice in how local authorities manage their activities in relation to capital investment.

6.2 Some of these issues were identified from survey responses provided by boroughs; in particular, Housing Revenue Account reform; reducing capital grant ring-fencing; revenue funding for supported borrowing allocations; and Section 106 constraints.

6.3 LG Futures has considerable expertise and knowledge of the technical aspects of the local authority capital controls and related regulations. We have employed that expertise to consider more ‘radical’ potential changes to these regulations, in addition to other technical issues.

6.4 Individual topics below are intended to provide an indication of the key relevant issues, firstly considering those specifically raised by boroughs, before going on to consider further potential technical barriers. It should be recognised that the topics covered are not exhaustive and the descriptions provided are necessarily summarised. Any local authority wishing to consider any actions in respect of any the issues raised should clearly seek further advice from their legal or accounting specialists.

6.5 We have initially provided an explanation of the specific issue, before considering the change that might be sought, the potential impact of any change and a view as to potential issues which could have immediate benefit, and those which would require legislative change. Such legislative change is likely to be more difficult to achieve in practice, particularly where bodies such as HM Treasury and CLG may have concerns over such changes. Recommendations have then been provided, linked to each of the respective issues.

## Issues identified by boroughs:

## Housing Revenue Account reform

6.6 The Housing Revenue Account (HRA) and associated requirements have proven to be a barrier to certain aspects of capital finance, but the government’s, “Reform of council housing finance: consultation”, published in July 2009, may assist in addressing such barriers. These issues are summarised below, and boroughs should have given consideration to these issues in compiling their responses to the CLG consultation paper, which were due by 27 October 2009.

- The ending of the pooling of housing capital receipts, which has diverted resources from Right to Buy, from areas where sales take place, to other areas. This regulation restricts the level of receipts retention by a local authority (25% is retained by the authority and 75% is pooled by central government). This is expected to benefit London boroughs, in general, given the relatively higher level of housing capital receipts that they are likely to generate.
- The consultation paper recognises that, under the prudential system, local authorities may wish to borrow to fund investment. It is suggested that the new arrangements could result in a significant increase in the available prudential borrowing. The consultation paper expresses concern about this potential growth and indicates that government are currently considering whether and how any local flexibilities for new investment could be reconciled with the need to ensure that the overall fiscal position for government is not undermined.
- 14 councils have been developing proposals to establish Local Housing Companies (LHC), that combine public land and private finance to deliver new mixed tenure housing. Current market conditions have created difficulties in taking the next steps. The consultation document states that the HCA will explore with the pilots how to make progress and sees self-financing as a way forward.

**It is recommended that boroughs maintain a watching brief on government proposals in relation to the HRA and respond accordingly, as further details of their potential impact become available. This will include ensuring that authorities retain responsibility to self-determine whether it is prudent and sustainable for them to borrow for capital purposes in relation to the HRA, with no additional restrictions being imposed.**

## Reduction of ring-fencing of capital grant

6.7 There is an inevitable tension between the wishes of central government to ensure that capital grants are spent on approved projects, with the desire amongst local authorities to have greater discretion in relation to spending. The range of grants involved and the differing arrangements for each can therefore be a complication.

6.8 Examples cited by boroughs where there is potential for reductions in ring-fencing included the pooling of HCA funding with LDA and any other significant housing funding (excluding Decent Homes) into a single pot, administrated on a sub-regional basis and more flexibility for Dedicated Schools Grant (DSG) to contribute to schools' capital.

**It is recommended that central government considers a more standardised approach to the arrangements in relation to capital grants, with a small leeway e.g. 5/10%, for**

**local discretion, as long as the overall objectives of the relevant central government department are safeguarded.**

## Revenue funding for supported capital borrowing

6.9 Supported borrowing is not perceived to work effectively for councils at the Formula Grant floor, which is the position for around three-quarters of London boroughs, with increases in net support for capital financing not feeding through into the grant actually received by a council. Therefore, if a council has received additional notional support for capital borrowing, there is no mechanism to ensure that this additional notional funding actually reaches the council. In past settlements, there has been an adjustment to ensure that increases in notional capital financing actually feeds through to grant, but this ended from 2005/06.

**It is recommended that CLG considers, as in past settlements, an adjustment to ensure that increases in notional capital financing actually feed through to grant (this previously ended from 2005/06).**

## Section 106 receipts

6.10 The Planning Act 2008 provides for the introduction of a new statutory charge on landowners who benefit from development - the Community Infrastructure Levy (CIL), and this levy will have a major impact on Section 106 agreements. The CIL builds on the idea of 'tariff' proposals, such as the Milton Keynes 'roof tax', where a clear link between development and contributions from the private sector is made. One of the major potential benefits of this system is intended to be that it overcomes the problems of negotiation and delay that can characterise Section 106 agreements.

6.11 Section 106 agreements will remain available to local authorities after the CIL regulations come into force and developer contributions towards affordable housing will continue to be made through planning obligations. The government considers that the existing Section 106 tariff schemes should, over time, be migrated to CIL and the ability to establish a new tariff should be prevented after a short transition period , possibly by April 2012, when Section 106 obligations would be restricted to impacts solely caused by development. Our comments below are therefore made on the basis of the existing arrangements, which are in the process of being changed.

6.12 Whilst national legislation sets out the general principles under which the existing planning obligations can be acceptable, it is local authorities that are empowered to interpret and apply Section 106. There are different interpretations of this guidance, which result in considerable policy variations between boroughs in London. The variations in authorities' approaches to Section 106 have led to a number of commentators raising concerns as to whether the community is getting the best out of these agreements, with recent criticisms of the current system of negotiating planning obligations including:

- The fact that agreements are difficult to enforce
- There is often no coherent strategic approach to negotiating Section 106 agreements
- The community has little involvement in determining how it is used
- Councils cannot afford to hold ‘big corporate players’ to legal agreements
- Councils are often forced into renegotiation of legal agreements by large developers, leading to a diminution of agreed community benefits
- Large developers use Section 106 agreements for ‘unfair leverage’ to influence council planning decisions

6.13 Section 106 agreements have had the potential to raise significant sums in a dynamic environment. The level of Section 106 receipts has reduced significantly as a consequence of the credit crunch, but the system, which is 20 years old, will require further review, alongside the impact of the new CIL. As identified previously, more specific research has been undertaken by the British Urban Regeneration Association (BURA) for the London Assembly in this area, with the publication, “Who gains? The operation of Section 106 planning agreements in London”, being launched in March 2008 and identifying a range of issues for consideration by London boroughs, in order to maximise the benefits of Section 106.

**It is recommended that boroughs consider the BURA recommendations, in order to maximise the benefits of Section 106 funding, and keep a watching brief over national developments in relation to Section 106/CIL.**

## Further issues identified:

## Capitalisation of procurement costs

6.14 Procurement costs of capital projects are significant and there are instances of these running to several millions of pounds. These costs are treated as revenue, until such time as there is certainty that an asset is to be created, after which they can be capitalised. From 1 April 2009, most PFI deals will become on-balance sheet; consequently, procurement costs that add to the value of the capitalised asset can themselves be capitalised. This will apply to both past schemes and schemes in procurement. As a rule of thumb, expenditure post-appointment of preferred bidder can be considered for capitalisation.

6.15 Allowing local authorities to capitalise procurement costs in respect of all capital projects, including PFI (without the risk that they might have to be charged to revenue if the project failed) would free up revenue resources, and could make councils less concerned about embarking on speculative capital projects; however, would run counter to current accountancy rules. In order to achieve this, changes to the capital controls would need to be requested, although it appears unlikely that CLG will support further relaxation.

**It is recommended that central government considers whether further flexibility could be introduced to capitalise such procurement costs, although changes to the capital controls would be required.**

## Capitalisation of interest

6.16 Local authorities are permitted to capitalise interest on the construction of relevant projects (for example, the redevelopment of an area where the work lasts over a year). To the best of our knowledge, this is not taken up by many authorities, even though it is acceptable in UK and international accounting. This could potentially free up significant amounts of revenue spending in the short term – potentially £1m or more for a large-scale project – although, eventually, the costs would have to be charged to the revenue account through Minimum Revenue Provision (MRP).

6.17 Although accounting rules permit the capitalisation of interest, historically, this has been discouraged. The development of new accounting procedures under IFRS could clarify that this is acceptable. The CIPFA consultation paper on the new accounting code left this question open. It is now apparent that a compromise arrangement has been agreed and the capitalisation of interest on relevant qualifying capital projects will feature in the new IFRS Code.

**It is recommended that boroughs consider the scope for them to capitalise interest on such projects and the potential spending capability it may provide.**

## Widening the scope of capitalisation orders

6.18 Local authorities can apply for capitalisation orders under strictly defined instances when they face revenue funding issues e.g. for redundancy costs. These orders make revenue expenditure capital for the purpose of local authority capital controls. There could be a case for an order that could defer revenue costs from impacting on the revenue account for a defined time – this could be for procurement costs as above, or it could be for projects where (as is commonly the case for major strategic partnering acquisitions), the future revenue stream will pay for the current costs but, in the short term, there is a deficit.

6.19 This would require legislative change, unless it can be accommodated through the Accounts and Audit Regulations, and it may be unlikely that CLG would be willing to consider expanding the scope of capitalisation orders. The deferment of the bad debt provisions/impairment charges arising from the implementation of proper accounting arrangements concerning investments in Icelandic banks illustrates how this might work, although this was driven by emergency financing issues, rather than efficiency or spend to save considerations.

**It is recommended that central government considers whether such an order could be introduced, although this would require legislative change, unless it can be accommodated through the Accounts and Audit Regulations.**

## Minimum Revenue Provision

6.20 The rules for MRP were previously set out in the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. These rules have now been revised by the Local Authorities (Capital Finance and Accounting (England) (Amendment) Regulations 2008.

6.21 Under the previous regulations, authorities were required to set aside each year, from their revenue account, an amount that equalled approximately 4% of the amount of capital expenditure financed by borrowing (for the general fund), with no discretion being available to authorities in relation to this requirement. The amended regulations introduced a duty for an authority to set aside an amount of MRP which it considers to be 'prudent'.

6.22 As an example of the use of this flexibility, instances exist where all the MRP relating to regeneration schemes is being deferred pending the scheme completion. The short-term deferment of MRP can assist with affordability, but clearly the benefit, when modelled, will erode, as interest costs are incurred on the debt where no provision for repayment has been made.[2] Our research identified a mix of approaches amongst boroughs in relation to MRP, although the majority of authorities had continued to use Option 1 (known as the regulatory method) for schemes funded by supported borrowing and Option 3 (known as the asset life method) for schemes funded by unsupported borrowing.

**It is recommended that boroughs keep their approach to MRP under review, in line with the flexibility for charging MRP and that CLG asks CIPFA to issue a practice guide on MRP arrangements.**

## Mortgaging of assets

6.23 Local authorities are not permitted to mortgage their assets and secure borrowing against them. They borrow based upon their legal position and on the fact that all borrowing is effectively secured by the future tax revenues of the authority. Allowing mortgages against defined assets might, however, have the potential to leverage in some additional resource e.g. for income generating assets, such as car parks. This can already be achieved by the use of local authority companies and by structured procurement. However, allowing loan finance through the authority, rather than through off-balance sheet vehicles, would perhaps secure finance at lower cost.

[2] The deferment of MRP will need to be modelled to identify the financial impact of the higher finance costs that are being incurred compared to the actual costs. Typically, deferment of MRP will have savings for a number of years, but will eventually result in higher revenue costs.

6.24 The bar on mortgaging assets is a long standing position taken by HM Treasury and embodied in law. Given the responsibility placed upon local authorities under the prudential code, a change linked to safeguards could be argued. A change in legislation would be required and may be difficult to effect in practice.

**It is recommended that central government considers whether there is scope to permit mortgages against defined assets, although a change in legislation would be required.**

## Securitisation of income

6.25 Securitisation of income streams (raising money by creating a charge against future income streams) is not permitted under local authority capital legislation. Subsection 13(3) of the Local Government Act 2003 states that, "All money borrowed by a local authority (whether before or after the coming into force of this section), together with any interest on the money borrowed, shall be charged indifferently on all the revenues of the authority".

6.26 Potentially, this approach could be used to finance income generation schemes – either revenue or capital. This has been achieved when authorities have used off-balance sheet vehicles or linked asset creation with procurement processes. Advisers have referred to vehicles which have been proposed where future housing rents are securitised in return for a housing association delivering Decent Homes Standard over a defined period of time. However, we are informed that uncertainty over the legal standing of such proposals has contributed towards their inability to get off the ground. However, if endorsed by legislation, it could potentially take place more frequently.

6.27 This is a long standing position taken by the HM Treasury and embodied in law. Given the responsibility placed on local authorities under the prudential code, a change linked to safeguards could be argued. Change in legislation would be required and may be difficult to achieve in practice.

**It is recommended that central government considers whether there is scope to permit securitisation of income, although a change in legislation would be required.**

## Tax Incremental Financing schemes (TIFs)

6.28 The development of tax incremental finance arrangements could facilitate regeneration projects. Cases have been developed for Accelerated Development Zones (ADZs), which would require legislation (or modification of existing regeneration/enterprise zone legislation); allowing authorities to regenerate defined zones based on future incremental tax increases. ADZs are intended to be financed from Non-Domestic Rates, but, in principle, other TIFs could be financed by a range of other incremental taxes e.g. increased stamp duty, VAT or corporation tax. ADZs could potentially be used to raise many millions of pounds of capital to invest in improvements, but at the risk of higher borrowing.

6.29 There may be reluctance from HM Treasury to provide guarantees to local authorities sponsoring such arrangements, to protect them against loss if the increases in tax revenue did not materialise and public borrowing had been employed, although the Treasury previously indicated a willingness to contemplate pilot studies e.g. the core city authorities have been developing such approaches. The Pre-Budget Report of December 2009 has since confirmed that the government will, "continue to examine the framework needed to implement tax increment financing and consider the primary legislation that would be needed if schemes were to be introduced"; although no TIF pilots will be introduced at the present time. This issue is considered in further detail under section 11 – New income streams.

**It is recommended that London Councils works with boroughs to gauge the potential level of interest in TIF/ADZ schemes; in particular, the scope for cross-borough working, and that boroughs keep a watching brief on national developments in this area.**

## Mortgage arrangements

6.30 Local authorities could potentially achieve more active involvement in housing by providing 'top-up' mortgages to stimulate the housing market and create economic activity and regeneration. The required legislation is in place, but the use of this legislation has lain dormant, during the previous period of sufficient resources from banks/building societies. The development of schemes could potentially be implemented now and would be aided by coordinated negotiation with appropriate building society partners, with business cases for volunteer local authorities potentially being prepared.

**It is recommended that boroughs consider whether the provision of mortgages within their area could provide potential benefits to homebuyers, subject to the assessment of financial risk.**

## Private sector leasing

6.31 The approach of paying rentals through private sector leasing schemes to landlords in relation to temporary accommodation can be a significant cost to authorities. A vehicle has been used in the past that provides the temporary accommodation required by a council in the short term, at the same terms as currently paid to private landlords. However, it also uses the revenue funding to pay down debt over time, so as to enable some or the entire property portfolio to eventually be converted to permanent affordable social housing.

6.32 This is the approach used by LB Newham to leverage in £200m, but the approach is no longer implementable owing to housing benefit regulations changes. These changes have meant that lower housing benefit is receivable on temporary accommodation leased by local authorities. In changes due to have effect from 1 April 2010, the maximum subsidy payable is linked to 90% of the local housing allowance plus £40 – this is much lower than when the Newham deal was signed.

6.33 This model was designed to fit circumstances that prevailed when it was introduced, and although it can no longer work in the original form, nonetheless, it provides an interesting example of what can be achieved by working with former regulatory arrangements.

Case study 1: The Newham partnership with Local Space housing association

Local Space was originally established to deliver a partnering contract with the London Borough of Newham to supply 1,000 settled homes over two years. The London borough leased 450 homes valued at £50 million to the Association for a 125-year period, while retaining the freehold. These properties had been used for many years by the council as temporary accommodation housing homeless households on council Non-Secure Tenancies.

