



# Capital Futures

Local capital finance options in an age of recovery

**Tom Symons**



New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this report as part of its programme of research and innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

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Of course, these remain the thoughts of the author and any errors or omissions are my own.

**Tom Symons**

*November 2011*

## *Executive summary*

*“In terms of future productivity, this infrastructure deficit is as serious as our budget deficit”*

**Nick Clegg, Deputy Prime Minister, Financial Times 31<sup>st</sup> October 2011**

**Delivering infrastructure at the local level lies at the centre of three of the Coalition’s main priorities for this parliament: deficit reduction, economic growth and decentralisation. While there has been considerable emphasis on driving growth at a local level despite substantial spending reductions, these priorities and their consequences are in reality not always mutually supportive. The task for local authorities is to reconcile the three to enable investment in roads, public transport, new housing, education facilities and other types of infrastructure to continue. The core objective of this report is to outline a range of ways in which local authorities can develop strategies to sustain vital investment.**

There has scarcely been a more challenging environment within which to pursue capital investment. Local authorities are in the midst of adjusting to unprecedented spending cuts. Total capital spending for local authorities is set to decrease from £11.1bn in 2010-11 to £6bn in 2014-15 in real terms. This equates to a 45 per cent real terms decrease in capital grant. In addition to this, there are substantial pressures mounting on the revenue side making it harder for councils to undertake additional borrowing for investment purposes. To compound this, the Treasury has made borrowing for councils more expensive by ramping the rates of interest at the PWLB to 1 per cent above Gilts. Other sources of finance, such as the PFI, asset sales and developer contributions have slowed with a fall from political favour and a flat-lining property market respectively.

The Coalition’s reform programme is also having a major impact on the core functions of councils and the tools and freedoms they have to deliver this. Most significantly the devolution of new primary responsibilities for economic growth at a local level alters fundamentally how we view the role of a local government finance service. Driving growth means an even greater role, and imperative, in delivering infrastructure investment. Also important

are reforms designed to promote bottom-up solutions and innovations, crucially by addressing the culture of central-local relations. Central government wants local authorities to be more creative and entrepreneurial across a range of functions, including capital investment.

We are seeing the beginnings of exciting new approaches from councils, and there are quick-wins to be had in the short-term. A burst of procurement activity on new Local Asset Backed Vehicles demonstrates the proactive approach councils and the private sector are taking towards the challenge. New government initiatives such as the Green New Deal offer councils the chance to drive capital investment, and to bring in private capital, without the need for large amounts of upfront capital. Such approaches help to keep up momentum on capital funding and stoke the fires of local economic prosperity. These approaches take us so far, but there needs to be a wider take up and an increase in the pace of change in the sector. The times demand fresh approaches and meeting the capital investment challenge will not happen without this.

### **New sources of borrowing**

The increase in rates at the PWLB makes it a priority for councils to find more cost-competitive sources of borrowing for capital purposes. Our survey found 62 per cent of local authorities we surveyed expected the profile of their borrowing to change following the decision, indicating high demand for alternative borrowing sources. This report analyses a range of potential alternative borrowing sources. Our research has shown that there are a number of alternatives which will provide a highly competitive margin on the PWLB. Many of these options will involve developing more mature and in-depth relationships with financial markets, which in turn offer a range of benefits to councils that are not experienced when accessing the PWLB. Bond issuance on the debt capital markets can be done in a variety of ways to reflect the varying size and scale of individual councils borrowing needs. A public offering could deliver a saving of on the PWLB of 20bps, a significant amount in the context of £150m+ bond issuances. For smaller borrowing needs, private placements or pooled issuances could present an alternative route which is still likely to offer a saving on the PWLB. Following the announcement to reduce PWLB rates for the HRA buy-out, the council

bond market looks set to develop gradually over the short to medium-term. There is also the potential that a collective agency, borrowing on behalf of multiple member authorities and the on-lending, could offer another source of finance that is cheaper than the PWLB.

There is nothing in legislation that would prevent local authorities exploring these options. There are however ways of structuring these options that would either make it easier or would help to mitigate some of the underlying risks involved, and as a result would be likely to bring down borrowing costs. Currently legislation relating to withholding tax prevents councils paying out on bond coupons gross of tax, meaning a SPV must be used for the issuance. An amendment to the legislation is recommended for inclusion in the Finance Bill to rectify this. Councils are currently prohibited from using derivative products, which when issuing a bond would help to mitigate for volatilities in underlying interest rates. Financial institutions require greater legal clarity that councils will be able to use derivatives in the future than the new General Power of Competence (GPC) can offer. Similarly cross guarantees are needed for the most effective operation of a Local Government Funding Agency, yet, again the GPC is not seen as a strong enough legal clarification about councils' ability to use these. We urge central government to support councils by finding a way to offer greater legal clarity on these issues. Without this, councils may be ill-equipped to manage risk or to secure the best rates from market finance.

### **The changing landscape**

Deficit reduction and localist reform means that the local capital finance landscape is changing. While funding is less readily available, there is in theory a greater range of options open to local authorities than there were previously in the capital finance tool-kit. The wave of devolutionary reforms provides opportunities for councils to develop alternative capital financing strategies. Incentives and revenue streams open up scope for investment in different ways, such as pump-priming, to facilitate private sector investment and development activity. A fresh approach to partnering arrangements with the private sector opens up the possibility of flexible and innovative partnerships which can combine each sector's discreet advantages to drive investment. Councils are also now using this

opportunity to look for creative ways to better capture economic value. In addition, new sources of borrowing, from debt capital markets for example, may too prompt a more commercially, business minded outlook for local authorities.

Underpinning our analysis on these new options are two themes. Firstly, it is clear that these new approaches present a higher degree of risk than traditional approaches to capital finance. Secondly, that localist reforms mean a changing role for central government which is as important to get right as the transition councils must themselves make.

The capital finance landscape contains intrinsically greater levels of risk. Successfully sustaining capital investment will mean implicitly that this risk can be effectively handled. Councils are currently, by their own admission, heavily risk averse. Risk aversion is one way to stifle innovation and is something that must change if councils are to embrace the new opportunities available to them. On the other hand, innovation can fail because risk has not been accurately gauged, with safeguards and arrangements to ensure that failure is survivable. In reality councils must land somewhere between these two positions. A less restrictive approach to risk is certainly needed, but that is not to say it should be disregarded.

Central government too is adjusting to a new role, moving away from centralist planners to hands-off decentralisers (in rhetorical terms at least). DCLG has championed the cause of localism and responded to many of the sector's calls for greater freedom. However, there are also question marks over how widely the localism agenda is shared across government. The Treasury appears keen to embrace the parts that will lead to incentivising private sector growth and better value-for-money on capital, but nervous about letting go of the levers as much as councils wish or need. In other departments, such as Department for Education, there appears to be no buy-in on the localism agenda, as shown by their new capital programme for primary schools. On a wider governmental level, autonomy may well need to be earned for the shift of power to be long-lived.

There are also fresh questions about what the role of central government is in a localist environment. Clearly the ambition is for greater local government



decision making and control. But realistically what does that mean for the role of the centre? There will be instances when councils need the support and backing of central government. This may be in the form of clarifying legal issues, or in advocating for councils across other central departments. Importantly, it means DCLG and, crucially, its Ministers, still have a vital role to play. If the aim is to have councils pursuing a more creative and entrepreneurial approach, there must be a system behind them in centre that does what is necessary to facilitate that.

The future for local capital investment is far from bleak. There are numerous opportunities arising that can help councils adapt and adjust, establishing new and innovative approaches to capital finance. The success of this will depend on many factors, but at the heart of all of them is the relationship between central and local government. Local authorities must be more creative, more adventurous and more entrepreneurial. Their latitude and ability to do this will be defined by the way that central government adapts to its own new role.

## Recommendations

- *The government should introduce a short piece of legislation, similar to the TfL Act, detailing the legal use of derivatives by local authorities.*
- *The government to use the passage of the Finance Bill 2011 to insert a clause stipulating local authorities' ability to pay gross bond coupons*
- *Councils should make risk management a public activity and communicate downside and upside risks to citizens*
- *If the Government implements regulation of TIF use this must be light-touch and localised as a system, with no arbitrary limits on the number of schemes allowed*
- *That the government injects new impetus into the use of land auctions by permitting the use of privately owned land in a series of pilots in early 2012.*
- *To make the needed advances the work that takes forward Total Place and Total Capital concepts, such as Community Budgeting, must build the use of capital resources into its scope.*

# 1 *Introduction*

**A major part of the British economy's revival has been pinned to the prospects for increasing local growth. This places a new emphasis on the role of local authorities to provide the underlying infrastructure and development needed to facilitate private sector growth, as well as continuing the work of regenerating areas and investing in the social infrastructure needed to make communities prosperous and economically viable. Councils now have the important task of having to lead, co-ordinate and deliver a significant proportion of the new development needed to build a resilient and sustainable economy.**

Providing high-quality infrastructure in an era of low growth will present significant challenges for local authorities. As the context and profile of local capital investment has changed, so too has the funding landscape within which it must be delivered. A combination of pressures has created new tensions and dynamics which will alter the way councils approach capital investment. A broad political shift towards localism will present councils with greater control and new governance frameworks at a local and sub-regional level.

This shift also brings with it the prospect of more localised revenue streams, such as the retention of business rate growth. At the same time, economic pressures mean that approaches predicated on high market growth may no longer be applicable. But in their place new financing techniques and models, such as Tax Increment Financing and land auctions, are now genuinely viable and councils must seize the opportunity to use them where they can make impact.

This report aims to help councils navigate a challenging fiscal period and provide the infrastructure required by communities and for economic growth. The report is divided into three sections:

**Section 1** is an analysis of what the Spending Review 2010 will mean for capital investment over this parliament

**Section 2** assesses a range of new borrowing options, including a return to municipal bond issuance, for councils in light of the new rates on interest at the PWLB

**Section 3** discusses the new capital finance landscape that councils will have to deliver new infrastructure within

Considered together, we hope this report presents a range of new strategies to help councils sustain the vital investment needed in the schools, roads, housing and other development which provides the backbone of community and business life.