Local Space has handed the homes back to Newham, but retained the leases. The Royal Bank of Canada originally provided the Association with a loan facility of £200m against the value of the leases. The loan is serviced by the Association's rental income, which is paid by housing benefit.

The Housing Corporation committed £25 million of social housing grant to the purchase of the first 1,000 homes. Newham uses the properties to house homeless households and is responsible for their day-to-day management.

The mortgages are to be repaid after 15 years and, at that date, the temporary accommodation converts into good quality permanent accommodation, with 100% nomination rights passing to the council.

Local Space established an innovative and efficient acquisition vehicle in partnership with a range of private sector agents. This efficient model helps to minimise the usual development risks for the association of time and cost over-runs, incentivising the agents to high quality delivery of ready-to-let properties.

In summary, Local Space creates public assets by diverting housing benefit away from the short-term use of expensive private rented houses and flats, to the creation of high quality long-term social housing. The establishment of Local Space and the transfer of the 450 equity units has allowed significant private finance to be made available to enable the acquisition of 1,000 properties in less than two years.

**It is recommended that boroughs consider whether approaches using elements of the model may enable capital finance to be secured, perhaps for different forms of grant and income streams.**

## Well-being powers

6.34 There are concerns that the wellbeing powers are insufficient to provide legal backing for a range of activities linked to collaborative working, highlighted by the London Authorities

Mutual Limited (LAML) case. Although an amendment to the Local Democracy, Economic Development and Construction Bill has provided a specific power to enable councils to engage in mutual insurance arrangements, there remains uncertainty as to how far local authorities can proceed with joint and collaborative ventures; for example, on joint procurement and the effectiveness of cross-guarantees between local authorities.

**It is recommended that central government provides clarification over powers in this regard, in order to provide greater certainty to authorities.**

6.35 Whilst removing such legislative and technical barriers clearly has the ability to enable greater capital investment, it should, however, be recognised that these can only go so far, whilst authorities have limited revenue budget availability to contribute towards servicing additional capital debt. This applies, in particular, to authorities who are at the funding floor.

6.36 Having considered background issues in relation to capital investment and key constraints, the remainder of this report goes on to consider ways in which capital investment could, potentially, be enabled. These issues are considered under the following broad themes:

Section 7 – Scope for Better Asset Management

Section 8 – Prudential Borrowing

Section 9 – Innovative Procurement and Joint Working

Section 10 – Capital Receipts and Asset Leverage

Section 11 – New Income Streams

Section 12 – New Forms of Finance

# 7. Scope for Better Asset Management

## Introduction

7.1 In times of recession or austerity, it is clearly even more important to ensure that all existing assets and infrastructure is managed and maintained as optimally as possible. There has been an increasing focus on improving asset management in recent years, and the expectation is that local authorities now have better controls and knowledge of their assets than they did a decade ago.

7.2 HMT's Operational Efficiency Programme (OEP): Property strand, published in May 2009, set out the government's intentions to achieve savings from the public sector estate. This publication identified potential efficiencies of £20 billion in receipts from property disposals (excluding council housing), over the next 10 years, and £5 billion a year savings in running costs across the whole public sector estate. The 2009 budget set a target for £16 billion in receipts from property and other assets over the three years from 2011/12, with the expectation that £13 billion of this will come from local government property disposals.

7.3 Good asset management is a demanding task, requiring knowledge of the future service needs for the activity that the asset supports, and detailed knowledge of each asset to determine such information as its condition; utilisation; market value; replacement cost; future service potential; and tenure. All these factors could influence when, or if, a disposal should take place, when, or if, major refurbishment takes place and when repairs are required.

7.4 Historically, local authorities have had more information on land and buildings than they have had in respect of infrastructure; for example, roads and street furniture, and some disparity in the respective standards of record keeping between types of assets is likely to persist. It is, however, important that any such disparities are addressed, as the absence of records can lead to misjudgements as to where resources should be allocated.

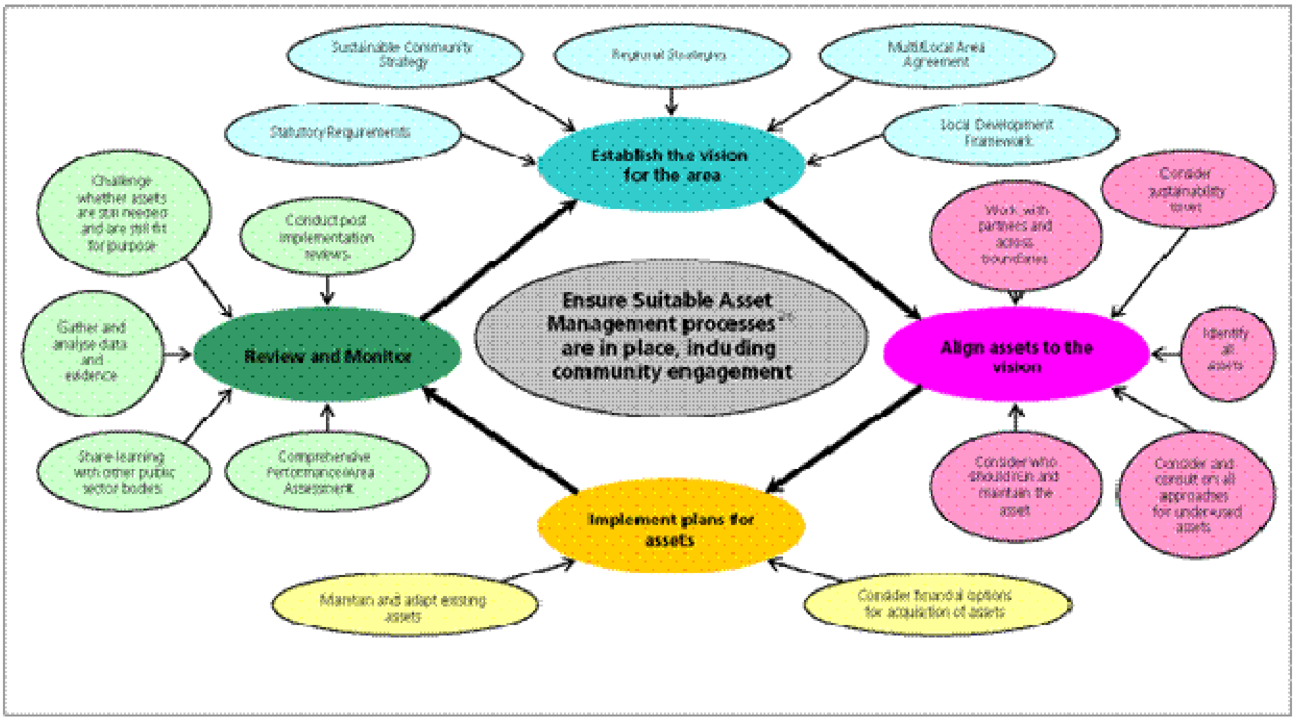
7.5 Ten benefits of good asset management were summarised by CLG in its publication, "Building on Strong Foundations: A Framework for Local Authority Asset Management", published in February 2008. The report stated that effective asset management can:

- Deliver exceptional services for citizens, aligned with locally agreed priorities, while focusing investment clearly on need
- Empower communities and stimulate debate
- Improve the economic well-being of an area
- Ensure that, once built, assets are correctly maintained
- Introduce new working practices and trigger cultural organisational changes

- Reduce carbon emissions and improve environmental sustainability
- Increase co-location, partnership working and sharing of knowledge
- Improve the accessibility of services and ensure compliance with the Disability Discrimination Act 2005
- Generate efficiency gains, capital receipts or an income stream
- Improve the quality of the public realm[3]

7.6 The elements of good asset management are set out in Figure 10, with this diagram being included as an Appendix to the CLG study on asset management. The Royal Institution of Chartered Surveyors (RICS) is also developing leaflets on aspects of good asset management in local authorities and these are expected to be published later in 2009.

*Figure 10: Asset Management Framework*




*Source: Appendix C - Building on Strong Foundations: A Framework for Local Authority Asset Management, Department for Communities and Local Government, 2008*

7.7 There is also recent evidence from the Audit Commission that there is scope for improvement in relation to local authority asset management. Their publication, "Room for

[3] Source: DCLG, Building on Strong Foundations: A Framework for Local Authority Asset Management

improvement: A review of strategic asset management in local government", published in June 2009, involved fieldwork with 22 authorities, of which 3 were London boroughs, and identified that:

- Few councils are managing their assets strategically with only 7% meeting the standard of being an exemplar
- In 2007/08, while 65 councils improved their performance on asset management, 46 deteriorated (based on Audit Commission 'Use of Resources' ratings)
- Only half of councils are assessed by auditors as having sufficient information about their estate. Only one in five directors of finance says that their council has all the information it needs to manage the estate properly.
- A third of councils do not yet share assets with other public services

7.8 The report recommends wide-ranging actions on the part of government and councils to improve the efficiency of asset management. Whilst the Audit Commission's report is not London-specific, it seems reasonable to anticipate that the boroughs will contain a mix of good performers and those performing less well. In order to ensure that each borough can enable future capital projects, they will therefore need to be satisfied that their asset management practices are aligned with those of the better performing authorities.

7.9 In order to enable future capital spending, local authorities will need to ensure that assets are only retained when there is service need and that those assets that are retained are used to their optimum potential. As ever, disposal of surplus assets should take place where reasonable capital receipts can be generated, but, where the current market is overly depressed, then other approaches may be necessary; for example, entering partnerships with the private sector, such as Local Asset Backed Vehicles (see section 11 – capital receipts and asset leverage), to generate greater capital receipts in the medium or longer term.

7.10 Arguably, in such constrained times, the same standards could also extend to heritage assets, including art collections and other valuable items that may be owned and be capable of being sold for the wider benefit of the community. The insurance value of many collections held by local authorities is significant, amounting to many millions of pounds. By convention, disposal of such items is rarely considered and even more rarely put into effect.

7.11 However, in times of austerity, there is a case for suggesting that a review of the collecting and retaining policy for such heritage assets could be reviewed and questioned. For example, Southampton CC is considering selling artworks to contribute towards a new £15m cultural quarter, following on from funding gaps as a result of reduced capital receipts and withdrawal of grant funding, due to spending cuts.

## Holding of assets

7.12 A question that is seldom asked is the extent to which local authorities need to own assets. The UK has, perhaps, grown comfortable with the concept of permanent solutions to long-term needs. Yet, it is evident that, in the near future, with the likelihood of public sector funding reductions, there is a case for securing more flexibility in asset provision. Rather than having fixed costs in respect of debt charges or unitary charges which are unavoidable, it could be considered whether it would be preferable to have shorter commitments for some types of asset and have greater ability to reduce cost burdens and redirect resources, if necessary.

7.13 Suggestions have been put to us during our research that the need for specialist buildings for public service delivery is less than it was previously and the use of more standardised buildings needs to be considered. It was also put to us that the way in which services are delivered in the future is likely to require less buildings and more reliance upon technology. In these circumstances, it could further be considered whether local government is putting too much resource into providing specialist buildings for the longer term. These are questions that can be posed for consideration, but would clearly need to be the subject of much wider debate.

## Recommendations

**7.14 Recommendations for boroughs in relation to achieving best practice asset management are to consider the areas raised by HMT in its OEP: Property strand and the Audit Commission in its Room for improvement publication, including:**

- **Management information for each asset, such as knowledge of the future service needs for the activity that the asset supports, and detailed information on, for example, the asset's condition; utilisation; market value; replacement cost; and tenure. It will also be important that any disparities between the levels of information held on different types of assets are addressed.**

- **Greater awareness over the balance between core, surplus and intermediate assets held, with assets only being retained where there is a defined service need, with disposal of surplus assets taking place where reasonable capital receipts can be generated.**

- **Where the current market is overly depressed, consideration of alternative approaches to disposal; for example, entering partnerships with the private sector, such as Local Asset Backed Vehicles, to generate greater capital receipts in the medium or longer term.**

- **The case for reviewing the collection and retention policy for heritage assets, which could potentially be sold for the benefit of the wider community.**

- **The scope to share assets with other public services, where appropriate.**
- **Taking into account the need to own assets against the potential requirements for more flexible asset provision.**

# 8. Prudential Borrowing

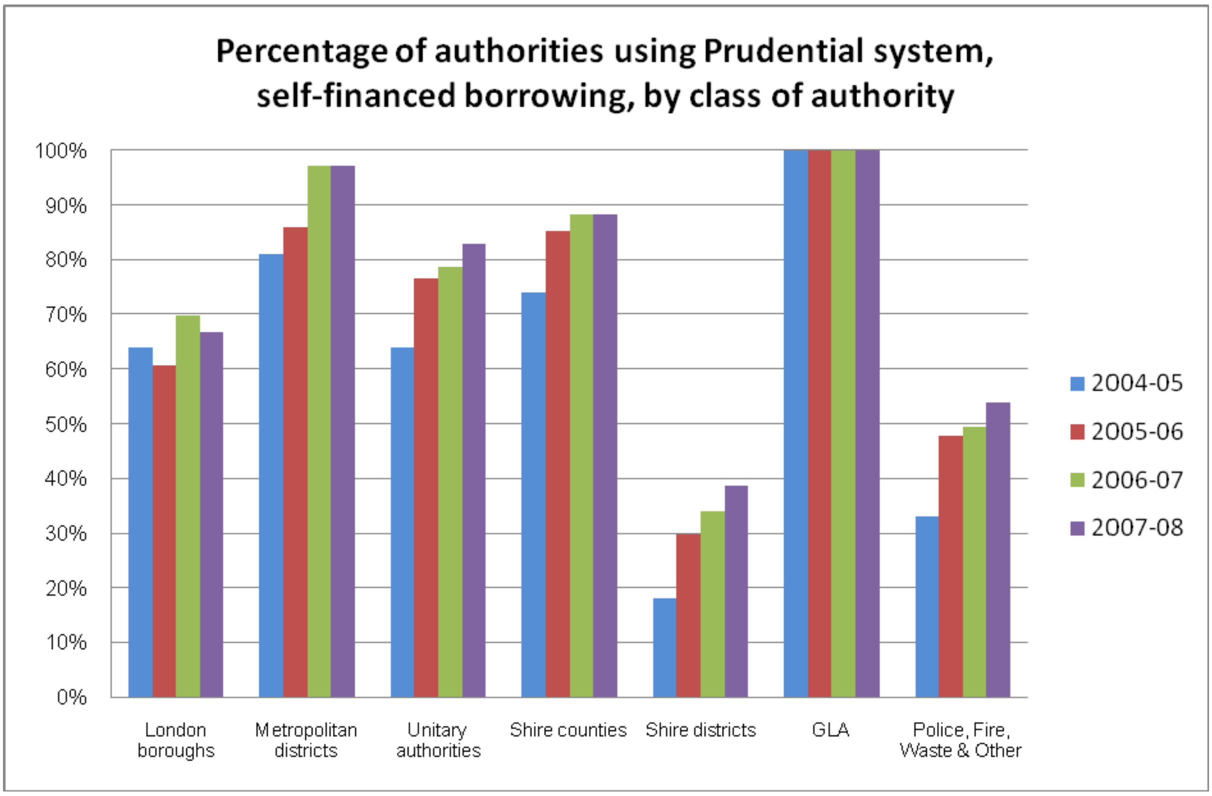
## Introduction

8.1 As identified previously, the Local Government Act 2003 abolished credit approvals and central control of borrowing in favour of a system of self-regulation (the prudential framework). Under this system, which was introduced from 1 April 2004, local authorities are free to borrow as long as such borrowing is affordable, prudent, sustainable and based upon sound treasury management practice. CIPFA's Prudential Code for Capital Finance in Local Authorities sets out the range of prudential indicators that must be used by local authorities to assist in establishing that this is the case.

8.2 The revised 'Prudential Code for Capital Finance' and revised 'Treasury Management in the Public Services: Code of Practice and Guidance Notes' were produced by CIPFA in November 2009. These are the first three revised public finance publications produced since the Icelandic banking crisis.

8.3 Since 2004, local authorities have been making use of prudential borrowing to varying degrees, both in terms of the amounts invested and the purpose to which it has been put. The proportion of local authorities, by authority type, using the prudential system, each year between 2004/05 and 2007/08, is shown in Figure 11 below. There has been a noticeable expansion in the use of prudential borrowing from year to year, amongst all types of authority, with the exception of London boroughs, who have seen slight movements up and down between years in terms of levels of usage.

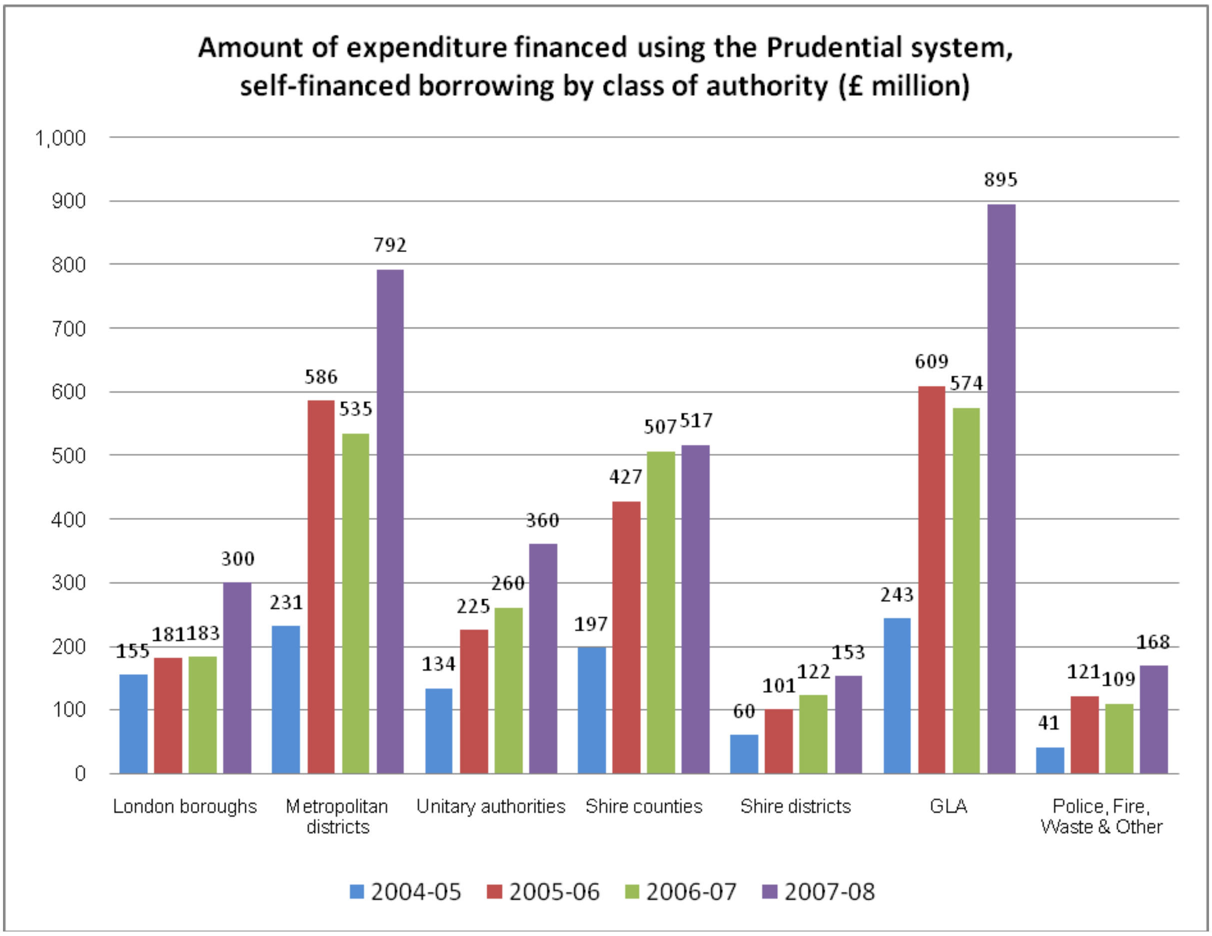
*Figure 11 – Percentage of authorities using prudential borrowing, by class of authority, 2004/05-2007/08*




*Source: Local Government Financial Statistics England No. 19 2009*

8.4 The amount of expenditure financed using the prudential system between 2004/05 and 2007/08, by class of authority, is shown in Figure 12 below, showing the scale of prudential borrowing, with more prudential borrowing being undertaken in 2007/08 than for any other year, for all classes of authority.

*Figure 12 – Expenditure financed through prudential borrowing, by class of authority, 2004/05-2007/08*




*Source: Local Government Financial Statistics England No. 19 2009*

8.5 With the post-credit crunch difficulties of providing private finance at affordable levels, the attractions of cheaper public finance by using the prudential system to bridge funding gaps and to ease affordability difficulties are readily apparent. Prudential borrowing has been employed by authorities, such as Birmingham CC, to ensure that projects which may otherwise have stalled, can progress. Birmingham has used prudential borrowing to part-finance the redevelopment of the New Street station development, known as the Gateway project.

**Case study 2: Birmingham Gateway project**

Birmingham City Council has a joint venture arrangement with Network Rail for the redevelopment of New Street station. The majority of the £600m project is being financed by a range of public sector grants. However, the scheme involves the refurbishment of a key shopping centre above the station. If the project was to proceed, the agreement of the owners of the centre would be required; otherwise, complex Compulsory Purchase Order arrangements would need to be put in place. The City decided that it would be preferable to acquire the shopping centre. £91m of prudential borrowing has been used for this purchase and the intention is that this will be repaid by a capital receipt, once the redevelopment has been completed.

8.6 The existence of prudential borrowing has also allowed capital projects to go ahead when they would otherwise have been dependent upon borrowing consents or central government grants. Case studies show how the use of prudential borrowing in respect of the development of the Tyne crossing and the Greater Manchester Waste PFI scheme contributed to the financing of the projects, providing solutions for difficult funding problems.

**Case study 3: Greater Manchester Waste Authority (GMWDA)**

In order to bridge a funding gap, £35m of prudential borrowing was used to provide equity debt to a project (equity debt is the more expensive element of PFI debt, normally receiving a higher rate of return because of the increased risk being taken). The approach will not be favoured by the Treasury for future projects, as they have made clear in subsequent announcements that any public sector investment should be made by the Infrastructure Finance Unit (TIFU).

This loan was made available on exactly the same terms as the funding from banks, to avoid State Aid issues, so arrangement fees have been charged and the interest rate being charged is higher than the costs to the authority. Within GMWDA, a ring-fenced account for prudential borrowing will be used, showing the costs incurred and costs recharged. This ring-fenced account is expected to show surpluses over the life of the project.

**Case study 4: Tyne and Wear Integrated Transport Authority (formerly Passenger Transport Authority) - New Tyne crossing project**

This project was the first toll concession to be tendered and let in the UK since the development of the PFI road sector and drew heavily on precedent PFI deals. The project is fully funded through tolls to the users, not requiring any subsidy from government and general taxpayers. The tolls needed to finance the new crossing are some 25% more than the existing tolls, but are much less than those anticipated in the original business case. The payment mechanism is based around a shadow toll structure, with the concessionaire being responsible for collecting user tolls and paying them to the PTA. The user tolls have been set to cover the cost of paying the concessionaire and repaying the £115m of prudential borrowing and the associated statutory debt repayments (MRP). It is considered by the authority that the use of prudential borrowing has saved £25m in costs over the life of the project. Prudential borrowing was taken out in advance of need and secured at 4.3%. The PTA was able to invest the borrowing in advance of need and, by 31 March 2009, had earned over £2m income in excess of interest costs. The PTA has also used the relaxations introduced in March 2008 to spread the MRP over the life of the project.

8.7 The research specifically explored boroughs' attitudes to prudential borrowing to date and how they perceived this potentially changing over time, if at all. As borne out in Figure 12 above, there was a mixed picture with regards to authorities who had or had not taken up prudential borrowing. For those that had undertaken prudential borrowing, in the vast majority of cases, this had been used to finance invest to save type schemes, although some boroughs had used prudential borrowing to meet the shortfall between planned capital investment and projected capital income resources, the shortfall between anticipated and realised capital receipts and/or timing differences on capital projects (more so recently, given the economic climate).

8.8 Prudential borrowing had been employed across a wide variety of service areas, including:

- Decentralised energy network
- New Homes
- Council accommodation strategy
- IT investment
- Start-up costs of a recycling programme
- Improvement programme for leisure centres
- Mobile CCTV
- Schools' investment programme
- Developing a 'burial village'
- Addressing investment backlogs

8.9 Views about the future use of prudential borrowing varied between boroughs; for example, with some boroughs identifying that the use of prudential borrowing is expected to increase as other sources of finance run out (and may, in future, be the largest source of funding). Other boroughs, however, felt that the level of prudential borrowing will reduce significantly in the future on the basis of affordability and forecast reductions in the levels of revenue support available to authorities. The prudential borrowing system is predicated upon good treasury management, involving a degree of certainty around the ability to service debt and interest repayments. Clearly, revenue funding constraints therefore significantly impact upon authorities' ability to undertake prudential borrowing.

## Prudential borrowing and mortgage lending

8.10 One of the impacts of the credit crunch has been the decline in property prices, the stalling of the residential housing market, with this also hampering regeneration projects. Reasons for this include the inability of lenders to provide finance on the same terms as previously and also the capability of individuals to meet repayments. Local authorities have had long standing powers to provide mortgages or guarantee mortgage repayments. In the 1970s and 1980s, local government was a major mortgage lender, albeit, a significant amount of those loans were linked to sales of council houses under Right to Buy.

8.11 A potential option could be for local authorities to re-introduce a form of mortgage offering using finance raised under prudential borrowing. Potentially significant sums of mortgages could be made available and, prima facie, the arrangement could be linked to redevelopment schemes.

8.12 Discussions with CLG and HM Treasury confirmed that local authorities have the powers to make mortgages, but they do not favour local authorities employing this approach, as they believe that other approaches are available to assist home buyers. Mortgages made with prudential borrowing could, nonetheless, be self-supporting with mortgage interest and principal repayments meeting the interest payment and MRP requirements respectively. Whilst there are technical capital control issues to address, the approach could be aligned to the spend to save concept that many boroughs adopt in determining when to use prudential borrowing.

Case study 5: A local authority mortgage approach in concept

This concept was put to us by one Council who had considered mortgage advancing. In this location, potential householders were being asked to raise significant deposits – 30-40%. This was far higher than first time buyers could typically raise. The Council was considering entering into a partnership with a Building Society who would enter into a joint venture. The Building Society would lend on its normal criteria and advance 60/70% of the loan and assess the financial robustness of the applicants. For approved candidates, the Building Society would recommend to the Council that a further advance could be made by the Council, up to, say, 95% of the dwellings value. The householder would then need to find a deposit of 5%.

The risks of bad debts would be shared equally on a proportional basis between the local authority and Building Society. The loan portfolio would be administered by the Building Society. Repayments of loan and interest would be set with regards to statutory requirements; for instance, CLG set a minimum interest rate and take account of risk of non-payment. The repayments of principal would be set-aside for MRP. Since the Housing Acts advances accounts are ring-fenced, the mortgage amounts do not impact upon council tax.

8.13 Comparatively few boroughs commented on the prospect of making mortgages available and the views expressed were mixed. One borough identified that the provision of mortgages to potential householders would be welcome as a potential stimulus to the market, although the provision of mortgages/guarantees was felt by another borough to be an area that local authorities should not become involved in, given that banks provide this service on a commercial basis and have developed the expertise in risk management to do.

## Prudential borrowing and housing

8.14 Linked to the ring-fenced nature of the Housing Revenue Account and technical features of prudential borrowing and housing subsidy, the views of the local authorities we have consulted suggests that there have been fewer uses of prudential borrowing for social housing than in other areas. Those examples that are encountered commonly relate to spend to save; for example, in CIPFA's 2007 publication, "Capital Success: Good Practice in the Implementation of the Prudential Code", it cites Solihull MBC who accelerated their planned maintenance programme and made substantial savings in the reactive maintenance programme. Some boroughs are also exploring the use of prudential borrowing for self-financing housing projects; for example, in relation to decentralised energy.

8.15 However, in the future, there might be greater potential for housing prudential borrowing projects. In July 2009, DCLG issued, "Reform of council housing finance: consultation", which considered radical changes to local authority housing finance in England. This indicated that, if reform takes place, there could be significant potential for the increased use of prudential borrowing for social housing purposes. The consultation paper does, however, sound a note of caution, as it indicates that, before going forward, the government will be assessing whether adequate fiscal controls would need to be established for the economy.

## Recommendations

**8.16 Recommendations in relation to prudential borrowing are:**

- **Boroughs should continue to assess the potential for greater use of prudential borrowing, although this will inevitably be constrained by individual boroughs' ability to provide headroom within revenue budgets for the required debt and interest repayments, with this becoming a further constraint as revenue funding pressures increase.**
- **There have been significant uses of prudential borrowing in respect of spend to save schemes, and central government could consider guidance that could be developed to enable the lessons learnt by individual authorities to be shared, to allow successful approaches to be easily replicated.**
- **Boroughs should consider whether the use of prudential borrowing to facilitate local authority mortgage lending for house purchase for homebuyers may warrant further consideration.**

- **Boroughs should continue to monitor central government plans for reforming the HRA and make their views known in relation to housing-related prudential borrowing, ensuring that they retain responsibility for self-determining appropriate investment levels in relation to the HRA, at a local level.**

# 9. Innovative Procurement and Joint Working

## Introduction

9.1 Following the introduction of the National Procurement Strategy in 2002 and the need to identify savings to support the Gershon efficiency drive, local authorities have been enhancing their procurement skills to secure economies. Any procurement innovation has to conform to EU procurement rules and regulations, but this has not prevented the development and spread of a range of new ways of working.

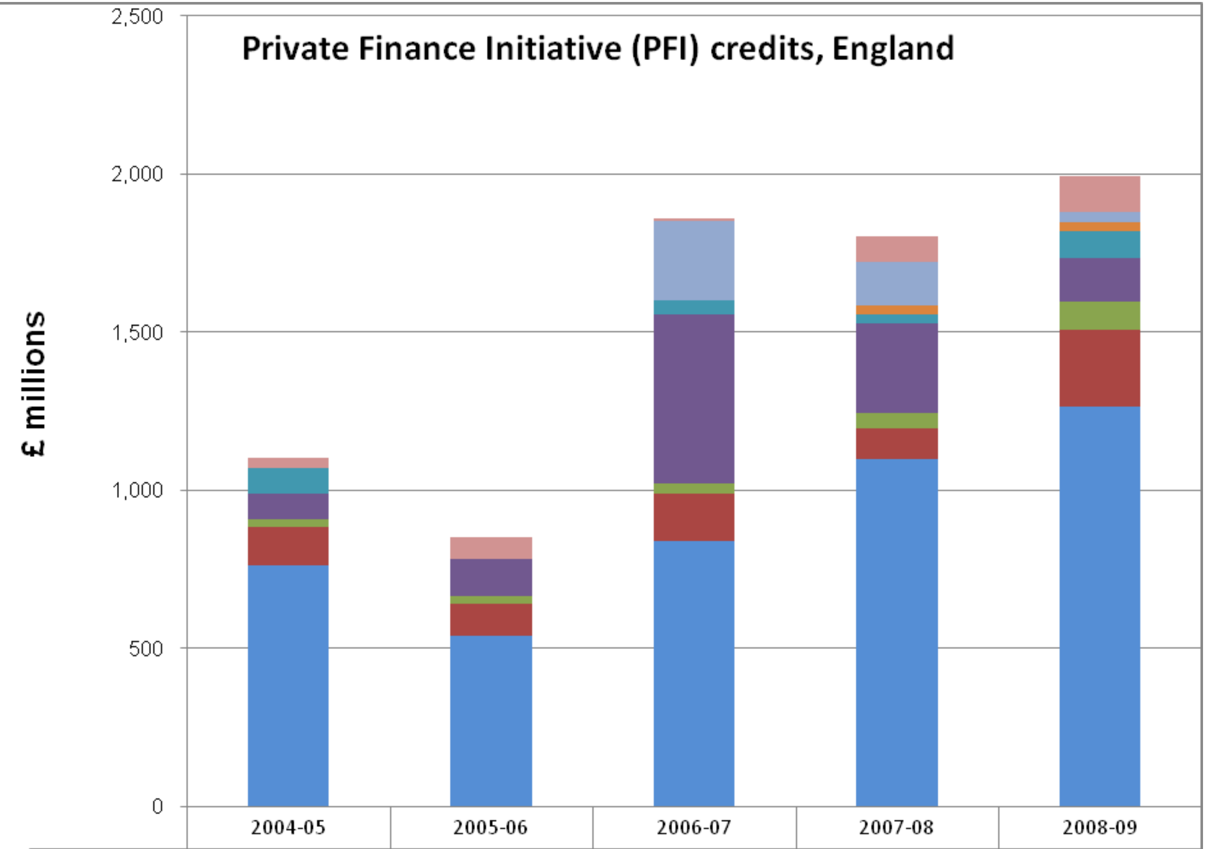
9.2 For capital procurement, where the amounts of spend are higher than most revenue procurement exercises, the need for efficient procurement is particularly important, as the costs of procurement are high, as is the risk of commissioning an asset which is not fit for purpose. The introduction of the competitive dialogue process now used for large complex capital contracts and most PFI contracts has also increased the procurement costs of many capital projects.