## Section I *The prospects for local capital investment*

### 2 *What the Comprehensive Spending Review 2010 means for local capital expenditure*

**The 2010 Comprehensive Spending Review heralded a wave of spending reductions not witnessed for generations. The ramifications across nearly all areas of public spending are profound. Local capital investment, just one part of this shrinking jigsaw, is no exception.**

Central government support for capital expenditure, via capital grants and supported borrowing, is expected to decline by 22 per cent over the period of the 2010 Comprehensive Spending Review (CSR).<sup>1</sup> In the first year of the CSR alone, between 2010-11 and 2011-12, local authority capital expenditure is forecast to decrease by 12 per cent from £23.1 bn to £20.5bn.<sup>2</sup>

#### **The impact of the CSR on local capital expenditure<sup>3</sup>**

Over the decade up to 2010 local capital expenditure grew steadily in real terms. A substantial amount of this expenditure was directed at addressing historic backlogs in capital investment created by previous periods of underinvestment, such as from the late 1980s up until 2000.<sup>4</sup> As Figure 2 demonstrates, however, levels of capital spending in real terms are already at pre-2007 levels, and are set to continue decreasing up until 2015 at the earliest.

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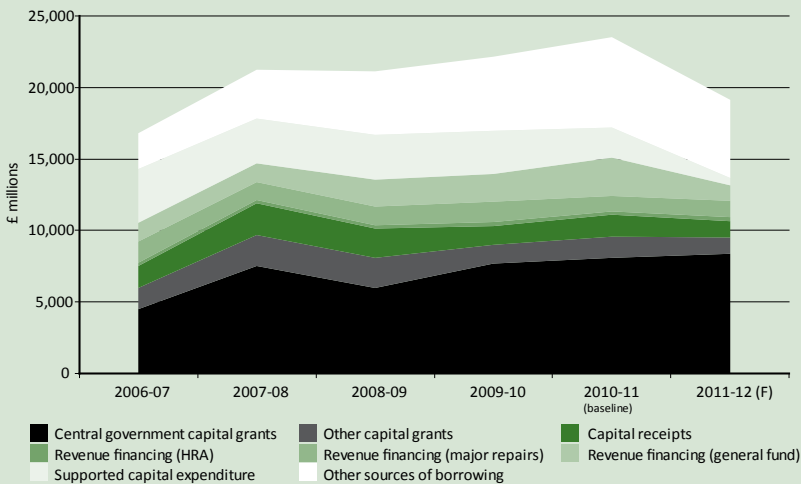
<sup>1</sup> HM Treasury, *Spending Review* (October 2010)

<sup>2</sup> DCLG, *Local authority capital expenditure and receipt: England 2011-12 forecast revision* (October 2011)

<sup>3</sup> The additions to capital funding announced in the Autumn Statement 2011 are discussed at the end of this chapter.

<sup>4</sup> For instance the Building Schools for the Future and Decent Homes programs

**Figure 1** Financing of local authority capital expenditure in real terms from 2006-07 to 2011-12

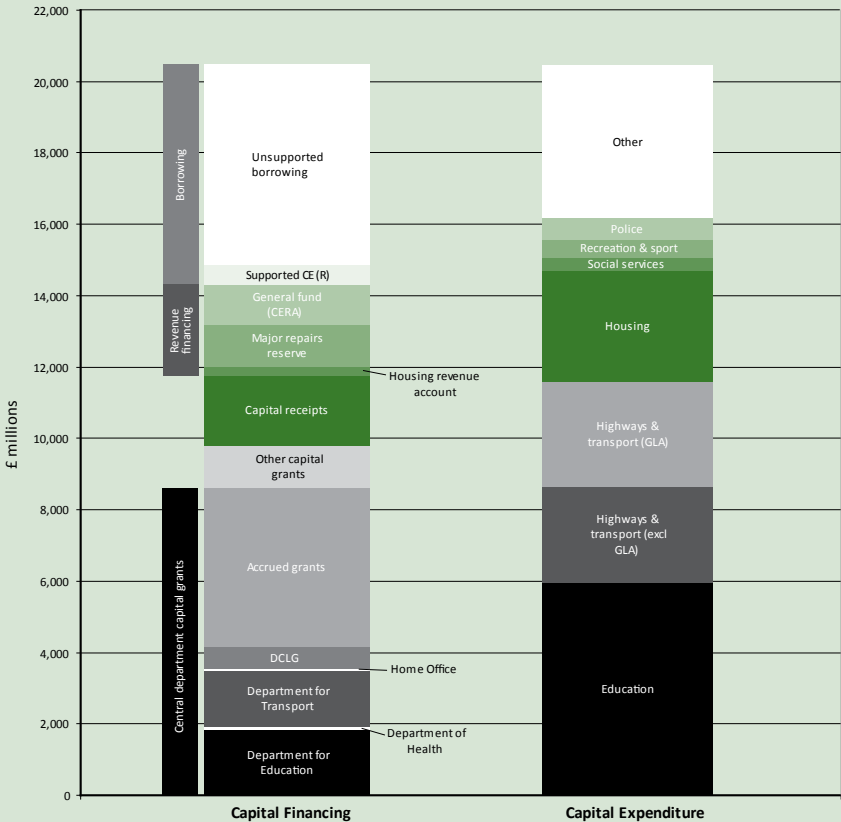


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Local authorities receive funding for capital expenditure from a wide range of sources, not all of which have their roots in central government. Support for capital expenditure can be broadly categorised into capital grants, revenue financing, borrowing and capital receipts. While the total level of capital expenditure will decrease between 2010 and 2015, the impact of the CSR on the different sources of capital funding will not be uniform. Some sources of capital expenditure are independent of the CSR and are hard to forecast. Capital receipts, for example, are heavily influenced by underlying market conditions rather than government spending. For further detail on the series of capital finance for councils see Appendices 3 and 4

5 DCLG, *Local authority capital expenditure and receipts, England: 2011-12 forecast revision* (Oct 2011)

**Figure 2** Breakdown of local authority capital financing and expenditure for 2011-12



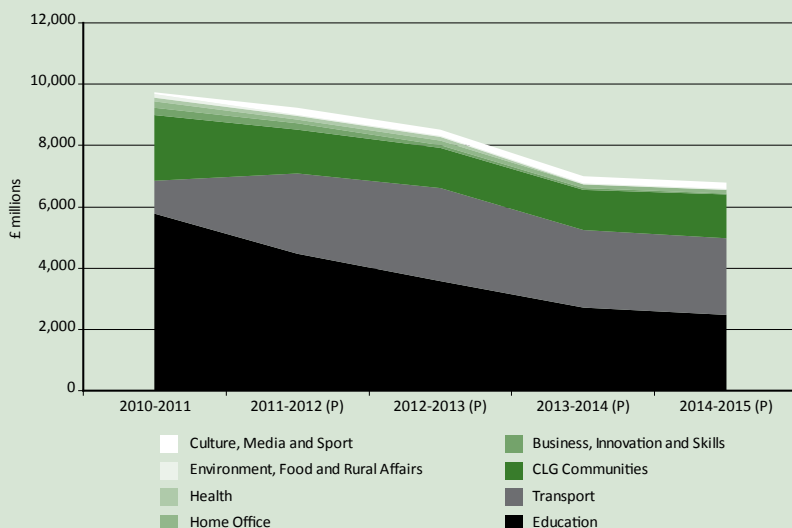
6

6 DCLG, *Summary of capital grant programmes 2011-12 and 2012-13* (Jan 2011); DCLG, *Local authority capital expenditure and receipts, England: 2011-12 forecast revision* (Oct 2011)

## Capital grants

Treasury forecasts show that the total capital (DEL) budget for central government departments will be cut in real terms by 28 per cent over the Spending Review period.<sup>7</sup> As a result, central government capital grants for local government, which include capital grants from both central departments and other sources, will fall by 30 per cent to £6.8 billion in 2014-15.

**Figure 3** Central government capital support for local authorities by department in real terms from 2010-11 to 2014-15



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Although local authorities receive capital grants from all central government departments, the biggest funders are Department for Communities and Local Government (DCLG), the Department for Transport (DfT) and the Department for Education (DfE).

<sup>7</sup> HM Treasury, *Public Expenditure Statistical Analyses* (July 2011)

<sup>8</sup> HM Treasury, *Public Expenditure Statistical Analyses* (Jul 2011)

**Department for Communities and Local Government:** Capital grants to local authorities will decline by 34 per cent from £2.1 billion in 2010-11 to £1.4 billion in 2011-12. This figure should remain stable until 2014-15 despite greater reductions in the overall departmental budget.

**Department for Transport:** the DfT's budget is forecast to fall in real terms by 9 per cent to £6.8 billion in 2014-15, however capital grants to local authorities are set to rise by 129 per cent from £1.1 billion to £2.5 billion in the same period. This figure is, however, misleading and reflects a shift from funding capital expenditure on transport via supported capital expenditure (revenue) (SCE(R)) to capital grants. The corresponding decrease in SCE(R) is discussed below.

**Department for Education:** capital grants to local authorities will decrease by 57 per cent, from £4.5bn to £2.5bn in 2014-15

### Revenue financing

DCLG forecasts show revenue financing falling dramatically in real terms by 38 per cent, from £4 billion in 2010-11 to £2.5 billion in 2011-12. This is mainly because revenue (DEL) finance for local government, an indirect source for capital expenditure, is forecast to fall from £81.7 billion to £70.2 billion. In interviews held for this research with local authority finance directors and chief executives, pressures on revenue accounts were cited as being one of the major challenges to future capital financing.

### Prudential Borrowing

Local authority borrowing is comprised of two parts: supported capital expenditure (revenue) and non-supported borrowing (or self-financed borrowing). DCLG forecast that total borrowing will fall in real terms by 29 per cent from £8.4 billion in 2010-11 to £6 billion in 2011-12.

**Supported capital expenditure (revenue):** The level of supported capital expenditure (revenue) has dropped dramatically in real terms from £3.7 billion in 2006-07, accounting for 60 per cent of total borrowing, to £2.1 billion in 2010-11 and only 23 per cent of total borrowing. This trend is due to continue as supported capital expenditure is phased out – it will fall in real



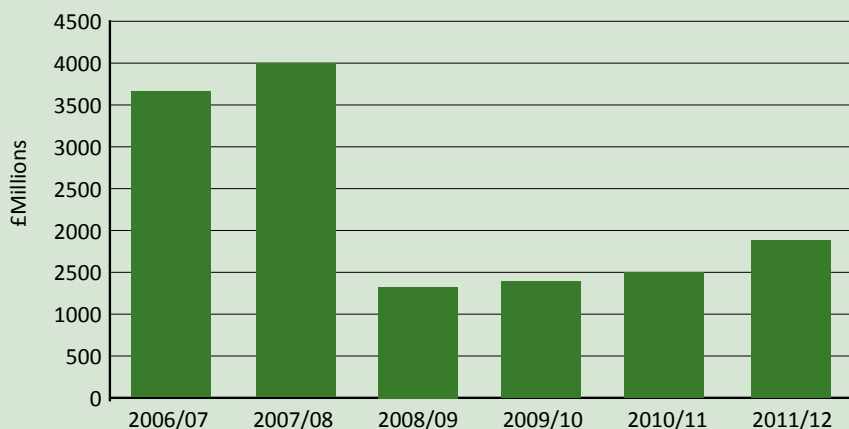
terms by 75 per cent from £2.1 billion to £0.5 billion in 2011-12.

**Unsupported (self-financed) borrowing:** There is a forecast real terms drop in unsupported borrowing of 24 per cent from £7.2 billion in 2010-11 to £5.5 billion in 2011-12. In the medium-term, the Treasury expects self-financed capital expenditure to fall by 17 per cent by 2015.

### Capital receipts

Capital receipts have declined sharply since the banking crisis of 2008, which led to suppressed land and property values. Capital receipts are now forecast to increase in real terms from £1.4 billion in 2010-11 to £1.9 billion in 2011-12. However, an uncertain property market could stifle these expectations and it is hard to make any firm projections about levels of future capital receipts.

**Figure 4** Local authority capital receipts: England 2006/07 - 2011/12



### Section 106 - Private Finance Initiative

The Spending Review 2010 cancelled the use of PFI credits, however, and these are set to decline as the remaining projects in the PFI pipeline are

finalised.<sup>9</sup> PFI does not appear in Government capital spending figures as it is predominantly paid for through the revenue account. It must be acknowledged that PFI has been a major source of financing which is not reflected in data relating to capital spending levels. Similarly, reductions in PFI are not reflected in the statistics from central government used in this report. The immediate reductions to capital spending are therefore sharper than they might initially appear.

### Other sources of financing

The CSR 2010 announced that the nine Regional Development Agencies would formally close in 2012. To counter this, the government announced the Regional Growth Fund (RGF). This is a £2.6 billion fund to support projects and programmes that promote private sector investment across England up to 2015. Though a welcome boost to some areas, it represents only slightly more than the £2.1bn spent on average each year by RDAs between 2005 and 2010.<sup>10</sup> In addition to the RGF, in September 2011 a £500m Growing Places Fund was announced to kick-start developments that are currently stalled.

### Geographic variations

The forecast change in capital expenditure in 2011-12 varies dramatically between regions in England. The North East and the East Midlands are forecast in real terms to spend 7 per cent less in 2011-12 than they did in 2010-11. The South West and East Midlands will also see sizeable reductions, while the East of England and the South East will see increases in capital expenditure. It is likely, however, that over the course of the CSR, all regions will see a decrease in capital expenditure, of varying degrees. It is clear that the capital spending reductions will be harder for some local authorities than others.

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<sup>9</sup> DCLG, *Local Government Financial Statistics England No 21* (May 2011)

<sup>10</sup> BIS RDA Outturn Data from SR2004 - <http://www.bis.gov.uk/policies/economic-development/englands-regional-development-agencies/rda-finance-and-governance>

**Figure 5** LA capital expenditure and percentage change by region for 2010-11 to 2011-12



11

**The Autumn Statement 2011**

The Government has published its National Infrastructure Plan 2011 alongside the Autumn Statement. This will bring in an extra £4.7bn of investment over the 2010 Spending Review period. The plan sets out a pipeline of over 500 infrastructure projects - energy, transport, telecommunications, water and waste.

11 Local authority capital expenditure and receipts, England: 2010-11 final outturn and 2011-12 forecast (Oct 2011) N.B. regional data excludes the acquisition of share and loan capital

Autumn Statement – New Infrastructure Funding 2011-2015	£m
<b>Total New Funding</b>	<b>£4690</b>
<b>Of which for local authorities or other local agencies</b>	<b>£2950</b>
Growth	£1515
Education	£715
Roads and Transport	£670
Housing	£50

Of the new funding made available, our initial analysis suggests that £2.9bn will be funding that is either available to local authorities, or to other agencies operating at the local level (such as Passenger Transport Authorities). While this funding is a welcome addition, it represents on average an extra £1bn of funding each year. This does not fully compensate for previous reductions in grant.

In addition to this, a number of measures were introduced by the Autumn Statement. The Government has signed a Memorandum of Understanding with two groups of UK pension funds to support additional investment in UK infrastructure. The Government will target up to £20 billion of investment from these initiatives.

### ***Capital investment – an ongoing challenge***

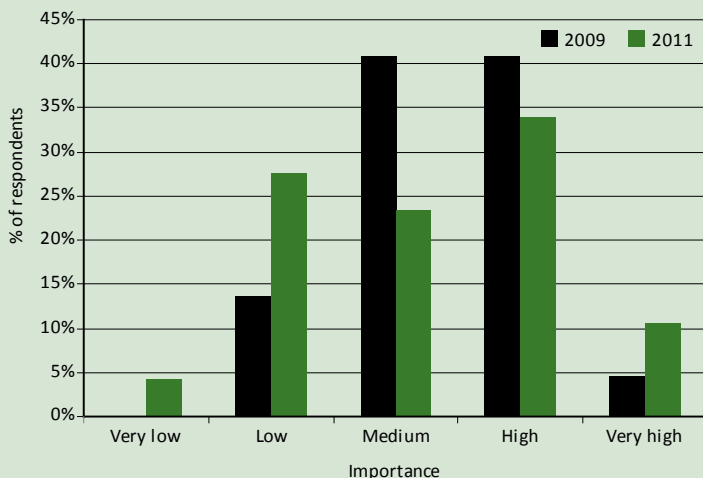
Reductions in capital spending are just one of many challenges faced by local authorities over the course of the 2010 CSR. It is a challenge precisely because the need to make investment in roads, schools, housing and public transport is an ongoing priority, and one that is arguably even more important in light of the Government's aspirations for an economic recovery driven by private sector growth. It is important, therefore, to establish how decreasing levels of capital expenditure match up with local authority investment priorities.

### 3 The continuing need for capital investment

*“Infrastructure is not an end in itself. Rather, it is a means for ensuring the delivery of goods and services that promote prosperity and growth and contribute to quality of life, including the social well-being, health and safety of citizens, and the quality of their environments.”<sup>12</sup>*

Our research found that capital investment remains a priority for the majority of local authorities we surveyed. 55 per cent of councils rated capital investment as at least six on a scale of 10 in terms of priority.<sup>13</sup> When compared with survey results for the same question in 2009, it appears that there has been a slight polarisation of the priority of capital investment between then and 2011. This is reflected by the higher number of respondents for whom it was either a very low priority (4.3 per cent compared with 0 per cent) or a very high priority (10.6 per cent compared with 4.5 per cent). Far fewer respondents reported that capital investment was a medium priority in 2011 compared with 2009 – 23.4 per cent compared with 40 per cent.

**Figure 6** Importance of capital investment over next 3 year period

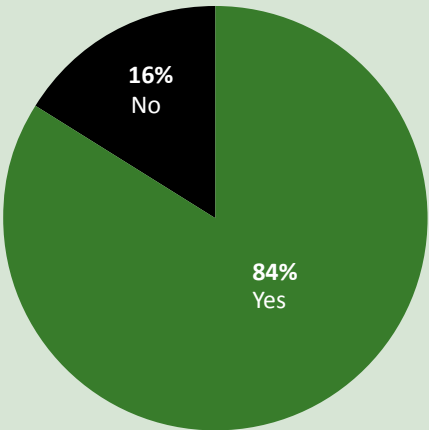


<sup>12</sup> OECD Infrastructure to 2030 (2008)

<sup>13</sup> Where 10 was a very high priority, and 1 a very low priority

Our survey also found that 84 per cent of local authorities we surveyed reported having a capital investment shortfall. The capital investment shortfall refers to whether there is a difference between the amount the local authority deems necessary to invest in capital to ensure high-quality physical infrastructure and promote economic growth, and the amount it has available. While this finding should be treated with a degree of caution – the method councils use for capital planning means there is always likely to be some degree of shortfall – it does indicate that there is a significant capital investment challenge facing local authorities.

**Figure 7** Is there a capital investment shortfall in your local authority



Local authorities currently have two main motivations for capital investment: as a driver for economic growth, and as a means of ensuring the provision of high-quality infrastructure for their communities and local businesses.

**The local authority role in driving economic growth**

***The case for capital investment to drive growth***

The Coalition government’s localism agenda has placed local authorities at the forefront of efforts to encourage local economic growth.<sup>14</sup> Capital

<sup>14</sup> BIS *Local Growth White Paper* (2010), DCLG *Local Government Resource Review Consultation* (2011)

investment is now widely regarded as a fundamental driver of growth. This view has developed a robust, objective basis in recent years. There is now firm evidence that capital investment in infrastructure, for example roads, schools and housing, is crucial for strong economic growth.