9.3 Recent national developments in this area include the Roots Review, "Review of arrangements for efficiencies from smarter procurement in local government", published in February 2009. This review was set in the context of the CSR 2007 requirement for English councils to collectively achieve £4.9 billion of cash-releasing efficiency gains, with an expectation that nearly 60% of this total (£2.8 billion) would arise through smarter procurement. The Roots Review focuses, in particular, upon an assessment of the effectiveness of procurement support already provided (e.g. by RIEPs, OGC, 4ps), including barriers to take-up of opportunities and ways to strengthen support activity and/or general procurement efficiency practice.

9.4 In recent years, the level of capital procurement through PFI credits has seen a steady increase, as shown in Figure 13 below. Changes in the levels of PFI credits received for specific services are also evident, with housing PFI credits reducing, whilst Transport and Education have seen significant increases.

9.5 It should be noted that these spend figures only reflect the value of projects that have reached contract signature in that year and are not a reflection of actual projects in procurement within the PFI programme. Depending on a number of factors, projects reaching contract signature can vary dramatically from year to year.

*Figure 13 – PFI credits by service 2004/05-2008/09*




| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
|---|---|---|---|---|---|
| Other | 34 | 69 | 11 | 79 | 112 |
| Waste | 0 | 0 | 251 | 139 | 33 |
| Fire & rescue | 0 | 0 | 0 | 28 | 27 |
| Police | 79 | 0 | 45 | 30 | 87 |
| Housing | 83 | 118 | 532 | 283 | 138 |
| Social Services | 24 | 25 | 32 | 50 | 89 |
| Transport | 121 | 102 | 150 | 95 | 242 |
| Education | 762 | 537 | 840 | 1,099 | 1,264 |

*Source: Local Government Financial Statistics England No. 19 2009*

9.6 However, the Budget 2009 has reappraised capital spending sharply downwards and this includes procurement under PFI, although further allocations of PFI credits continue to be made. For example, this included £1.7 billion for housing PFI in July 2009 and £440m for street lighting in August 2009, as well as an ongoing commitment to fund the Building Schools for the Future (BSF) programme, alongside waste and highways. Figure 14 shows the allocation of PFI credits over the CSR 2007 period, by government department.

*Figure 14 – Government department PFI credits 2008/09-2010/11*

| | Allocations (£m) | | |
|---|---|---|---|
| **Government department** | **2008-09** | **2009-10** | **2010-11** |
| Children, Schools and Families | 1,320 | 1,320 | 1,320 |
| Communities and Local Government | 710 | 610 | 610 |
| Environment, Food and Rural Affairs | 600 | 700 | 700 |
| Health | 130 | 130 | 130 |
| Home Office | 120 | 120 | 120 |
| Transport | 750 | 750 | 750 |
| **Total** | **3,630** | **3,630** | **3,630** |

*Source: Local Authority Capital Finance Overview, August 2008*

9.7 Beyond 2012, however, local authorities can expect fewer PFI credits and less capital support from central government. For the purposes of this report, innovation means going beyond the conventional approach for procuring assets, both for conventional procurement and for PFI. In particular, this includes joint working with other organisations, whether public sector or private sector. Innovative procurement in itself does not enable capital expenditure, but it does potentially allow for greater efficiency in the use of resources and lower procurement costs. There are a number of procurement approaches that can be considered under this heading:

- Local authority joint working in the procurement of assets
- Local authorities working with other public bodies to procure/share assets
- Entering into joint ventures with the private sector (considered further under section 10)

## Local authority joint working in the procurement of assets

9.8 There are relatively few instances of joint working in the procurement of assets and, indeed, in the joint use of assets between local authorities (and public sector bodies generally). This is one of the reasons why HM Treasury's Operational Efficiency Programme has supported the piloting of the Total Place programme[4]. Joint working and joint use has the potential to

[4] Public agencies in 13 pilot areas (including Croydon and Lewisham) will work together to map their total combined spending and identify efficiencies. The pilots are being encouraged to look flexibly and innovatively at

create economies and release assets for other use. Boroughs will need to be satisfied that such approaches are workable and can be implemented successfully and experience shows that joint working can be challenging.

9.9 The research did, however, identify a number of areas where joint procurement activity had taken place between boroughs, as illustrated in the case studies below. These tended to relate to upfront joint procurement or the use of framework contracts. Such framework contracts allow the possibility of several public sector bodies being able to 'piggyback' on the procurement efforts of others, thus saving time and cost. The use of framework contracts provides the possibility of streamlined and more efficient procurement and these are now commonly employed for the purchase of commodities and services. They are also used in conjunction with the EXPRESS LIFT process which is explained further in para 9.18 below.

Case study 6: Joint procurement of works

Both the London Boroughs of Croydon and Lewisham believe that good quality street lighting delivers a significant contribution to improving the quality of life in their respective boroughs. Some 90% of the columns in the Boroughs do not, however, meet European lighting standards, and a significant proportion of the columns are effectively life-expired and need to be replaced. In addition all bollards, beacons and illuminated signs, totalling 8,644, require renewal.

As part of a best value review, both Councils examined a number of options for replacing their street lighting and other street furniture and identified the fast track replacement solution to be the most attractive, as this route achieved the highest benefit to cost ratio and the highest non-financial benefits in comparison with other options.

Both Councils identified that a design, build, finance and operate approach, procured under PFI, would deliver best value and was, therefore, the preferred procurement route. With the launch of a new PFI funding round, both Councils took the opportunity to work together to seek PFI funding, and were successful in obtaining PFI credits totalling £79.5m, to be split between Croydon and Lewisham on an approximate 60:40 basis.

Case study 7: Joint procurement of waste services

LB Croydon identified that it had formed a joint waste partnership with the Boroughs of Sutton, Merton and Kingston and is currently undertaking Competitive Dialogue to procure a residual waste treatment contract that is LATS compliant.

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redesigning public services and to break down the barriers between their organisations that result in poor value for money or make it difficult for the public to access and use services. Potentially the approach will be rolled out nationwide.

LB Haringey identified that partnership working with other London boroughs in the procurement of new capital assets is already underway, through, for example, the North London Waste Authority. This was established in 1986 and is the statutory waste disposal authority for seven local authorities, including Haringey Council - where groups of London boroughs have joined together as a collective entity to procure specialist waste services through innovative means, where appropriate.

Case study 8: Framework contracts

LB Merton identified that they had a collaborative arrangement with LB Sutton to access their frameworks for major building works projects to council buildings (with the exception of housing), alongside their exploration of alternative procurement methods with other public bodies.

9.10 The use of joint procurement for capital assets and greater joint working across a number of boroughs would potentially have increasing benefits to the boroughs involved, although clearly, there would be practical difficulties to overcome, in terms of how relative benefits accrue. In addition, competition between boroughs in some cases e.g. for pupils, can also make it difficult to plan delivery points, future needs and funding.

9.11 Large-scale regeneration schemes, for example, may also be more appropriately planned at a sub-regional basis and accessing capital markets (subject to addressing any potential legal constraints), may also be easier, given the increased scale offered by a pan-London approach. As increased pressure is placed upon revenue budgets, the need to consider delivering the procurement of capital assets on a pan-London basis will, however, become more pressing. A similar approach could be applied to private sector joint ventures such as Local Asset Backed Vehicles, which are considered further in section 10 – capital receipts and asset leverage.

## Local authorities working with other public bodies to procure/share assets

9.12 The most common joint working arrangement between boroughs and other public sector organisations is with health service bodies. The Local Improvement Finance Trust (LIFT) approach has been used most frequently to procure jointly used assets between local authorities and the NHS.

9.13 LIFT has been considered by the HM Treasury and National Audit Office (NAO) to be a successful initiative and has been instrumental in the delivery of investment into primary and community care services and the buildings from which these services operate.

9.14 The Treasury identified in its March 2006 publication, “PFI: strengthening long-term partnerships”, that, “The partnership procurement models are reducing procurement timeframes. The average procurement time for a project within the LIFT initiative was 21 months for the first wave of the programme. This is much shorter than the average procurement time of almost three years. Thirty subsequent projects undertaken by LIFT Companies have been procured in six to nine months. An advantage of the LIFT model is that the partnership contract is already in place".

9.15 NAO identified in its May 2005 publication, "Innovation in the NHS: Local Improvement Finance Trusts", that, "LIFT itself appears to be an effective and flexible procurement mechanism, capable of providing value for money. The process for selection of private sector partners has produced good initial results with robust competition from at least three credible shortlisted bidders in all LIFT areas. Business cases to develop initial schemes and to establish the joint ventures are now robust".

9.16 The scheme supports joint initiatives between the NHS and local government, even though it is principally driven by primary care health needs. To date, a relatively small number of local authorities have engaged in LIFT as full partners of the special purpose vehicles used (referred to as LIFTCos). However, a more significant number of local authorities are classed as local partners and have strategic input.

9.17 Our impression is that local authorities who have actively used LIFT have secured significant benefits in the form of joint use buildings, either as joint service centres or health and social care centres. A number have secured central government support for projects. PFI credits for new projects in relation to joint service centres are no longer available from CLG and, therefore, future projects of this type will need to be financed on the basis of the business case and available resources. LIFT has also helped provide local authorities with the resources to deliver community centres; social housing; local offices; swimming pools; leisure facilities; and libraries.

9.18 LIFT is designed to be a long-term partnership between public and private sector shareholders and to facilitate and deliver a pipeline or programme of projects over that period. This sort of model was selected for development in primary and community care, as it is tailored to a planning environment in which it is not possible to determine with any degree of certainty what facilities and services will need to be put in place over that frame of planning horizon.

9.19 There are innovative examples of councils and their partners developing state-of-the-art integrated facilities, but, as the University of Birmingham Centre for Public Sector Partnerships has said in its July 2009 discussion paper, "Capital Future", "...much more difficult to find cases of good joint strategic asset management. BSF and the NHS LIFT are increasing the scale of collaboration on new facilities and requiring primary care trusts and local authorities to develop capital plans based on strategic priorities. Joint working is affecting only a relatively small proportion of the total capital resources available."

9.20 This matches our understanding of how joint working in this area has often developed in response to an opportunity or a project need, rather than being a core strategic objective of local authorities. In terms of the future, LIFT has been extended to those areas which wish to participate and it is being developed into EXPRESS LIFT, where there is a national framework of pre-qualified partners with whom public sector bodies will be able to set up LIFT-type companies. New LIFTCos will be able to be established relatively quickly, obviating the need to develop a series of sample schemes to a finite level of detail.

9.21 A selection of case studies has been provided below, covering both LIFT schemes and wider joint working between boroughs and health partners.

Case study 9: Joint service centre LIFT schemes

Combining Health, Sports and Leisure in Burnley. The St Peter's Centre in Burnley town centre brings together, under one roof, health, sports and leisure facilities and services. Using the East Lancashire LIFT programme, Burnley Borough Council procured the project through a public private partnership with Burnley, Pendle and Rossendale Primary Care Trust, East Lancashire Building Partnership, and Eric Wright Group Limited. As well as improving the town centre landscape, the new centre provides opportunities for improving health within the borough; removes physical, economic and social barriers to participating in sport and physical activity; increases the number of young people taking part in sport and physical activity; and improves the local economy and civic pride.

Case study 10: Joint health and social services LIFT schemes

East Ham Care Centre, Newham, East London. The £14.6m centre provides integrated and holistic care services for older people. The physical structure of the building allows the PCT and Newham to provide joint services, which deliver improved care for the service user, whether they are using the day centre or the Elders Resource Centre. The planning of the Centre was built on the partnership between Newham and Newham PCT.

Gracefield Gardens Health and Social Care Centre, Streatham, Lambeth. The £10m Centre provides social services and health care to the local community. It is an exemplar of what can be achieved if IT planning and implementation is undertaken hand in hand with the deliverers of the service. Lambeth, Southwark and Lewisham (NHS) Shared ICT Services worked closely with the partners in the Centre to ensure an organisation-independent infrastructure was implemented to enable full connectivity and access to ICT services. The shared services arrangements provide a centralised service desk which supports all the partners in the building, health and local authority.

Case study 11: LB Kingston upon Thames

We are working closely with NHS Kingston (formerly Kingston PCT) to make better use of assets by co-locating services where these are provided to the same or similar client groups e.g. creation of a hub for disabled children's services through co-location of staff from social services, hospital trust and NHS Kingston, development of a playscape for disabled children and sports facilities for the wider community (including one primary and secondary school) with new sports pavilion enabling full access to people with disabilities.

Case study 12: LB Brent

As part of the Council's efficiency and improvement strategy, it is currently in the process of procuring the design and build of a new Civic Centre which will deliver a major change to the way the Council works and the services it delivers. The building will contribute to the Council's regeneration policies and produce efficiency savings through the vacation of existing operational buildings and associated sales, where appropriate, plus a change in staff working practices, adopting more flexible approaches and ensuring best use of space and efficiency.

The Council will be working in partnership with other public sector bodies to provide a range of all services from the building, including health provision. The project's business plan will deliver a cost neutral building with no impact on the council tax payers and costs being met through the move from redundant buildings and associated efficiency savings.