A recent study by the International Monetary Fund (IMF) found that estimates of the total amount of public capital from 48 advanced and developing economies during 1960-2001 are significantly correlated with higher growth<sup>15</sup>. The report also highlights that if investment and public capital grow at different rates, then investment will only appear to have a positive effect on growth if it covers the cost of declining public capital. In countries with high initial levels of public capital, the relationship with growth may be hard to identify but is not necessarily absent. The OECD found that between 1970 and 2005, capital investment in roads, rail and energy generation had a stronger effect on GDP per capita in the short-term than any other type of capital investment.<sup>16</sup>

Studies by the World Bank,<sup>17</sup> the OECD<sup>18</sup> and the EIB draw the same conclusion. The World Bank used case studies of twelve countries and found that investment in education and health in particular support growth and development. Research from the OECD concluded that “greater provision of broad measures of infrastructure is associated with higher subsequent growth rates.” Finally, the European Investment Bank (EIB) has conducted a critical analysis of recent evidence about the relationship, and causality, between investment and growth. The EIB found that there is a greater level of consensus in recent years from academic research about the growth enhancing effects of public capital investment.<sup>19</sup>

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<sup>15</sup> Arslanalp, Serkan, Fabian Bornhorst, Sanjeev Gupta, and Elsa Sze *Public Capital and Growth*, IMF Working Paper 10/175 (2010).

<sup>16</sup> Égert, B, Kozluk, T and Sutherland, D, *Infrastructure and Growth: Empirical Evidence*, OECD Economics Department Working Papers 685 (2009).

<sup>17</sup> World Bank, *Fiscal Policy for Growth and Development: Further Analysis and Lessons from Country Case Studies* (2007).

<sup>18</sup> Egert, Kozluk and Sutherland *Infrastructure and Growth: Empirical Evidence* (OECD Economics Department Working Paper No. 685, 2009)

<sup>19</sup> Ward Romp and Jakob de Haan *Public Capital and Economic Growth: a Critical Survey* (EIB PAPERS Volume10 N°1 2005)

Capital spending also has an immediate impact on growth as a form of stimulus. The Office of Budgetary Responsibility (2010) published 'impact multipliers' showing the effect of changes in different taxes and types of spending on growth. This showed that capital spending had the highest multiplier compared with other types of fiscal instruments such as tax cuts and welfare increases.

### ***The need for capital investment to drive growth in the UK***

The Government's growth white paper makes it clear that there is a need for focussed infrastructure investment to facilitate economic growth. This is supported by a survey by the Confederation of British Industry carried out in 2011 which found that infrastructure businesses depend on in the UK is inadequate and in urgent need of upgrading.<sup>20</sup> The survey reported that 65 per cent of firms felt that local road networks have deteriorated in recent years, and that energy supplies and digital connectivity remain pressing concerns for business competitiveness. Furthermore, a report to the Core Cities group, which represents the 8 largest cities in England outside of London, has also reported that the UK lags behind its competitors in infrastructure investment.<sup>21</sup> They argue that a step change in investment levels in rail transport is needed to help UK competitiveness and growth.

### **The provision of high quality physical infrastructure**

The motivation to provide physical infrastructure is not solely related to its impact on subsequent growth. Local authorities are also motivated to provide it to meet the needs of their communities. Though deemed less media-worthy than major national infrastructure schemes, high-quality schools, housing, roads, waste facilities, culture and leisure facilities represent the foundations of everyday life.

The Government made clear in the Spending Review 2010 and National Infrastructure Plan 2010<sup>22</sup> that their major priorities for capital expenditure

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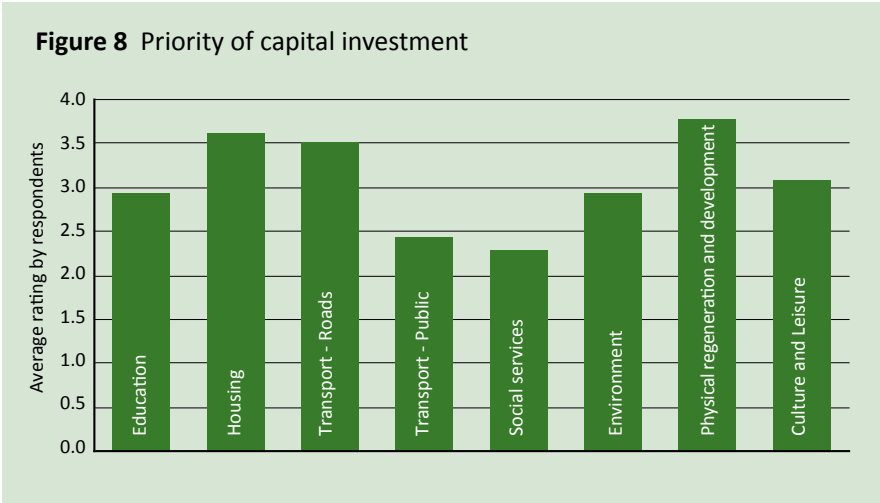
<sup>20</sup> CBI *Making the right connections CBI/KPMG infrastructure survey* (2011)

<sup>21</sup> Core Cities Group *Understanding the transport infrastructure requirements to deliver growth in England's Core Cities* (2011)

<sup>22</sup> HM Treasury, *National Infrastructure Plan* (2010)



are transport and infrastructure that aid a low carbon economy. Our research found that at a local level there is a wider range of capital investment priorities. Investment in physical regeneration and development was rated as the highest priority, with housing and road transport only marginally lower in terms of priority. Semi-structured interviews supported these broad trends, but also revealed that there are marked differences between authorities in terms of their main capital investment priorities.



***New affordable and social housing***

The majority of councils have now met the Decent Homes Standard, benefitting from over £19 billion in investment. However the funding is now drying up and councils must rely on the Housing Revenue Account to fund continued maintenance. The main priority is now new homes, particularly affordable and social homes in areas of high demand, such as London and the South East. According to the Countryside Alliance, only 54,000 affordable homes were built in the 2010-11 among the 306 councils surveyed. The UK population is estimated to grow from 62.3 million in 2010 to 67.2 million by 2020, which means there is likely to be a large shortfall in affordable homes and councils must be given more control of money to build new housing.

In November 2011 the Government unveiled *Laying the Foundations: a housing strategy for England*, which included measures to help an extra 100,000 new homes be built. In addition to this, the government has announced that Housing Revenue Account Subsidy System will be ended, enabling councils to invest in new social housing units. As the government state in their housing strategy, the problems faced are stark and a far greater number of new homes must be built to meet future demand.

### ***Education***

The Building Schools for the Future (BSF) investment programme in secondary schools was the single most expensive departmental capital programme, with an expected budget of £55 billion. Despite the ambitious aim of rebuilding or refurbishing all 3,500 secondary schools in England by 2020, it was formally ended in July 2010. At this point 735 schools of the 1,592 listed were withdrawn. As of March 2011 only 310 schools had benefited from BSF investment. A further 694 will be completed over the Spending Review period.

Many councils benefitted from BSF but a halt to funding has left some with a large shortfall in investment and a two-tier network of schools. The complementary Primary Capital Programme, which was due to spend £1.9 billion on 675 primary schools, has now also stopped. A replacement fund, the Priority School Building Fund, will refurbish approximately 100 primary schools.

Demographic and economic trends have increased the demand for state education, placing further strain on the schools network. In some areas, such as Surrey, there has been a large decrease in the number of pupils in private education since the onset of the recession in 2008. The result is that many local authorities have large requirements for capital investment in schools.

### ***Transport***

Highways and transport have a near constant demand for capital investment, but only generate a small amount of revenue that can be spent on maintenance. Roads are routinely in the public eye and general maintenance, especially pot holes, are often a point of contention. For example, one local

authority we interviewed reported a £400 million backlog of road repairs, but only £20 million of grant funding per annum to remedy this.

Transport is also intrinsically linked to economic growth, which is an agenda set to rise in importance for local authorities over this parliament. The CBI's survey found that over 80 per cent of those surveyed stated that transport infrastructure and the quality of energy provision has a significant influence on their future investment decisions. Creating a competitive economy will be helped by local authority efforts to invest in road networks and public transport.

## Conclusion

The capital investment challenge is substantial. Our research, and the statistics presented in the previous chapter, have indicated strongly that there is set to be a large shortage of capital. The result could be that many vital investment needs will go unmet. The links between capital investment and growth mean there is even the possibility that a vicious cycle develops, with insufficient investment made to promote growth, and subsequent low levels of growth preventing any additional capital investment.

The mistakes of the past, when recessions prompted swingeing capital spending reductions which led to huge investment backlogs, should not be repeated. Councils have far less capital grant available to meet their investment needs and avoid repeating past mistakes. However, there is also a new capital finance landscape developing. The reductions in grant may be off-set by devolution of powers and freedoms from central government. There are a range of options available to councils that have not been in the past. It is upon these that the attempt to meet the capital investment challenge must be based.

## 4 *The changing capital finance landscape*

*“We can’t just sit and wait for the UK government to give us money as those days have gone”<sup>23</sup>*

**The way that councils invest in local infrastructure is changing: new sources of capital finance; new mechanisms for investment; decentralisation; greater freedoms and new motivations and incentives are all combining to create what is in some respects a very different capital finance landscape. These changes will fundamentally alter the nature and purpose of the local government finance function. Having been primarily oriented on service delivery and grant based capital investment, there is now additional responsibility for local authorities to use their capital finance function to drive economic growth.**

This responsibility comes, and is to a large extent directed by, a time of unprecedented public spending reductions. Previous chapters have detailed the sharp reductions in capital grant and the pressures placed on revenue budgets by the CSR 2010. However localised or decentralised capital finance becomes, this presents a substantial challenge. In response, the raft of decentralist reforms introduced by the coalition government present a number of ways for councils to drive investment that were not previously available. The tools councils now have available to them enhance a range of more traditional approaches, supporting a more varied approach to investment.