## Recommendations

9.22 **Recommendations in relation to joint procurement are:**

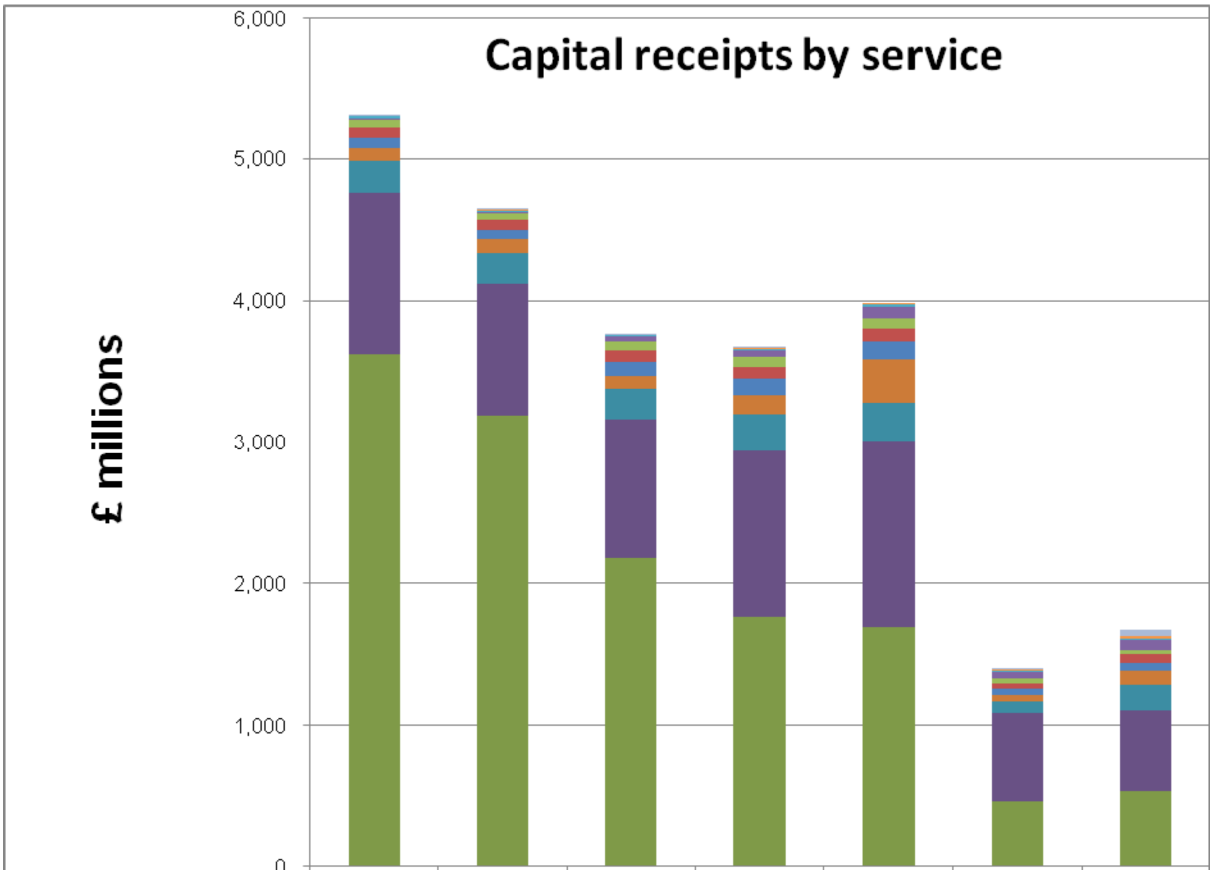
- **Boroughs, working with Capital Ambition, should consider whether there is scope for introducing greater strategic asset management, leading to more joint working between boroughs.**
- **If boroughs have not done so already, they should consider successful precedents of joint working and explore whether the LIFT and the newer Express LIFT approach provides scope for beneficial joint working with the health service.**

# 10. Capital Receipts and Asset Leverage

## Introduction

10.1 Local authorities have the ability to use the receipts from the proceeds of sale of assets. The level of capital receipts by local government service area, for the period 2003/04 to 2009/10 is shown in Figure 15 below. The current economic climate is clearly reflected in the provisional figures for 2008/09 and forecast figures for 2009/10, where there is a significant fall in the expected value of capital receipts.

*Figure 15 – Capital receipts by service 2003/04-2009/10*




| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 (P) | 2009-10 (F) |
|---|---|---|---|---|---|---|---|
| Magistrates courts | 6 | 8 | 1 | 0 | 0 | 1 | 39 |
| Libraries, culture & heritage | 5 | 10 | 7 | 10 | 13 | 15 | 19 |
| Fire & rescue | 18 | 6 | 8 | 9 | 20 | 10 | 11 |
| Sport & recreation | 7 | 11 | 48 | 51 | 78 | 47 | 81 |
| Agriculture & fisheries | 53 | 45 | 63 | 65 | 69 | 30 | 24 |
| Social Services | 74 | 75 | 84 | 85 | 100 | 35 | 68 |
| Police | 78 | 71 | 96 | 117 | 126 | 50 | 50 |
| Transport | 92 | 101 | 87 | 130 | 301 | 46 | 100 |
| Education | 221 | 210 | 217 | 261 | 272 | 80 | 173 |
| Other | 1,145 | 931 | 987 | 1,172 | 1,316 | 621 | 573 |
| Housing | 3,622 | 3,193 | 2,179 | 1,769 | 1,696 | 466 | 539 |

*Source: Local Government Financial Statistics England No. 19 2009*

10.2 The Audit Commission's, "Room for improvement", published in June 2009, identified that councils across the United Kingdom are expected to dispose of £4bn of surplus assets per year. Although the asset disposal targets were being met, this is not necessarily leading to reductions in holdings or savings, as councils reinvest the proceeds from sales. For example, over the last nine years, the Audit Commission identified that councils have spent £1.2bn more on buying or refurbishing their offices than they have raised from sales. It is now highly questionable whether this overall target will be met in future, given the significant drop in capital receipts in 2009 and 2010.

10.3 The 2009 budget took this process of requiring surplus asset disposals a stage further. On advice from Lord Carter of Coles, the government has set a target, as part of its Operational Efficiency Programme, of realising £20bn in receipts from property disposals (excluding council housing) over the next 10 years, along with savings in running costs of up to £5bn a year by the end of that period, for the public sector as a whole. The 2009 budget set a target for £16bn in receipts from property and other assets over the three years from 2011/12, with the expectation that £13bn of this will come from local government property disposals.

10.4 Retained capital receipts are a major source of funds for capital expenditure. Other than in respect of sales of HRA properties, all receipts from the disposal of capital assets are available to fund capital projects. Any reduction in capital receipts will result in lower available capital resources and, in due course, to lower capital spending. As identified in section 5, boroughs responding to the capital survey reported a steep reduction in capital receipts, with this being seen as the most important constraint on future capital spending.

## Generation of capital receipts

10.5 Boroughs provided examples of where they had identified surplus assets and responded to approaches from prospective developers, as shown in the case studies below.

Case study 13: LB Bexley

A private sector partnership scheme to provide new civic accommodation, plus retail development and housing units. The scheme will generate receipts from the site rationalisation, provide savings in relation to building maintenance costs, and the retail development will encourage economic growth.

Case study 14: LB Barking

We are reducing our buildings from 22 to 5, rationalisation which is self financing (and intended net saving overall).

Case study 15: LB Enfield

The Place Shaping policy is seeking to bring about regeneration through site assembly and joint working with other public services, private sector providers and local employers and businesses. One example is that the Council is currently in consultation with TfL, the HCA and a Registered Social landlord to bring back into use properties that had been compulsorily purchased as part of the North Circular Road widening project. This will provide a significant contribution to the regeneration of this part of the borough.

Case study 16: London Borough of Wandsworth[5]

This Council has rigorously controlled its asset base for many years with the objective of minimising the amount of capital it employs. It has sold over £1 billion of surplus assets since 1980. Capital receipts from sales of surplus assets are an important source of finance and have allowed the capital programme to be funded entirely without borrowing. The absence of debt, and consequently no interest payments, maximises revenue available for frontline services and minimises council tax.

A strong corporate property function sets the Council's overall property strategy and ensures that services act in tandem. But service departments bear the cost of capital in their own budgets and have other financial incentives to identify and dispose of surplus properties, in some cases, including keeping a proportion of the proceeds.

Rationalising the occupancy of properties to push out surpluses has to be engineered through imaginative service redesign. The Council has motivated its service directors and property managers to think about how they could operate with less.

Knowing the estate and its hidden potential has been key. The Council knows how much its buildings would be worth on the open market and how to maximise their value by granting appropriate planning permission and by spending to bring assets to market in suitable condition.

## Leverage using the local authority asset base

10.6 Many London boroughs are, in relative terms, asset rich, and using that asset base to leverage in capital investment has, of course, been considered repeatedly by local government. Throughout the capital, there is a need for major improvement. There is no homogenous need for new assets and there are various strategies that could be developed. In central London, in particular, many properties attract premium prices and there will be a

[5] Source: Audit Commission, "Room for improvement", June 2009

necessity for some public sector assets which occupy valuable sites to be freed up, with capital receipts sought as an integral part of borough asset management in those locations.

10.7 As identified previously, over the last year or so, capital receipts have been much harder to generate and local authorities have had to significantly reduce their expectations of income that could potentially be received from capital receipts. The downturn could also, in some ways, represent an opportunity, as property can be secured at lower prices and this does allow for the prospect of future gains in development potential.

10.8 Lessons can be drawn from the precedents of innovative practice in London and elsewhere and from other public bodies in the use of the asset base to leverage capital resources. Such approaches are not without difficulty, disposal of assets can be criticised as ‘selling the family silver’ and disposing assets that provide income to support the budget can exacerbate difficulties in balancing the revenue budget position.

10.9 Using assets will not be an easy route to enabling future capital resources, especially if the information and skills building blocks are not in place and with the currently depressed property market. Nonetheless, asset leverage has a role to play and, arguably, putting the mechanisms in place now would allow for greater and quicker benefit in the future, particularly given the likely lead in times in relation to asset leverage schemes, whereby by the time that these are fully operational, there may be an expectation that the property market has ‘picked up’.

10.10 As a first step in considering the value of an authority’s assets and to what use they could potentially be put, the authority would stand back and consider what assets are currently held. Challenge would take place about their use now and in the future, why they are in their current location and their relationship with other assets and development. At one end of the scale, there are assets that are surplus to requirements, that can be disposed of, next are the income generating assets that can be compared to a commercial business, towards the bottom end of the scale, there will be assets that are empty, cost money to keep secure and maintain but are not used, and, at the very bottom, assets (effectively liabilities) that have no use and have negative value owing to, for example, contamination.

10.11 The next step would be to determine how assets could be used to generate more capital receipts. If this is to provide added value, it is an issue of recognising the synergies between assets, the geographic location and market need. It has been suggested to us that many local authorities lack the entrepreneurial skills to maximise the potential development value of their asset base. Many local authorities have appropriate property skills, but the focus within authorities is, of course, to deliver good services, and not necessarily to capitalise on the inherent or hidden value within their asset base. The expansion of that capacity by having either a private sector partner, or greater focus on an activity, could be a way forward to secure value from their property holdings.

10.12 Local authorities might then consider what other public bodies have done. We have identified the following approaches and actions that have been taken, or, in some cases, which might be considered by public sector bodies, to secure benefits which have secured value from properties.

## (i) Using capital receipts differently

10.13 The interest received on capital receipts has shrunk from around 5-6% in 2007/08 to 1-2% in 2009/10. Whilst there will be few boroughs with capital receipts to spare, there may be some scope for boroughs to provide assets for other public bodies and take a rental stream. These approaches are unusual, but might aid any borough with capital receipts that it does not have any long term need for, to secure a better fiscal return and help another borough obtain financial resources.

Case study 17: Wychavon District Council

The Council used assets as enablers of change in schemes for a supermarket and a hospital. The Council identified that the area needed a district hospital which the NHS was unable to provide. It built one, which is now let out to the Primary Care Trust, and is earning the Council a return of some 7% on its investment.

## (ii) Disposal of shares

10.14 Whilst most local authorities will not hold shares in trading companies, this it is not always the case and the real value of such holding can be significantly higher than anticipated. Where trading activities have been placed into separate entities and a successful trading record established, there is the opportunity for significant capital value to be created. A variant approach is to introduce a private sector partner into an ongoing activity and retain a market share in that new business – again, that business share will provide an opportunity for capital income.

10.15 Local authorities have raised substantial capital receipts in the past from the disposal of shares – historically, sales of shares in airports and Local Authority Waste Disposal Companies (LAWDCs) have raised sums in excess of £50m for interests of this nature. The trading ventures in Kent and Norfolk illustrate that successful ventures can be created by local authorities and these holdings can be retained for income generation, disposed of for capital resource or be converted into a joint venture. We have not identified any London borough that has exploited the trading powers in the same way as the two Counties cited. Whilst such actions may be perceived as commercialisation and have critics, in order to secure capital resources, they warrant further consideration.

## (iii) Commercialisation of income generating assets

10.16 Whilst the majority of local authority services are held to deliver services that incur costs to run, there are a number that provide the potential for significant profit and capital gains. Local authorities have transferred assets such as car parks into separate entities and secured financial benefit. For example, Glasgow City Council transferred its car parks into a limited liability partnership and then raised private finance against that income stream, creating capital resources.

10.17 Manchester City Council has a joint venture with NCP dating back to 1999, whereby NCP has invested £13m to repair and refurbish car parks, replacing and modernising parking equipment and introducing a new multi-storey car park at a transport hub in conjunction with the Greater Manchester Passenger Transport Executive.

10.18 Since the credit crunch, car parking income has fallen, but deals of this nature could potentially be undertaken. Other income sources have also dropped, albeit, the position is not uniform, and some income sources are more resilient than others. The exploitation of other income generating services for public private partnerships of this nature appears infrequent; however, as an illustration, a crematoria PPP has been established in Scotland. It may be that such activities have traditionally been seen as relatively small and, therefore, so is the related capital leverage – however, the increasing environmental requirement of such assets might alter the benefit:reward ratio.

## (iv) PPP structures for empty properties

10.19 The concept of having a private sector partner to focus on empty properties is a variant of the Local Asset Backed Vehicle (LABV) approach (see para 10.22 below). It focuses on properties that are not being used, but which are creating ongoing revenue costs. Projects of this nature are more difficult in the present economic climate; however, these structures will have their place in any comprehensive review of property and leveraging in additional income.

Case study 18: Glasgow City Council

Glasgow City Council had taken plans forward to address their empty properties issue, but, in October 2008, suspended plans to sell more than 50 sites across the city, as part of a £100m plan to manage the surplus property in its £1.8bn portfolio. In February 2008, it hoped to sell the freeholds of 56 empty sites, including schools, offices and its own building, which it estimated could net more than £100m, into a partnership with a developer. The partnership would then bring the sites to market.

The Council had three aims for this venture, which was to generate an upfront payment of £85m, a transfer and sharing of risk to a joint venture partner, and a system to bring sites more quickly to the market. A City spokesperson said that the partnership would, ‘take the risk away, gain value, and leave our property in the hands of people perhaps more expert than us'. The joint venture proposal might resume when market conditions improve. Glasgow's surplus property is understood to cost the council up to £1m a year.

## Local Asset Backed Vehicles (LABVs)

10.20 Boroughs might consider the establishment of a LABV, which have traditionally been used by Regional Development Agencies and which have recently been considered by individual authorities. A LABV involves the identification of assets that are not being used optimally, but which have potential for redevelopment. These assets are then transferred into a special purpose vehicle, with private sector partners owning a percentage of the vehicle (usually 50%), subject to their undertaking specified development activities. The process might be along the following lines:

- The Council collaborates with other public bodies, identifying a portfolio of assets and a pipeline of regeneration projects which require funding. Clarity over the future pipeline will be a key investor issue. Normally, the collaboration needs to be formalised into one organisation, so that the institutional investor, investing alongside the public sector, deals with only one partner.
- Assets can encompass any, or a mix, of the following:
  - Surplus properties
  - Investment properties
  - Sites for development
  - Operational assets
  - Income producing assets
- If operational assets are to be included in the vehicle, the partnership agreement will have to address the issue of transfer of risk from the public sector partner to the private sector in relation to the projected returns and covering rentals. The development process will need to consider State Aid, to ensure that the arrangements cannot be seen as providing a subsidy to the private sector, as well as procurement and other local government regulatory matters. However, all these issues have been successfully addressed in similar models. One or more of the public sector participants could contribute cash rather than assets.
- Summary details of the portfolio, together with an outline business plan for each individual asset, and each regeneration project, is produced. The outline business plan details the restrictions on the use of the assets, the development proposals for each asset, and regeneration projects (to the extent that they are to be carried out through the vehicle).

- An institutional investor is procured in accordance with public sector procurement practice. Where works or services are involved, this will be under the EU procurement rules. Once a list of investors is drawn up, the summary business plan is circulated to potential investors, who are then invited to submit outline bids for the portfolio on the basis of the business plan.

- A full due diligence pack and draft legal agreements are produced on the portfolio properties and the business plans, and circulated to the short-listed investors, in a formal invitation to negotiate. The ownership of the LABV is usually a 50/50 deadlocked joint venture, with arbitration provisions for resolving disagreements. The assets are transferred with individually agreed business plans into the model, to minimise the risks of disagreement. This is one of the principal ways in which the public sector exerts control over the vehicle. The other is that the memorandum and articles of association of the LABV are explicit in recognising the aims, objectives and operating rules of the LABV upfront.