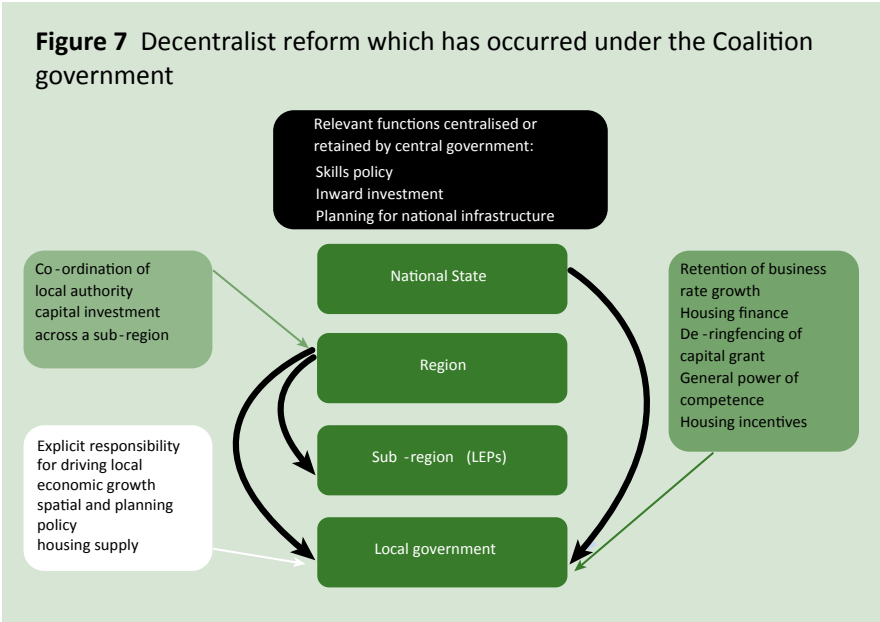
### **A changing environment**

The 2010 white paper ‘Local Growth’ and the Budget 2011 both made the Government’s intentions and strategy for economic recovery clear. In order for Britain to have a more sustainable, competitive and resilient economy there must be a rebalancing of the economy towards the private sector. In line with the coalition’s commitment to localism, a significant emphasis has been placed on the role of local authorities and ‘bottom-up’ measures in driving this growth.

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<sup>23</sup> Interview respondent I

The Localism Bill has been hailed as the most significant piece of legislation for local government in a generation. It contains a number of measures that impact upon capital finance at a local level. Following this there are a range of changes to the dynamics of capital investment. In turn this will alter councils’ mindsets and approaches to infrastructure investment. The impact will be, arguably, as important as the more material changes to the sources or mechanisms of capital finance. The diagram below represents the decentralist reform which has occurred under the Coalition government.



### Plans for business rate growth retention

The Local Government Resource Review aims to undertake the most fundamental reform of local government finance since the universal business rate was implemented. The Review aims to enable local authorities to retain increases in business rate growth in their area. Set for implementation in 2013 the Review would for the first time in 23 years see local authorities receive a direct financial benefit from growth in their business rates. In light of sharp reductions in funding, councils will be given a strong incentive

to promote business growth in their area. This reform will therefore have an impact not just on the purpose of a local government finance service – comprising economic growth as well as service provision – but also the approach councils take and the priorities they have for capital investment. This also has implications for the ability of councils to use Tax Increment Finance as a method of investing in infrastructure.

### **Devolution of housing finance**

The Localism Bill will dismantle the currently centralised system of housing finance (the HRA Subsidy System) and give local authorities their own individual Housing Revenue Accounts. In effect this means that local authorities will have access to the rental income on the social housing they own and manage. Crucially, this change will enable local authorities to borrow against future rental income, drastically improving the potential for local authorities to invest in the creation of new housing stock. Though all local authorities will be left with an element of housing debt to service, it is expected that there will be sufficient headroom to enable borrowing to invest in new social housing stock.

### **The General Power of Competence (GPC)**

The GPC is a piece of legislation designed to free councils from legal constraints and alter cultural attitudes in local government. Historically councils have been ‘creatures of statute’ and as such only permitted to act where there is a specific piece of legislation giving them powers to do so – so called ‘vires’. The GPC turns this on its head and gives councils the same right to do anything that an individual can do so long as it’s legal and there is no existing legislation expressly prohibiting such rights. Implicitly it is hoped that this legislation will help local authorities become more independent and creative.

### **Changing Spatial Governance**

The Localism Bill holds provisions for the abolition of Regional Development Agencies from 2012 onwards. This in effect signals the end of the regional tier as an active force in capital investment. There are also changes at the sub-regional tier, with Multi Area Agreements disbanded and the

introduction of Local Enterprise Partnerships. Though LEPs have no statutory powers the Budget 2011 confirmed that LEPs would be able to bid for Enterprise Zones (EZ). EZs enable all business rate growth within that specific area to be retained for a period of at least 25 years, and a business rate discount worth up to £275,000 per business over a 5 year period.<sup>24</sup>

There are accompanying changes in responsibility for spatial policy, such as housing supply and planning, both of which are now either a national or local issue. LEPs have only a marginal role in planning, and no statutory powers. Planning policy has also been devolved further than local government, with a more active voice and greater say given to communities in planning decisions.

### New sources of finance

There are a range of new sources of capital investment. The government has implemented the **New Homes Bonus (NHB)** which matches any council tax income from new houses for a period of 6 years. For new affordable housing the government pays 125 per cent of the council tax income. The **Community Infrastructure Levy (CIL)**, introduced originally in the 2008 Planning Act, began to reach fruition in a number of local authorities and represents another means for councils to capture developer gains in 2011. The **Regional Growth Fund (RGF)** and **Growing Places Fund (GPF)** have both been created to support local capital investment and private sector growth. The government has also legislated to help bring in more private capital, such as through the **Affordable Rent Programme (ARP)** and the **Green New Deal (GND)**. The ARP enables housing associations to build new social housing which can be rented out at 80 per cent of market rental values. It enables housing development to continue with far lower levels of grant. The Green New Deal enables households to borrow (from either private or public sources) to fund new carbon-efficient adaptations. The 'Golden Rule' of the Green Deal is that these savings are higher than the costs of repaying the borrowing. The Autumn Statement announced that the government will allow local authorities more flexibility to support major infrastructure. The Government will consider allowing city mayors to borrow against future CIL receipts where this can make a significant contribution to national infrastructure.

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<sup>24</sup> DCLG Enterprise Zone Prospectus (2011)

New Capital Funding Mechanisms

The government has committed to enabling local authorities to use Tax Increment Financing and land auctions as a means of investing in infrastructure or of deriving grater funding for capital (or other) purposes.<sup>25</sup> Land auctions at present will only be permitted for publicly owned land, but could potentially be used for privately owned land. Chapter X discusses these two approaches in more detail.

Figure 8 illustrates the local capital finance landscape as it will be at the start of 2012. The sources of capital finance are unchanged in terms of origin – either flowing from central grants, self-financed borrowing, use of assets and investments or in the form private capital. However, some of these areas have declined substantially, such as central government grant, whereas the composition of other sources has changed markedly. The diagram demonstrates the wide range of mechanisms that are available to councils for capital investment purposes. There is of course a large element of inter-connectivity, with some new mechanisms or sources only made available by changes in the dynamics of investment.

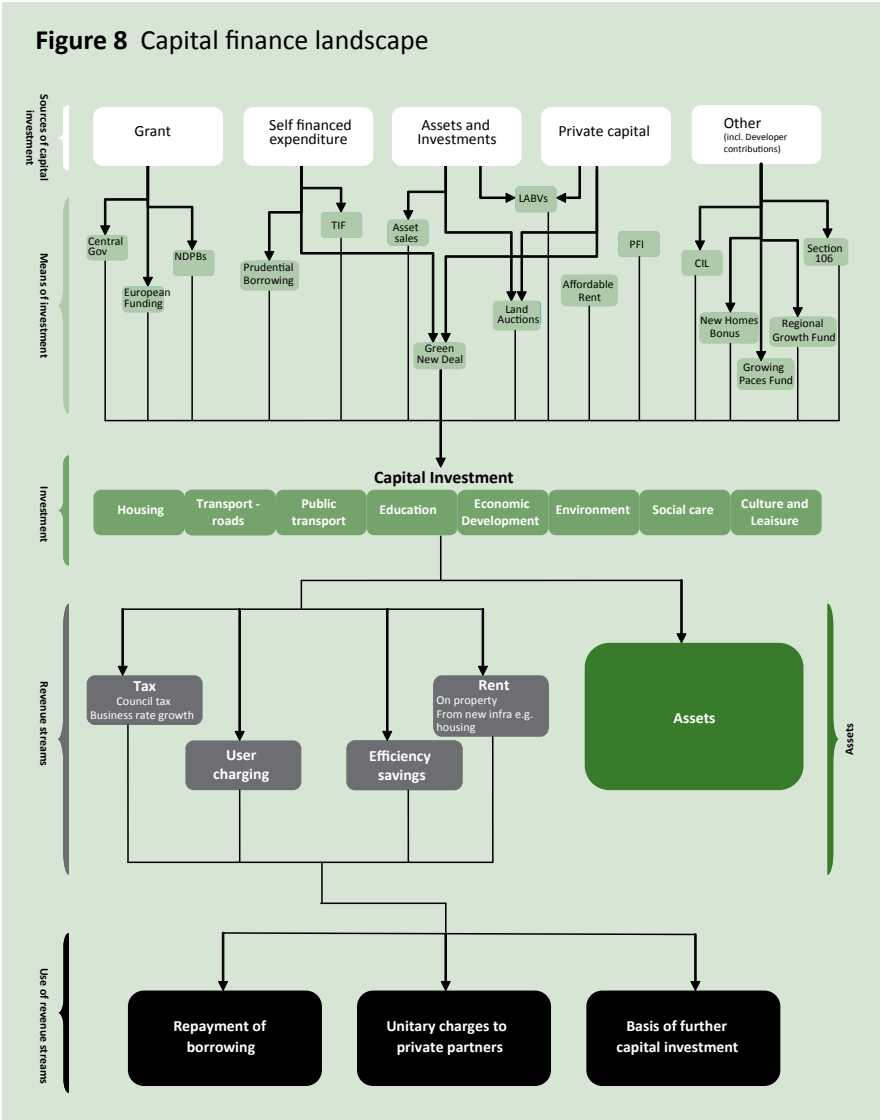
To give some further detail to the extent of this change, the table below contrasts the dominant approaches to capital investment between 2000-2010 and what are expected to be the primary drivers of investment from 2012 onwards.

2000-2010	2012-
<ul style="list-style-type: none"><li>● Central capital grants</li><li>● PFI</li><li>● Borrowing from the PWLB</li><li>● Asset sales</li><li>● Section 106</li><li>● Grants from Regional Development Agencies and other Non-Departmental Public Bodies</li></ul>	<ul style="list-style-type: none"><li>● TIF</li><li>● CIL and Section 106</li><li>● New Homes Bonus</li><li>● Regional Growth Fund</li><li>● LABVs</li><li>● Growing Places Fund</li><li>● Enterprise Zones and LEPs</li><li>● Borrowing from a more diverse range of sources</li></ul>

<sup>25</sup> HM Treasury Budget 2011



Figure 8 Capital finance landscape



### The response so far from local authorities

The survey and interviews carried out for this research indicates that it is the more traditional forms of capital financing that local authorities are actively considering using the next three years. The survey found that 86 per cent of councils were considering assets sales as a source of capital finance, and three quarters were considering self-finance borrowing. In terms of newer approaches, 31 per cent of councils were considering using Local Asset Backed Vehicles (LABVs), 20 per cent were considering using EZs and 44 per cent considering Tax Incremental Finance.

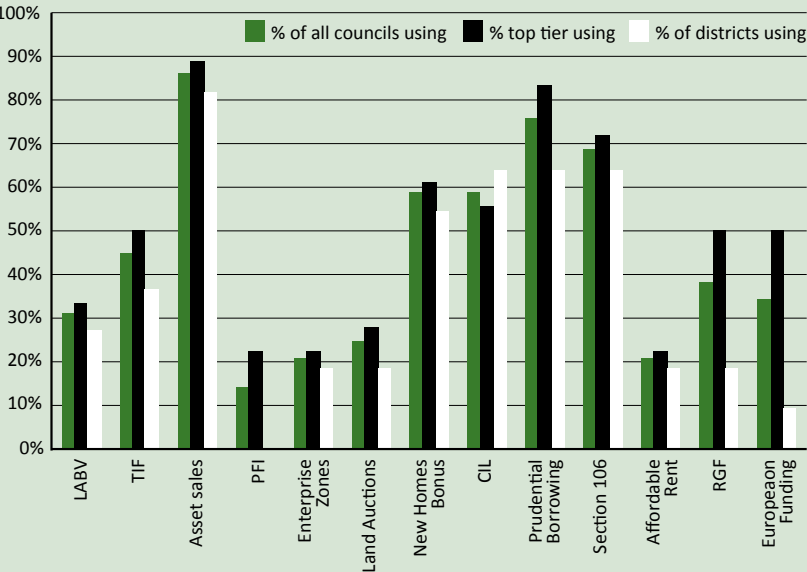
This is reflective of the fact that some elements of the capital finance landscape are context or geographically specific. Affordable rent is only likely to function in areas of high market rents such as London and the South East. Similarly, Enterprise Zone status is only granted by central government where there is a LEP. Some new sources or mechanisms are also dependent on the introduction of new legislation, and so may not be in active consideration until this has been passed.

In addition, though there is a broader spectrum of financing sources, many of these are highly specific and small by comparison with previous funding streams. The RGF, for instance, is worth over 3 years what the RDAs would distributed in grant in one year.<sup>26</sup> With less funding available, it is conceivable that many councils are not considering some new capital finance sources because there is simply not enough funding to go round.

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<sup>26</sup> Paste ref from same stat in chapter 2

**Figure 9** Over the next three years, which of the following capital finance mechanisms is your authority considering using?



The assessment of interviewees to the government’s decentralist reforms and growth agenda was mixed. Where there have been specific policies or devolution of powers these were broadly welcomed. Enterprise Zones, the promise of ability to use TIF and the New Homes Bonus were all cited as having a positive impact on the prospects for capital finance. It was apparent that many feel this impact will be felt largely at the margin, rather than combining to act as a replacement for reducing levels of central capital grant. The interviews also suggested that councils have interpreted recent reforms as being primarily about changing some of the dynamics of how councils approach capital investment and development. Interviewees reported that it was clear councils now had a designated role in driving growth and that the primary vector the government is using for this is an incentive based approach.

Some respondents questioned the degree of material change that would result from the Coalition’s first 18 months in office. There were also fears

about the negative impact some reforms may have on areas in the north of the country, in particular the plans for business rate growth retention. There was a definite sense in some interviews that much of the growth agenda and some new capital financing tools are southern-centric in terms of their applicability. Business rate growth retention was seen as potentially damaging to councils where the underlying conditions for growth are not present in the same way that they are in London or the South East. Similarly, New Homes Bonus benefits local authorities where new housing is needed, which is typically in high-growth areas such as London and the South East.

### Interviewees assessment of the coalition's capital finance reforms and growth agenda

#### **Positives**

*"TIF and EZs have been good, as well as the general move to give us more freedom. That's all been very welcome."*<sup>27</sup>

*"The New Homes Bonus gives us income streams and acts as an incentive, but it is not new funding. It will though focus minds on brining new development forward"*<sup>28</sup>

*"What comes out is that it is all incentive driven. New Homes Bonus, business rates, council tax benefit. And I think that's a good thing."*<sup>29</sup>

#### **Mixed**

*"TIF may have some impact, and will mesh together around the EZ. The New Homes Bonus is worth £2.5m for us and we're putting back into housing areas. It will make some difference, but ultimately it's pretty marginal."*<sup>30</sup>

*"Overall I'd say none of the Government's reforms have been*

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<sup>27</sup> Interview respondent K

<sup>28</sup> Interview respondent L

<sup>29</sup> Interview respondent F

<sup>30</sup> Interview respondent J

*unhelpful. None will stop investment or economic growth. What is unhelpful is the revenue constraint we've been left with"*<sup>31</sup>

*"At a high-level it's been broadly welcomed. It's a recognition of how important local government can be. But as with all things, the devil will be in the detail."*<sup>32</sup>

### **Negatives**

*"We have some concerns with it. There are dangers in the localisation of business rates that it would actually make it harder for us to achieve growth and continue capital investment"*<sup>33</sup>

*"if [the government] wants us to be more entrepreneurial, well we have lots of new tools which are all predicated on growth, so they might work well in the South East but not sure how well they'll work up here."*<sup>34</sup>

*"[the reforms] have been good in theory, but we are yet to see the results in practice."*<sup>35</sup>

*"It's brilliant rhetoric, but a shame about the actual legislation."*<sup>36</sup>

*"There's a debate about whether localism is real or illusory – it feels like a lot of centralism."*<sup>37</sup>

Our survey also indicated that there will be challenges in the sub-regional aspect of capital finance. In total 58.6 per cent of respondents were either very unconfident or unconfident that LEPs have the powers needed to help drive capital investment. Just 3.4 per cent of respondents expressed confidence that they do have the powers needed. This was reflected in

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**31** Interview respondent D

**32** Interview respondent G

**33** Interview respondent L

**34** Interview respondent C

**35** Interview respondent E

**36** Interview respondent I

**37** Interview respondent A

interviews where a broad consensus was found that LEPs are in theory a good vehicle to drive growth and capital investment, particularly as they reflect ‘natural economic geographies’. However, survey and interview respondents felt that Enterprise Zones were the only tangible benefit to come from forming a LEP, and that more powers were needed.

**Figure 10** How confident are you that LEPs have the power to assist in driving capital expenditure



The initial round of applications for LEP status contained a list of requests for powers from central government. These included responsibility for skills funding as well as a greater responsibility in planning processes and decisions. Central government has outlined a range of areas in which it expects LEPs to play an active role, yet so far very few powers have been devolved to LEPs. The indication of our research is that linking Enterprise Zones to LEPs was a very positive step in terms of giving the vehicles a genuine sense of purpose and function. We encourage the government to explore further tangible responsibilities or powers it could give to LEPs to help them drive growth and stimulate capital investment.

### The immediate response to the CSR from councils

Our interviews indicated that local government has taken a pro-active and positive approach to capital investment in the wake of the first round of capital spending reductions. While the scale of the cuts should not be downplayed, the response of the local government sector has demonstrated that councils are in a position to adapt approaches and work innovatively to sustain capital investment where it is most needed. In the remainder of this chapter some of the short-term strategies councils have adopted are discussed, along with some 'quick-win' approaches councils can take. Councils that view capital as one of their main priorities, have demonstrated the ability to modify approach in order to sustain investment. There have been a range of examples of councils modifying their approach and strategies to help sustain investment. Spending reductions have required councils to reappraise their capital programmes and take a more stringent view on the prioritisation of projects. This has helped to focus on the necessity and value-for-money of each project. Some interview respondents reported establishing new capital control mechanisms to ensure that spending does not reach unsustainable limits. Councils have also begun comprehensive assessments of their full estate to understand where it can be rationalised and extra capital funding gleaned by selling assets that are not maximising their full economic value.