- To maintain the 50/50 structure, the institutional investor matches the public sector's asset contribution and subscribes the amount it bid for the portfolio for shares in the vehicle. It is possible at this stage to gear the LABV, and it may not be unreasonable to introduce debt of at least 50% of the equity, subject to public sector accounting and Treasury debt policy. This level of gearing will need to be sustained through income or disposals within the SPV and is therefore only viable if the joint venture is generating sufficient income to service the equity and debt requirements.

- The 50/50 ownership structure ensures that the return is also split equally between the public and private sector, and therefore that risk and reward are equally split. It would be possible to structure the vehicle in such a way that each party can take their return in a different way. For example, the institutional investor may prefer not to take their dividend from the vehicle, but to reinvest it, or alternatively, the public sector partners may wish to take profits out of the vehicle early to fund alternative projects.

- A hands-on management team is generally formed once the LABV is established, to oversee the running of the company; this may involve the transfer of some existing resources into the joint venture. The authority will also need to allocate appropriate Board level resource to ensure that effective governance and control is maintained.

- As a variation to injecting all the assets on day one, an alternative structure would be to grant the institutional investor an option over the assets (with a value of, say, 10% of the asset), and to gradually transfer assets into the vehicle as and when needed for the delivery of the business plan.

- Once the LABV is up and running, it can begin to embark on the delivery of the agreed business plans, as this is the principal way in which value is created by the vehicle. In addition to the agreed regeneration projects, the business plans established at the outset would also have envisaged some of the following:

- Realising development potential
- Re-gearing leases
- Implementing professional property management practices
- Deriving scale opportunities
- Land assembly
- Trading assets etc.

- Previous LABV vehicles have had a finite lifespan and typically, therefore, the structure could last for 10-15 years (they have to be long enough to enable the value to be captured by the mechanisms outlined above). At the end of the 10-15 year period, the vehicle can either be extended or it can be wound up. In the event that it is wound up, the following would happen:

  - Any assets/projects which were deemed to be key strategic assets to the public sector could be acquired back from the vehicle at market value, possibly having agreed pre-emption rights at the time the LABV was established.
  - The partners would then have the opportunity to bid for the remaining assets. In the current investment climate, it is highly likely that the institutional investor would want to acquire a significant proportion of the assets.
  - Remaining assets would be sold on the market in the usual manner and the proceeds distributed equally to investors.

Case study 19: The Croydon Council Urban Regeneration Vehicle (CCURV)

Competitive dialogue in relation to the Croydon Council URV was initially launched in April 2007, with 19 expressions of interest being received. Two rounds of shortlisting were undertaken and John Laing was selected as the preferred private sector partner in June 2008. The Council reached commercial close for the URV on 28 November 2008 and is expected to reach financial close around January 2010. The life of the vehicle will be up to 28 years.

The URV is to take charge of a number of council-owned town centre sites, including the existing civic centre complex. As well as a means of investing in regeneration, maintaining a stake and influencing the development process, the URV will also provide a new public sector delivery hub (civic accommodation).

The two URV partners have taken a 50:50 deadlocked stake, with the Council providing the land and property assets and the private sector providing cash for investment. The URV has a business plan setting out the purpose of the vehicle, and the Council will commit to feeding through a pipeline of new development sites.

The entity is a Limited Liability Partnership (LLP), with shared control, shared profit extraction and day to day management by the private sector. The LLP mechanism means that arrangements are 'tax transparent' i.e. each body treats revenue arising from the URV as they would in their own accounts, whereas a limited company approach would mean that the council loses tax advantages.

The URV Board is made up of 3 council officers and 3 representatives from John Laing. The deadlock structure means that neither Croydon Council nor their partner will control the assets unilaterally, but the business plan for the URV will safeguard objectives around regeneration, profit generation and extraction.

The object of the URV vehicle is to work in partnership to maximise the value of the Council's assets by improving the traditional asset disposal route. The total value of the 'developed out' assets is estimated at £450m and there is scope to add in future sites at a later date. The key benefits of the partnership from the council's perspective are seen to be:

*Financial* – leveraging major private sector investment; achieving substantial premium over book value; sharing in prospective tenfold growth over ten years; avoiding complex overage payments; and manoeuvring best value requirements.

*Regeneration* – attracting major specialist funds/developers; incentivising a long term approach; holistic regeneration (financial, physical, economic and social); and building partnerships, rather than managing processes.

*Risk* – transferring risk; retaining control through 50:50 deadlock; leveraging private sector expertise; risk reduction through area uplift over the long term; funding for improvements of public realm; and creating subsidies for operating costs.

## Local Housing Companies

10.21 A specific case study in relation to housing assets, which follows a similar approach of placing local authority assets into a special purpose vehicle, with authorities sharing in the benefits, has been provided below for LB Barking & Dagenham's Local Housing Company.

Case study 20: LB Barking & Dagenham – Local Housing Company

Local Housing Companies were a concept set out in the Housing Green Paper, with guidance for 14 local authority pilots being published by CLG in November 2007. LHCs are a partnership between councils and the private sector, with the intention of enabling local authorities to bring forward land for housing development; in particular, to increase the supply of affordable housing.

The principle of a LHC is that, rather than simply receiving a capital receipt for the sale of surplus land and retaining limited future control over its use or the type and quality of housing provided, the local authority's surplus land is provided to the LHC. The local authority agrees the development plan, including being able to directly offer low cost housing deals to meet local needs.

Private sector partner, including developers and Registered Social Landlords, benefit from the surplus asset, and provide equivalent investment and the construction expertise needed to build homes.

For LB Barking & Dagenham, a 50:50 deadlocked joint venture company (private company limited by shares) is in place, with the local authority contributing the land and the developer putting in an equivalent amount of capital. The land is principally owned by the Council (although the Council may need to make compulsory purchase orders or otherwise acquire minority land interests by agreement).

The land will be transferred by way of a series of long leases, each at a premium. The premium due to the Council will be satisfied by way of the issue to the Council of interest-bearing long-term loan notes (expected to be at least 20 years, which represent risk capital invested into the LHC by the Council) on a scheme by scheme basis. The deferral of monies due to the Council by way of loan notes has a cashflow benefit to the LHC and removes the need for the LHC to cash fund land acquisition costs upfront. The LHC will be the long-term asset owner of land transferred to it (150 years) and will be responsible for all relevant management functions (although some of which it may then contract out).

The LHC will require CLG/HCA approval, as the business plan in predicated on the release of National Affordable Housing Programme grant (40% of build costs) – and negotiations for government approval are still ongoing. It is intended that the LHC will undertake the redevelopment of the Council's major regeneration sites in the borough, designated for principally residential development, in order to deliver mixed tenure sustainable communities.

An objective of the LHC is to minimise the LHC's development finance costs and therefore enable the development of more affordable housing than would otherwise be delivered through traditional procurement. The LHC business plan will require that at least 50% of the residential units it completes to be affordable (a higher level than would be delivered under traditional redevelopment mechanisms).

## Pan-London approaches

10.22 London has the potential to attract significant private investment; arguably, more so than any other part of the UK. There may therefore be scope to reflect on radical solutions to provide capital investment; perhaps driven by tax incentives. There is scope for ambitious and potentially highly innovative pan-authority and/or pan-London initiatives. There are, at least in theory, significant potential advantages in cross-authority working, including the potential for:

- Greater economies of scale
- Greater expertise and focus
- Increased interest from the private sector and the ability to raise finance
- Cross-border development
- Increased redevelopment and growth

10.23 As an example, would it be feasible for a pan-London regeneration approach to be undertaken? Perhaps, a special purpose vehicle e.g. London Regeneration PLC, could receive a mixed portfolio of properties from the boroughs in exchange for shares. Alternatively, a pan-borough approach, based upon the geographic areas of the Capital might be used.

10.24 On the back of a well prepared prospectus, further shares might be issued for the PLC and loan finance raised from the City and private investors. In return, such a company could take responsibility for aspects of regeneration and maintenance of public assets. An approach like this would need significant development and, of course, until a business case is put in place, it would be uncertain whether such an approach could be made viable.

10.25 Potentially, a cross-London capital initiative of a bold nature could provide potential resources and rewards that individual authorities could not deliver. Under such an approach, boroughs could sell or retain shares on the open market. Other approaches on a similar basis could be contemplated for roads and river crossings and other asset-based services, such as waste disposal.

## Recommendations

**10.26 Key recommendations in relation to the use of capital receipts and asset leverage are:**

- **Boroughs should give consideration to whether there is possibility for contemplating the commercialisation of aspects of regeneration and challenging the ownership of assets, when it is evident that, in the near future, with the likelihood of reducing levels of public sector finances, there is a case for securing more flexibility in asset provision.**

- **Boroughs should examine what other public bodies have done to capitalise on their asset bases. We have identified a number of successful approaches and actions that have been taken to secure benefits which have secured value from properties. The LABV approach, including coordinated approaches across several boroughs, should be given particular consideration.**
- **Capital Ambition should consider the potential scope for pan-London approaches to regeneration activity.**

# 11. New Income Streams

## Introduction

11.1 This section considers the possibility of introducing new levies and usage charges, new taxes and whether additional capital grants might be accessed.

## Levies and usage charges

11.2 Where there are secure income streams, it becomes easier to raise finance for capital projects. The regulated industries, such as the water industry and national grid, show that once such activities move away from the public sector and rely principally upon usage charges to finance their activities, raising finance for new infrastructure can be put onto a firmer footing. Local authorities do have freedom to generate income through fees and charges, although most core services are provided to those that need them at no charge or at a fraction of total cost due to subsidy.

11.3 For new substantial charges to be raised, such as road levies or further charges for the usage of services, legislation or government consent is often required. This may be controversial and inevitably would take time to put in place. The development of Workplace Parking Levies (WPL) could also potentially raise significant sums and arguably represent an environmentally friendly approach. On 14 September, Nottingham CC approved its Workplace Parking Levy (WPL), a charge that would be made to employers in the City where their liable parking spaces for staff exceed 10 liable places and for certain types of business visitors.

11.4 The WPL will commence in April 2012, although the scheme will be introduced, without charge, in October 2011. Once operating costs have been covered, all remaining income would go towards improving public transport. On each liable parking space, the levy would be in the region of £185 per year, rising to around £350 at the opening of NET Phase Two, with increases linked to inflation in future years.

11.5 However, all charges have other implications; for example, workplace charging might reduce other income, such as congestion charges, and might displace future economic growth to areas outside those where charges were made. In addition, in the London-specific context, WPL may not be an attractive option for some parts of outer London, with the Outer London Commission having argued that blanket parking quotas in the planning system across London may need to be revised. Many outer London boroughs are competing with the 'outer metropolitan area', with much less stringent parking restrictions.

11.6 In England, major River crossings are often tolled (River Tamar, River Severn, River Tyne, River Mersey and River Humber) and, in London, only the Dartford tunnel is tolled. There is an inconsistency in the way in which the UK charges or does not charge for river crossings and changing the status quo would again be controversial. Charging for all major river crossings in London could be imposed, but, as identified, it would be unpopular.

11.7 Schemes similar to the London current congestion charge have been under consideration by the British Government since the early 1960s. The first congestion charge in the UK was a much smaller £2 million scheme which has been running in Durham since 2002; however, the London scheme was the first large-scale implementation. The power to introduce a form of congestion charge was provided to any future Mayor in the Greater London Authority Act 1999.

11.8 Having won the first mayoral election in 2000, Ken Livingstone opted to exercise these powers, as promised in his independent manifesto, and carried out a series of consultations with interested parties. The basic scheme was agreed in February 2002, and charging commenced, with some concessions accepted, on 17 February 2003. By law, all surpluses raised must be reinvested into London's transport infrastructure.

11.9 Further extensions of congestion charging in other UK Cities has proven difficult. For example, in December 2008, 79% of voters in Greater Manchester turned down proposals which would have seen the introduction of a major congestion charge scheme. Under the rejected plans, it would not have been introduced until 2013 and would have operated peak-time only.

## Tax revenues

11.10 New income could be raised by way of taxation. We differentiate taxation (compulsory payment), from road charges and tolls, which represent amounts paid for the use of public provided assets or services. The use of Tax Incremental Financing (TIF), Accelerated Development Zones (ADZ), Business Rate Supplement (BRS) and Community Infrastructure Levy (CIL) is referred to below.

## (i) Tax Increment Financing (TIF)

11.11 Tax Increment Financing (TIF) is a tool that has been used for redevelopment and community improvement projects throughout the United States for many decades. TIF is a financing tool designed to forward fund key infrastructure improvements, and works by deploying the projected future tax gains of those improvements to finance the infrastructure itself.

TIF works on the basis that a specific public sector project results in a corresponding increase in the value of surrounding property, often combined with additional investment in the area. The increased property value and new investment creates more taxable property, which also increases the potential revenue available from taxation i.e. the ‘tax increment’.

This increased revenue is used to finance debt issued to fund the initial infrastructure development. TIF is typically designed for improvements in run down or underdeveloped areas where development would not otherwise occur and which would therefore be unaffordable. In the US, 49 states and the District of Columbia have enabling legislation for TIF, with Arizona being the only state without a TIF law.

11.12 The TIF approach depends upon sufficient additional income being generated on an improvement of an area so that, over a period of years, the hypothecation of that income is sufficient to provide for the repayment of the loans and interest incurred and, in the United States, sufficiently attractive returns to private sector investors. The record of TIFs in the United States is good and the suggestions put to us as part of our research are that they have sometimes been criticised for being too successful i.e. being used when development would have happened in any event or displacing investment from more needy areas.

11.13 The 'Barnet Bond' is based upon a similar approach. The Barnet Bond was a proposal to raise finance by a bond issue that could provide as much as half the £700m plus that the borough identified in 2007 that it needed to improve its infrastructure to cope with expected housing growth over the next 10 years. The bond would be financed by earmarking extra income created by expanding housing stock, including higher council tax and business rate receipts. The borough could raise money from the expansion of Brent Cross shopping centre, with a £1 per day levy on each parking space. This is still a potential proposal, although implementation has not yet taken place. There are likely to be a number of areas throughout London that would seem to have the characteristics required for such an approach, in terms of the ability to hypothecate increased tax revenues.

## Accelerated Development Zones

11.14 The Core Cities have been promoting a form of the TIF concept, referred to as the Accelerated Development Zone (ADZ), and they have lobbied for pilots to be carried out focusing on cities in the North and the Midlands, where, in their view, regeneration investment has been hardest hit. The Birmingham city-region has been pushing for an ADZ in its Eastside area, which, it is suggested, could bring more than £1bn of upfront investment in transport and regeneration, and create thousands of additional jobs. In Leeds, there are plans for a similar programme in the Aire Valley that, with ADZ, could potentially deliver an additional 14,000 jobs.

11.15 A number of boroughs, in response to our survey, expressed interest in this approach. We are also aware that TfL have an interest in such an approach in connection with the redevelopment of the Battersea Power Station area.

11.16 The 2009 Budget gave tentative acceptance to the potential for ADZ to help development. Interested local authorities and city-regions have been allowed to submit projects for using this approach and we understand that around 80 expressions of interest were put forward. The 2009 Pre-Budget Report has, however, identified that no proposals will be taken forward at the present time, and the primary legislation that would be required will be considered by the government.

11.17 Without central government guarantees, such borrowing would represent a significant risk on the future revenues for those local authorities involved, with local authorities needing to reflect on how much risk they would be prepared to accept. In such an event, the risk of financial loss may lead to smaller scale initiatives being favoured, compared to the larger schemes that have been cited by Core Cities.

11.18 The ADZ concept is based on that of TIF and is designed to allow defined areas to 'participate in the growth dividend' – or, in other words, allow local authorities to capture incremental value in the form of tax revenue generated from new development. In order to do this, local government requires the power to retain long-term local tax revenues generated from development, such as business rates, allowing funds to be raised for investments, through securitisation of those revenues.

11.19 This concept may tend to encourage development in already successful areas, but the supporters of this approach argue that, without some prioritisation of investment and link between investment and returns, in many situations, future projects will be delayed or will not happen. Once investment has been repaid, future tax income streams could be redirected to their normal 'home'. Key aspects of the concept include the following:

- ADZs would be defined physical areas, linked by a common infrastructure requirement
- Local authorities could reinvest additional business rates that are supplementary to the existing revenues for the area, and use that income to raise funding for upfront infrastructure
- New business rates would be reinvested for a maximum of, say, 20 years or until funds raised to invest in upfront enabling infrastructure are repaid
- There would not be a blanket entitlement to use ADZs, but cities would need to make their case to the government, so that designated zones create the maximum sustainable economic impact
- Approved ADZs would therefore need to meet strict criteria on achieving accelerated growth and multiplied outputs.

## Business Rate Supplements

11.20 The Business Rate Supplements Act 2009 creates a new power for upper tier local authorities in England and Wales to levy a local supplement on the business rate and to retain the proceeds for investment in that area. It is effectively a hypothecated income stream that will be used for a dedicated purpose, with the following conditions applying:

- Only the highest tier of local authority will be entitled to levy rates; in London, the power will rest with the Greater London Authority

- Business rate supplement revenues must be spent on economic development
- A national upper limit of 2p per £1 of rateable value will apply
- Stipulations are made for consultation with business and matters concerning the prospectus for each scheme
- Circumstances are specified in which a ballot will be required and provisions made for regulating such ballots
- All properties with a rateable value of £50,000 or less will be exempt

11.21 In London, the business rate supplement will be used to finance the Crossrail development, raising several billions of pounds. This supplement will be implemented without a ballot, which will be required in other schemes.

Case study 23: Financing Crossrail

The Mayor of London agreed with the government in November 2007 that the GLA and Transport for London (TfL) would contribute around £7.7bn towards the estimated £15.9 billion costs of Crossrail, which will build major new railway connections under central London. The government will contribute most of the remainder.

The GLA is expected to contribute around £4.1bn of this by introducing a new Business Rates Supplement (BRS), using powers granted to it under the Business Rate Supplements Act 2009 (the 'BRS Act'). This will mainly fund the financing of £3.5bn worth of borrowing by the GLA and the repayment of this sum after the end of the Crossrail construction period. It is estimated that a total of £7.9bn will need to be collected from the BRS over its lifetime, once financing costs are included.

The Mayor is not required to hold a ballot of business ratepayers before introducing the Crossrail BRS and, in order to provide certainty and stability for the project, does not intend to do so. This conforms with the principle outlined in the Crossrail funding package agreed in 2007 that London's business ratepayers would contribute towards the project, as they will be amongst the biggest beneficiaries from the scheme.

The Mayor intends to direct the GLA to set an annual basic BRS multiplier (or tax rate) of 2p per pound of rateable value on individual business properties with rateable values of £50,000 or more from April 2010. He will have regard to the impact of the 2010 revaluation on ratepayers, however, before confirming the multiplier for 2010-11 in the final prospectus.

It is anticipated that the BRS will run for a period of between 24 and 30 years, until the GLA's £3.5bn of borrowing is repaid, with a target end date of 2036-37. The actual end date is dependent mainly on the interest rate payable on the GLA's borrowing and the level of the taxbase over the lifetime of the BRS.

Some categories of ratepayer or property will be eligible for full or partial relief on BRS contributions. As a minimum, the same level of reliefs applying to National Non-Domestic Rates (NNDR) will also apply to the BRS at the same rate, having regard to the local policies of each of the 33 billing authorities in London and relevant legislation.

Transitional arrangements under NNDR to ease the impact of property revaluations will not apply to the BRS. The GLA could set a lower BRS multiplier than 2p to mitigate the impact of any revaluation on ratepayers, including in 2010-11.

## Community Infrastructure Levy (CIL)

11.22 As identified previously, the Planning Act 2008 provides for a new statutory charge on landowners who benefit from development – CIL. The CIL builds on the idea of ‘tariff’ proposals, such as the Milton Keynes ’roof tax’, where a clear link between development and contributions from the private sector is made. One of the major potential benefits of this system is intended to be that it overcomes the problems of negotiation and delay that can characterise Section 106 agreements. More certainty about financial arrangements allows the public and private sectors to concentrate on delivery – saving time and money in the process. Planning charges may also encourage a greater degree of buy-in to the overall development process.

11.23 Charging Authorities (mainly local planning authorities, but including the GLA), have the choice to implement the CIL. In London, both the Mayor and boroughs will be able to charge CIL and the funding agreement for Crossrail requires £300m to be raised through CIL. It is expected that the Mayor will introduce a CIL charge at an early stage and that the Mayoral CIL will be used entirely for Crossrail for the immediate future. Where adopted, CIL will be levied based upon a charging schedule established by the authority. The amount of CIL in the schedule will be determined by the authority, based upon certain factors set out in regulations. The schedule will be subject to consultation and examination, and will then become part of the Local Development Framework.

11.24 CIL is intended to be used to bridge infrastructure funding gaps arising from new development. Levy monies will be available for use by authorities to fund infrastructure and are likely to be used, in particular, to support housing growth and economic development. Section 106 agreements will remain available to local authorities after the CIL regulations come into force and developer contributions towards affordable housing will continue to be made through planning obligations. The government intends to change the way that Section 106 agreements are currently used, once the CIL becomes operational.

11.25 Once established, the proposals will generate funding from development activity. However, the rate and quantum of development activity is subject to commercial, financial and technical risks. Its use as an effective funding tool to forward-fund infrastructure provision will depend upon the degree to which the risks that impact on the future build out or sales rate can be managed or mitigated and the extent to which upfront funding can be raised against projected future CIL revenues.

## Capital Grants

11.26 Capital grants from the UK central government will be subject to the same constraints as other forms of capital funding and are therefore likely to be under significant financial pressure.

11.27 Our research did, however, identify views from some financial advisers that some EU grants were taken up more quickly and for bigger schemes than the UK. Reference was made to schemes in Portugal involving several €100 million, whereas the equivalent UK schemes were much smaller. The grant scheme that was being referred is known as JESSICA[6].

11.28 In London, the LDA takes the lead in securing JESSICA funding. The LDA has been proactive in developing approaches that use EU funding, such as JESSICA, but the amounts of money raised seem comparatively small for a City the size of London. The JESSICA model does enable funds to be spent in City areas to promote sustainable investment and jobs.

11.29 Our research identified views by financial consultants active in the market that local authorities had, to date, taken a rather passive role in not pressing RDAs, including the LDA, to push forward schemes that might benefit their areas. This could therefore warrant further consideration, although additional investigation would be required.

## Recommendations

**11.30 Recommendations in relation to new forms of income are:**

- **Levying charges for schemes such as road use, tolling and workplace parking need to be kept on the agenda by boroughs, albeit, any introduction of charging is not in immediate prospect.**
- **Boroughs should monitor the developments in respect of TIF and ADZ and consider the further working up of schemes that could have substantial benefits, were ADZs to be further considered by government in the future. As identified in section 10, a coordinated approach through pan-authority and/or pan-London initiatives for developing propositions may be able to deliver significant advantages from cross-authority working and London Councils should seek to discuss the potential for such ADZs with central government.**

[6] Joint European Support for Sustainable Investment in City Areas – an initiative of the EU Commission, in conjunction with the European Investment Bank, to promote sustainable investment, growth and jobs

- **The impact of Business Rate Supplements should be reviewed during the life of the Crossrail project, with London Councils considering the case as to whether boroughs should be able to retain receipts from BRS in their own right, once Crossrail is concluded.**
- **More enquiries should be made by boroughs into the workings of EU grants and support and whether boroughs should be more proactive in ensuring that available resources are focused on projects that they would support.**

# 12. New Forms of Finance

## Introduction

12.1 The current recession has had many implications and one of these has been the difficulties in raising finance. This has impacted on local authorities directly, where PFI deals have not been able to find affordable finance and where developers have had to pull out of schemes and in the private sector, where businesses have faced closure, owing to a combination of poor trading and an inability to secure loans to allow their businesses to continue.

12.2 There is now an improving supply of finance for PFI deals; with this difficulty having reduced since the creation of the Treasury Infrastructure Financing Unit (TIFU) in March 2009, with PFI deal closure accelerating since then; albeit, the cost of finance has increased significantly. This section therefore considers alternative forms of finance of relevance to capital investment.

## Municipal bonds and institutional investment

12.3 In the light of current funding difficulties, alternative forms of finance have been suggested in the place of private finance. Such finance would not, in itself, result in cheaper finance, but could enable some procurement which would otherwise be difficult to fund to proceed more quickly. The availability of alternative funds to the banks could act as a moderator in the market place and dampen any potential cost increases. However, in the case of PFI, the use of more public sector finance might reduce the degree of risk transfer and provide the public sector with potentially poorer value for money than would otherwise be the case.

12.4 Historically, local authorities have issued bonds and large local authorities have issued bonds for £50m or more in order to finance capital programmes. They have also issued bonds for much smaller amounts to individuals - £5,000 or less. Such approaches have become scarce, as, generally, the PWLB has been able to provide value for money loans at lower cost. The costs of issuing bonds and administering the loans involved are high and it is not self-evident that, in the present market, such an approach is needed. If the banking system is returning to a more stable position, the need for this approach also becomes more questionable.

12.5 Bonds still have to be repaid and, unless they result in lower interest costs, it is not clear that they would enable more capital expenditure. If they are linked to an ADZ or TIF or BRS scheme, they may appear to facilitate additional capital expenditure, but, in reality, it is the new income stream that is providing the stimulus for change.

12.6 Institutional investment from pension funds could, like bonds, provide a new form of finance, but again, it would not enable more capital expenditure in itself. In principle, there is a close match between the funding requirements for PPP and PFI schemes, where affordable long-term finance is required, and the investment needs for pension funds, which require long-term, but low risk, investments. Pension funds have invested in PFI and PPP projects, but typically only once the construction phase of projects has passed and when the projects are being refinanced.

12.7 A 2008 client survey undertaken by the pension advisers Mercer highlighted that only 0.7% of UK pension schemes were shown to invest in infrastructure. The average allocation to infrastructure by those schemes was 2.3% on an unweighted basis and 0.8% on a weighted basis. A more recent survey by the NAPF shows continuing low levels of investment in UK infrastructure projects.

## Making loans to business

12.8 Making loans available to businesses is defined as capital expenditure for the purpose of local authority capital controls. By making use of prudential borrowing, loans to businesses can be made and a cost neutral position reached, as it can for mortgage lending to individuals. However, business loans need to be made at rates that do not contravene State Aid requirements, and there is a higher than average risk of bad debts by implication, if commercial banks have determined that finance should not be made available. No boroughs indicated that this approach was on their agenda, but it might an area that some might wish to consider.

12.9 The difficulties of finding affordable finance for many private sector businesses continues throughout England, as well as in London. In order to address this difficulty, some local authorities have considered establishing municipal banks and one authority, Essex County Council, has established a bank to effectively offer good local businesses with cash flow difficulties a lifeline of finance.

Case study 24: Essex local bank

Essex wants to support local businesses which are having difficulty raising finance. It has entered into a partnership with Santander, the Spanish-based banking giant, that owns Abbey and Alliance & Leicester. The Council has set aside £50m and the Santander group has put in a similar amount, to enable small and medium size businesses to access loans of up to £100,000.

The County has used its well-being powers to do this. As it has not formed a bank, but formed a partnership with an existing regulated business, it has not encountered the legal and regularity problems that it would by creating its own bank. Only ongoing businesses that are based in Essex are eligible to apply for loans. Banking on Essex does not offer start-up loans, overdraft facilities or personal loans. The County is taking a higher proportion of the bad debt risk than Santander.

12.10 Birmingham City Council explored this approach, but the financial business case for the Essex model did not work in the City's situation and a major reason for this was the risk of bad debts falling on the public sector. The model it has been studying involves supporting and with working with existing organisations, rather than creating a new organisation. The City considers that there is a need to provide both capital and revenue grants to businesses – capital grants would be made available, requiring the use of prudential borrowing, whereas revenue grants would be financed from revenue resources, perhaps, balances. Birmingham is considering making some £10m of resources available. The City has identified tranches of funding routes that already exist that could be used to support this strategy.

12.11 The equivalent approach in London could to be to:

**For smaller business needs (loans to £20,000).** Provide additional support to existing Community Development Finance Institutions[7] (CDFIs), which are organisations that lend to enterprises that banks and other mainstream lenders consider to be too risky, e.g. because of lack of business experience or poor credit ratings. The businesses that are supported by the CDFI must be commercially viable.

**For medium business needs (loans to £250,000).** In the West Midlands, not for profit organisations already exist to provide loan finance to businesses where banks are not able to meet their needs. For example, Advantage Transition Bridge Fund Limited has been provided with government and EU grants to help provide additional finance in the short to medium term to businesses impacted upon by the closure of a major regional employer. Loans of between £50,000 and £250,000 are considered for SME businesses based in the West Midlands who have a viable business plan, but who are unable to secure finance from normal commercial sources.

**Facilitating access to equity (finance up to £2m).** The Regional Development Agency in the West Midlands is called Advantage West Midlands (the equivalent of the LDA). A wholly owned subsidiary of Advantage West Midlands has been established with the aim of assisting expanding SMEs to raise equity finance of up to £2m by connecting them with investors. The EU has endorsed the arrangement as acceptable under State Aid rules and provided aid of £3m to the company.

12.12 Finance Wales (FW) provides a comparative model, as illustrated in the case study below.

[7] CDFIs are sustainable, independent organisations which provide financial services with two aims; to generate social and financial returns

Case study 25: Finance Wales

FW was formed in 2001 by the Welsh Assembly Government. It is an independent company, providing commercial funding to Welsh SMEs, which invests private and public funds, including EU funds. It has xénos, the Wales Business Network, as a subsidiary company. It has invested in more than 2,000 growth SMEs in Wales, leveraged £322m of funds, and directly invested £110 million.

In 2007/08 it: invested £20.8m; completed 185 investments, 151 of them syndicated; saw three successful equity realisations; saw two of portfolio companies listed on AIM; made three early stage co-investments with Fusion IP. FW managed funds of £270m as at 31 March 2008.

## Recommendations

**12.13 Recommendations in relation to new forms of finance are:**

- **Boroughs could explore potential approaches to make financing available to local businesses, where appropriate risk assessments have been undertaken.**

# 13. Conclusion

13.1 LG Futures' research has identified a significant additional level of capital need by London boroughs and, at the same time, has considered a number of barriers to capital investment. In the context of reducing national levels of funding and the current economic climate, impacting upon the level of capital receipts that authorities themselves can generate, combined with revenue budget pressures and the position of the majority of London boroughs at the funding floor, it will become increasingly important that a wide range of options are considered in order to maintain capital programmes.

13.2 Clearly, individual local authorities and London boroughs differ widely in their attitude to capital expenditure and, therefore, there is not a generic approach that can be followed. However, by considering the full range of options open to authorities, as set out in this report, the intention is that capital investment will be optimised, delivering the benefits of improved assets and infrastructure for London's residents.