Councils have also adapted to reflect the challenges the private sector is facing. Interviewees reported rescheduling and adjusting Section 106 payments to ensure that they were not preventing private sector development coming forward. Respondents also reported using new sources of capital investment, such as the New Homes Bonus, as a means of bringing in extra private sector capital by investing in brownfield sites to bring them up to a position of being development-ready. Surplus council assets are being used to leverage extra private sector investment through LABVs and other partnerships. The planning system has also been used to help struggling private developers and one council has invested in staff with the responsibility of promoting international investment in the local authority from Europe, India and China.

There are also opportunities for councils to stimulate capital investment at no net cost. The Green New Deal presents a chance for councils to help the local economy by supporting the capital investment in retrofitting households with more carbon efficient technology. The following case study demonstrates the strategic co-ordinating role that local authorities can play in this, as well as the opportunity to use public funding to 'pump-prime' investment from the private sector.

### Case Study

#### *Birmingham City Council's Green New Deal*

*The Green Deal has enabled Birmingham City Council to use its position and credibility to secure large amounts of private sector finance. Birmingham hopes that its position as a reputable body will allow it to mediate in the Green Deal process. It will begin the process, starting in 2012, with £100m of funding for the green housing work. Commercial banks will provide £50m of this, with £25m borrowed by the council and £25m provided by energy companies.<sup>38</sup> Provided this stage is successful £300m of private funding will be made available, with an estimated 200,000 houses being refurbished by 2026, requiring a total £1.3bn of funding.<sup>39</sup>*

*The model works by allowing households to pay back the costs of the improvements to their homes over time, through the savings made on their energy bill. Energy companies provide Birmingham Energy Savers (branch of the council) with funding. They reclaim this money through fixed charges levied on the energy bills of the houses in receipt of the work over a 25-year period. Birmingham Energy Savers will undertake this task in combination with a delivery partner.*

*One of the major advantages of the Green Deal is that it creates assets that are likely to be of great interest to the private sector, thus encouraging capital investment through or in partnership with local*

<sup>38</sup> <http://www.guardian.co.uk/environment/2010/oct/03/birmingham-solar-panel-council-proposal>

<sup>39</sup> <http://www.greendealguide.co.uk/birmingham-to-become-first-local-authority-green-deal-provider/>



*authorities. In the case of Birmingham funding was achieved through joint financing of a Special Purpose Vehicle (SPV), from which the installation companies are paid. As the debt is attached to a household rather than an individual the rate of default is likely to be very low, making the debt attractive to private investors. The model delivers benefits to citizens and decreases carbon emissions. It also supports jobs in the private sector and brings in large amounts of private capital to help improve Birmingham's green infrastructure.*

## Conclusion

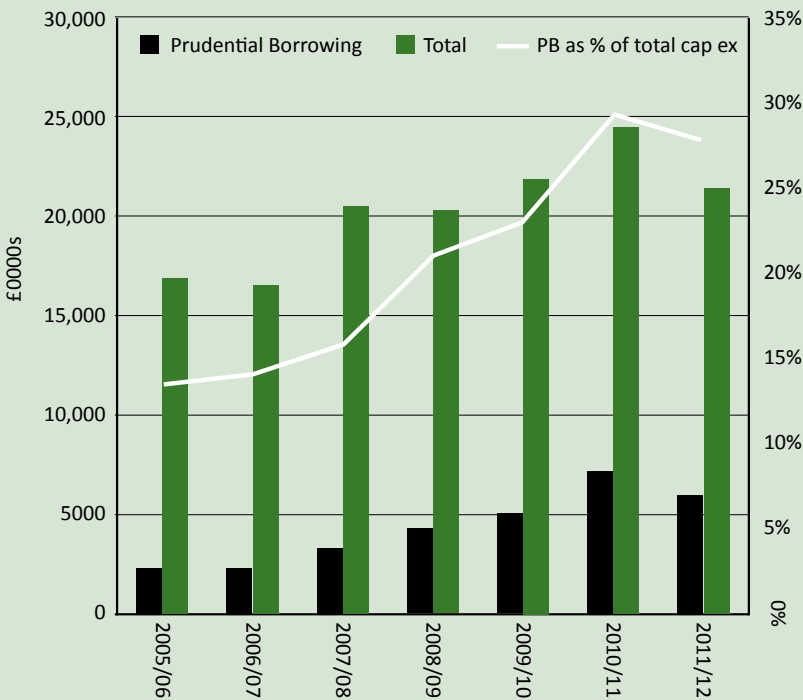
Councils are adapting quickly to a new fiscal climate. But this adaptation is also reflective of the changing roles of central, local and sub-national governance in capital finance policy. It is clear that there are avenues of genuine potential for different approaches to capital investment to develop. It is also clear that making this transition will require collaboration across the local government sector, a change in culture and a supportive role from central government.

## Section II *New borrowing options*

### 5 *The need to develop alternative means of accessing finance*

The CSR 2010 increased the rate of interest at the Public Works Loan Board from Gilts + 13 basis points to Gilts + 100 basis points. In response the sector must develop a range of alternatives to the PWLB. These should not be sought as a replacement to the PWLB. Alternatives should be seen as a way of increasing the level of choice associated with council borrowing and enabling local authorities the best possible chance of finding the most cost effective means of accessing debt.

**Figure 11** Prudential borrowing and total capital investment



This increase has occurred partially as a result of the new freedoms extended by the Prudential Borrowing framework (through the Local Government Between 2005/06-2010/11 self-financed borrowing increased dramatically as a source of capital expenditure. This growth has been both absolute and proportional. Prudential borrowing in 2005/06 was £2.25bn, representing 13.4 per cent of total capital expenditure. By 2010/11, this figure had risen to £7.15bn – 29.2 per cent of total capital expenditure. While the forecast level of self-financed borrowing fell in 2011/12 to £5.9bn (27.7 per cent of the total), this was still the second highest year on record for self-financed borrowing.

Act 2003). This ended the need for council borrowing to require approval from central government. The Prudential Framework allows councils to borrow from any source so long as the borrowing is affordable, prudent and sustainable. It marks one of the most significant acts of financial devolution seen in the past 25 years and gives local authorities far greater control over the levels of capital investment they undertake.

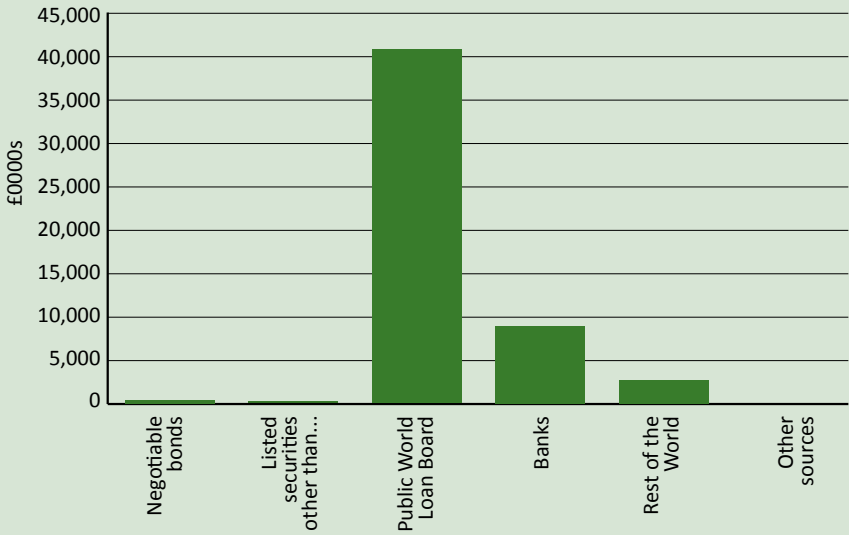
These figures show that self-financed borrowing is a vital part of council capital investment programmes. While pressures on revenue budgets will inevitably limit each local authority's capacity to borrow, prudential borrowing is certain to remain a vital source of investment for authorities. Indeed, while self-financed borrowing is likely to decline in absolute terms, the decreases expected in grant may mean that prudential borrowing becomes an even larger proportion of total capital expenditure. In the context of capital investment and driving local growth, the ability to borrow at the most cost-effective rate is essential for councils, and by extension will play an important role in new business creation.

### **Sources of local authority borrowing**

The Public Works Loans Board has been the predominant source of local authority borrowing. Up to 2010 it accounted for 76.1 per cent of all long-term borrowing by local authorities. The only other notable contribution to local authority borrowing has come from bank lending, which accounted for

16.8 per cent of the total.<sup>40</sup> The reason for the PWLB’s dominance in local authority lending relates to the price and ease of lending it offers. Typically lending at a rate of UK government Gilt + 13-20 basis points, it was very difficult for any market lending to compete. Similarly, transaction costs are low and the lending is available two days after it is requested (assuming the request is granted).

**Figure 12** Sources of local authority borrowing



There are also wide differences between local authorities and their sources of borrowing. Our survey of finance directors found that roughly a third of local authorities are almost completely dependent on the PWLB for their borrowing, while another third either do not borrow at all or use it for less than 10 per cent of their borrowing.

<sup>40</sup> DCLG Local Government Finance Statistics No. 21 (2011)

**Figure 13** What percentage of debt comes from the PWLB

### Increases in the rate of borrowing at the PWLB

The Comprehensive Spending Review 2010 contained a measure which has significantly altered this lending dynamic by increasing the rate at which the PWLB lends to Gilt + 100 basis points.<sup>41</sup> This was estimated by the Local Government Association to have increased the costs of borrowing from this source by 25 per cent.<sup>42</sup>

The government's rationale for this change was multifaceted. The reason provided in the CSR was that to ensure that local authority borrowing reflected the tough choices that were being made across the rest of government, the lending at the PWLB should better reflect market rates. In an interview for this research a Treasury official revealed that there were additional factors to consider in the change in interest rate.