# Appendix A – Stakeholders Consulted

British Bankers' Association

Butlers

Capital Ambition

Chartered Institute of Public Finance and Accountancy

Deloitte

Department for Communities and Local Government

Department of Health

Department for Transport

Greater London Authority

HM Treasury

Homes and Communities Agency

Local Partnerships

New Local Government Network

Partnerships UK

Pinsent Masons

PricewaterhouseCoopers

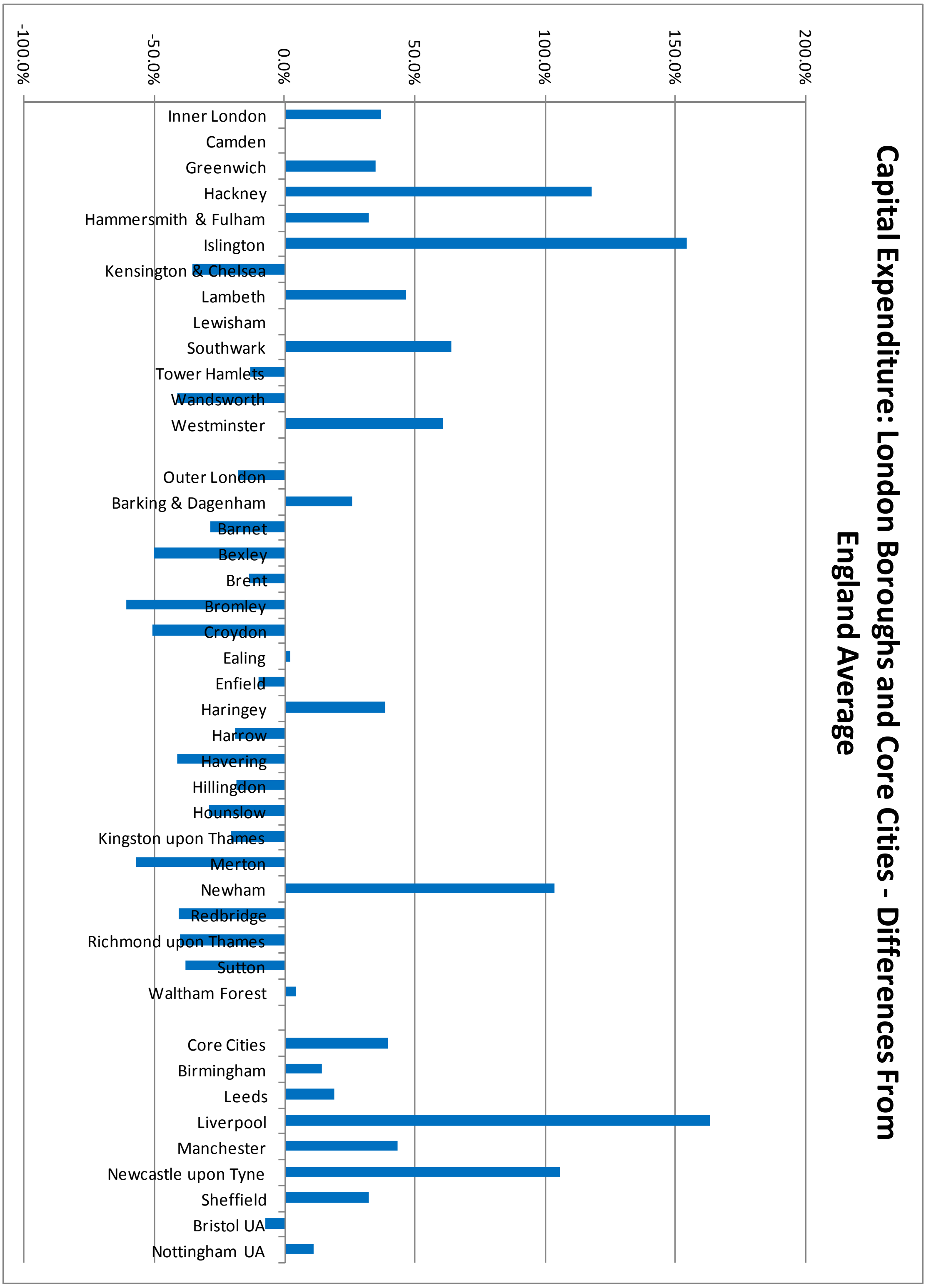
Public Works Loan Board

Transport for London

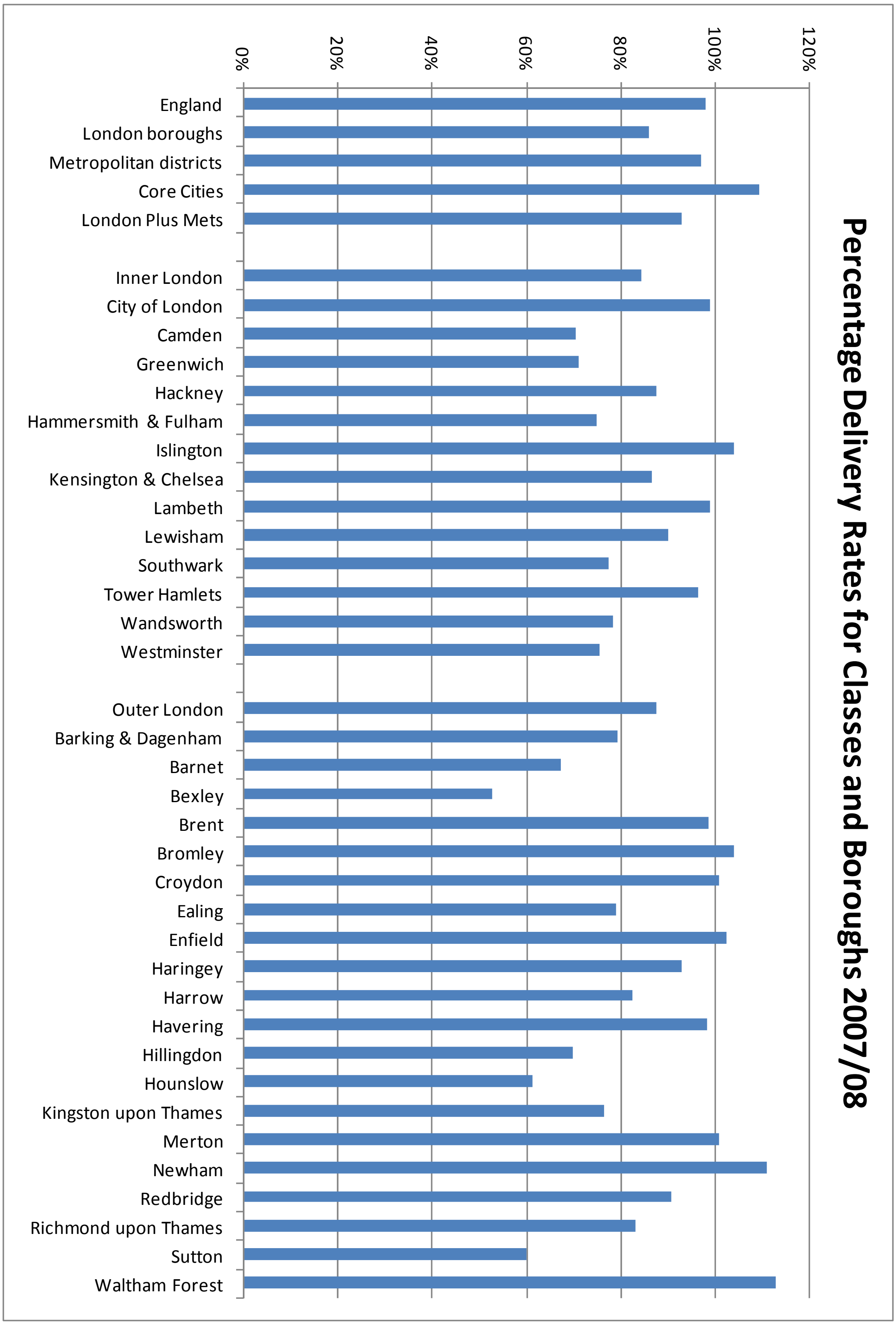
# Appendix B – London boroughs responding to the capital investment survey

1. Barking & Dagenham
2. Barnet
3. Bexley
4. Brent
5. Bromley
6. Camden
7. City of London
8. Croydon
9. Enfield
10. Greater London Authority
11. Hammersmith & Fulham
12. Haringey
13. Havering
14. Hounslow
15. Islington
16. Kingston
17. Lambeth
18. Merton
19. Newham
20. Redbridge
21. Richmond
22. Sutton
23. Tower Hamlets
24. Waltham Forest
25. Westminster

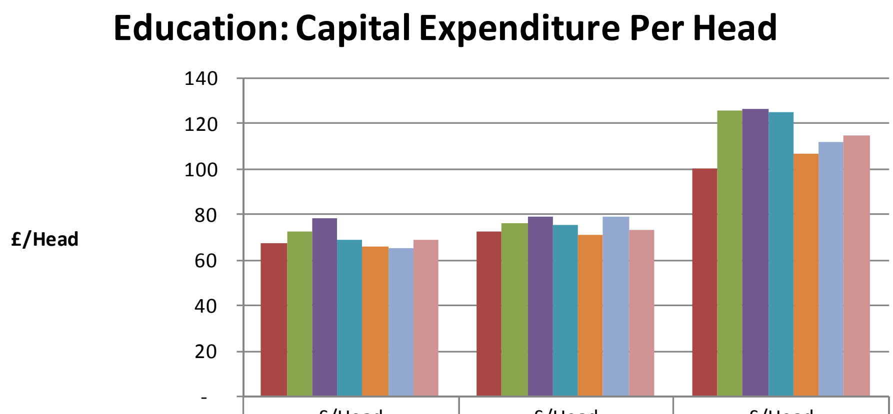
# Appendix C – London borough capital expenditure per head – difference from national average (based upon three year average)



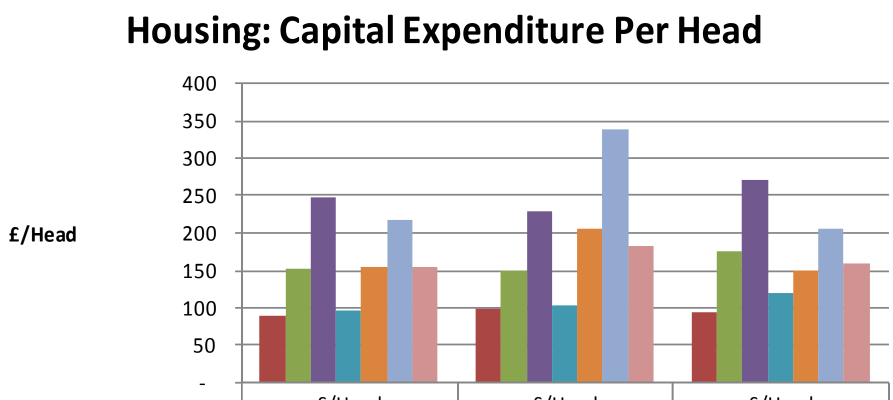
# Appendix D – London borough capital programme delivery rates compared to other classes of authority for 2007/08



# Appendix E – Capital expenditure per head for individual local government services

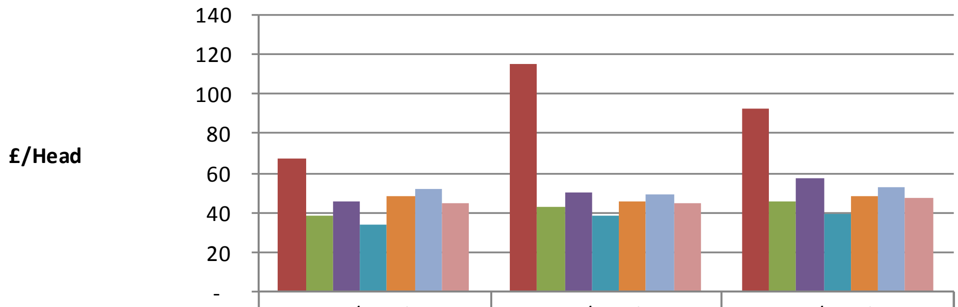



| | £/Head Education 2006/07 Outturn | £/Head Education 2007/08 Outturn | £/Head Education 2008/09 Budget |
|---|---|---|---|
| England | 67 | 72 | 100 |
| London boroughs | 72 | 76 | 125 |
| Inner London | 78 | 78 | 126 |
| Outer London | 68 | 75 | 125 |
| Metropolitan districts | 66 | 70 | 107 |
| Core Cities | 65 | 79 | 111 |
| London Plus Mets | 68 | 73 | 114 |



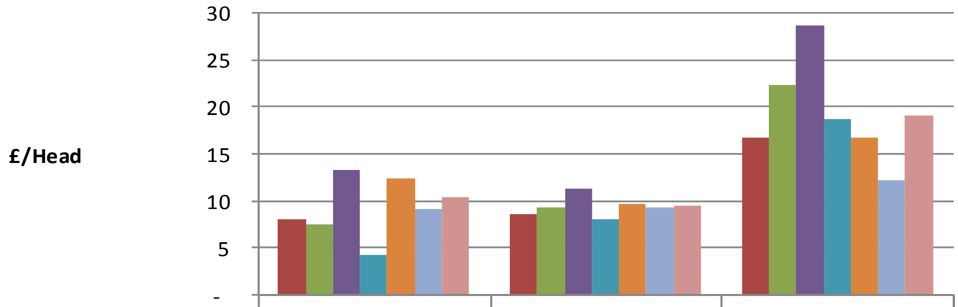

| | £/Head Housing 2006/07 Outturn | £/Head Housing 2007/08 Outturn | £/Head Housing 2008/09 Budget |
|---|---|---|---|
| England | 88 | 97 | 92 |
| London boroughs | 152 | 148 | 174 |
| Inner London | 247 | 228 | 270 |
| Outer London | 96 | 102 | 118 |
| Metropolitan districts | 154 | 205 | 148 |
| Core Cities | 217 | 337 | 206 |
| London Plus Mets | 153 | 182 | 159 |

## Highways: Capital Expenditure Per Head



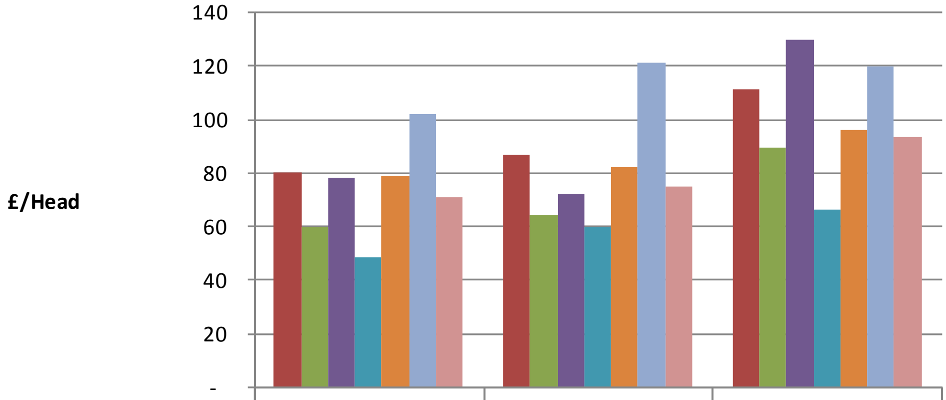

| | £/Head Highways & Transport 2006/07 Outturn | £/Head Highways & Transport 2007/08 Outturn | £/Head Highways & Transport 2008/09 Budget |
|---|---|---|---|
| England | 68 | 115 | 93 |
| London boroughs | 39 | 43 | 46 |
| Inner London | 46 | 50 | 58 |
| Outer London | 34 | 38 | 39 |
| Metropolitan districts | 49 | 46 | 48 |
| Core Cities | 52 | 49 | 53 |
| London Plus Mets | 45 | 45 | 47 |

## Sport & Recreation: Capital Expenditure Per Head




| | £/Head Sport & Recreation 2006/07 Outturn | £/Head Sport & Recreation 2007/08 Outturn | £/Head Sport & Recreation 2008/09 Budget |
|---|---|---|---|
| England | 8 | 9 | 17 |
| London boroughs | 8 | 9 | 22 |
| Inner London | 13 | 11 | 28 |
| Outer London | 4 | 8 | 19 |
| Metropolitan districts | 12 | 10 | 17 |
| Core Cities | 9 | 9 | 12 |
| London Plus Mets | 10 | 10 | 19 |

## Other: Capital Expenditure Per Head




| | £/Head Other 2006/07 Outturn | £/Head Other 2007/08 Outturn | £/Head Other 2008/09 Budget |
|---|---|---|---|
| England | 80 | 87 | 111 |
| London boroughs | 59 | 64 | 89 |
| Inner London | 78 | 72 | 129 |
| Outer London | 48 | 60 | 66 |
| Metropolitan districts | 78 | 82 | 96 |
| Core Cities | 102 | 121 | 119 |
| London Plus Mets | 71 | 75 | 93 |

*Source: DCLG Capital Outturn Returns (COR) and Capital Estimates Returns (CER)*