*"The rationale was to put some downward pressure on borrowing, but also to prompt harder decision making for local authorities to add rigour to their*

<sup>41</sup> HM Treasury The Comprehensive Spending Review (2010)

<sup>42</sup> LGA internal paper

*project finance. The choice was between a cap on borrowing or using a pricing pressure to suppress borrowing, so we're effectively rationing through price. And there may also be advantages of local authorities having a more varied borrowing approach. We may also need to consider the role of the PWLB in the 21<sup>st</sup> Century to ensure it continues to meet the needs of local authorities and the wider public sector.”<sup>43</sup>*

A further objective was listed as prompting local authorities to develop a more diverse selection of borrowing options, in recognition of the current dependence on the PWLB.

In addition to the rationale provided by the Treasury and the CSR, there is a further benefit to the government through the projected increase in revenues from higher interest payments. In total the increase in rates is estimated to net the Treasury £1.3bn in extra income over the four year period to 2015.<sup>44</sup> This represents 6 per cent of the total contributions to deficit reduction made through the Annually Managed Expenditure account. Some interview respondents questioned the logic of the decision to increase rates, in the context of the government's desire to drive local economic growth as a means of reducing the deficit. There is a conflict between using the PWLB as a means to reduce the deficit, and expecting councils to help reduce the deficit by using self-financed borrowing to encourage private sector growth.

### The impact of the rate change

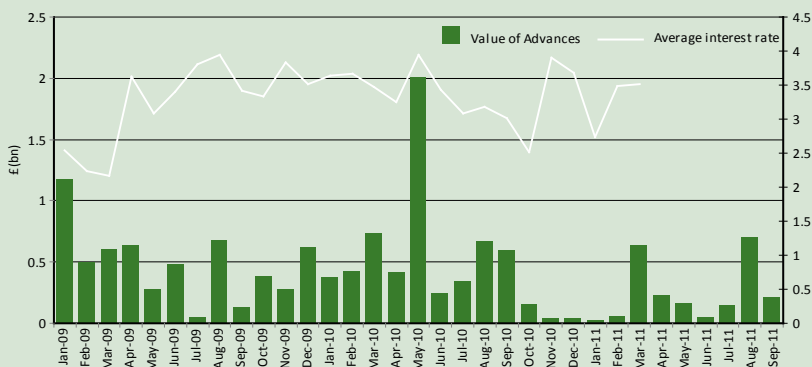
Following the CSR borrowing from the PWLB has been significantly reduced. In the 11 months from November 2010 to September 2011 the total amount borrowed from the PWLB was £2.3bn. In the corresponding 11 month period between 2009-10 the total borrowed was £6.7bn.<sup>45</sup>

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<sup>43</sup> Interview with HM Treasury official

<sup>44</sup> HM Treasury The Comprehensive Spending Review (2010) p. 12

<sup>45</sup> DMO Advances from the PWLB 2009-2011

**Figure 14** Borrowing from PWLB

The reasons for this decline in borrowing from the PWLB cannot be attributed entirely to the changes in interest rates. There are a wide number of contextual factors that must be accounted for. Across this same period councils experienced significant reductions in their revenue budgets, and were planning for total reductions in central funding of 28 per cent between 2011-2015. This inevitably places pressure on the revenue budgets of councils, meaning that borrowing from any source became more difficult. Councils have also been using financial investments and asset sales as a means of financing capital investment.

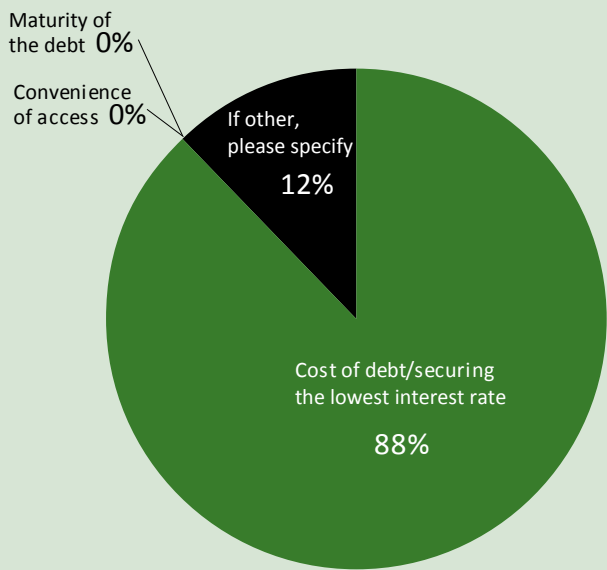
### The HRA buy-out

In total local authorities must borrow approximately £13bn as part of the abolition of the HRA Subsidy System. With the CSR increasing rates to Gilts + 100 there were plans from many local authorities to issue bonds for this borrowing. However, in an announcement at the Liberal Democrat annual conference in September 2011, the Chief Secretary of the Treasury Danny Alexander announced that the rate of borrowing at the PWLB would return to its historic rate of Gilts + 13 basis points exclusively for the HRA transaction. This effectively ended the prospects of bonds being used for the HRA buy-out transaction.

Prospects for future borrowing for capital investment purposes

Our survey found that the main consideration councils have when accessing debt is its cost. While the PWLB has clear benefits in terms of its low transaction costs and convenience of access, these are not the primary consideration of local authorities.<sup>46</sup>

Figure 15 Main consideration when accessing debt

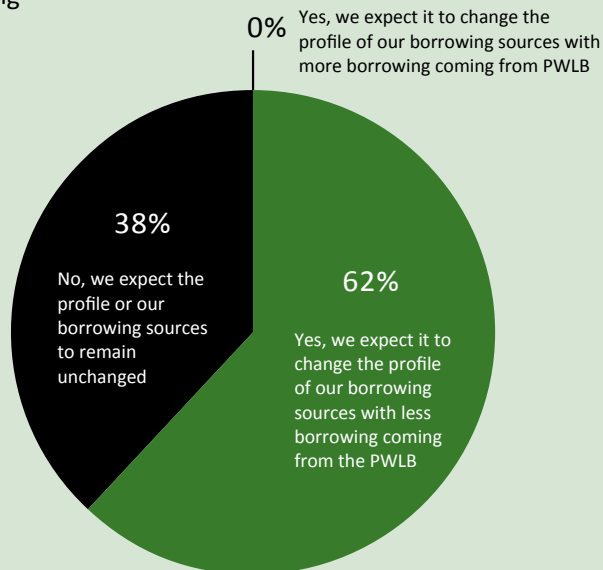


Our survey found that 62 per cent of councils who responded would access debt from alternative sources as a result of the PWLB rate change. This indicates that the low transaction costs and convenience of access do not compensate for the increased price of debt at the PWLB.

<sup>46</sup> In the category ‘Other’ respondents indicated that they did not borrow (3) or that it was a combination of all three (1)



**Figure 16** What will the PWLB rate change mean for your future borrowing



### Alternative sources of borrowing needed

The change in the PWLB issued a significant prompt to the local government sector. While it may have been entirely rational to utilise the PWLB for the majority of borrowing while its rates were low, there were few contingency plans in the event that its rate did increase. It served as a reminder that councils need access to a diverse range of borrowing options so that should one market close they have access to another. As the CSR showed, councils can no longer depend on the PWLB as the cheapest source of borrowing. With the rate having changed once, there can be no guarantee that it will not increase again.

The new pricing of the PWLB means a number of other financing routes are now cost-competitive with it. In this Section we assess a range of alternatives and outline the processes involved in accessing these. Each of these routes has discreet benefits that are not provided by the PWLB. However, there are also

drawbacks and considerations associated with each alternative. The result is a far more level playing field of borrowing options for local authorities.

By pursuing alternatives councils are likely to acquire new skills-sets, disciplines and a change of mind-set when borrowing for capital purposes. There are clear parallels therefore with the under-current of much of the Coalition's local government reform agenda. It will represent a more mature and independent financial outlook for councils, and reduce the sense of central dependency that is believed to have crept into local government in past years. By explicitly pushing councils towards market-based borrowing options the Government appears intent upon fostering a new culture within council finance departments. While new borrowing options will inevitably be more expensive than historic PWLB rates, there are a range of additional benefits that will accompany such approaches.

The alternative sources of borrowing considered in the rest of this section are:

- 1.** Bond issuance
- 2.** The retail bond market
- 3.** A Local Government Funding Agency
- 4.** Non-market finance - European Investment Bank and inter-council lending

## 6 Bond finance

The use of bond issuance for local government capital projects is not a new concept. Some of the earliest municipal infrastructure was funded this way and municipal bonds remain the primary source of local capital investment in many major economies such as the United States. However, the practice has all but died out in the UK, with only a handful of local authority bond issuances happening in the last 20 years.

The ability to access debt at a price of Gilts + 20bps at the PWLB left little incentive to continue bond issuance. However, the PWLB rate change, combined with the pricing of Greater London Authority's 2011 bond issue at 17 basis points below the PWLB, have meant that this option is now genuinely viable. Assuming suitable market conditions it is likely to provide a highly competitive source of finance compared with the PWLB for authorities with a high credit rating.

### Municipal Bond: a definition<sup>47</sup>

A municipal bond is a debt obligation issued by a local government entity. When issuing a bond, a local authority is borrowing money from an investor on the agreement that they will pay a set number of interest payments over a predetermined period. At the end of that period, when the bond has reached maturity, the initial sum, called the 'principal', is paid back to the lender.<sup>48</sup> The coupon rate is the interest the issuer agrees to pay each year (usually paid in annual instalments). The maturity date can range from 1 year to 30+ years.

#### Case Study

##### *The Greater London Authority Crossrail bond*

*In July 2011 the Greater London Authority issued £600m of bonds as part of London's Crossrail scheme, paid for by a 2 per cent Business*

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<sup>47</sup> It should be noted that there are differences between municipal bonds as issued in America and municipal bonds issued by English local authorities referred to in this report.

<sup>48</sup> The principal is also known as the 'par value'

*Rate Supplement on companies based in London. The bond priced at Gilts +80bps. With all associated fees and transaction costs included, the rate of the borrowing was at least 17bps cheaper than would have been obtained at the PWLB; approximately Gilts +83bps.*

*In total £3.5bn must be borrowed by the GLA for Crossrail, and it is estimated that if the remaining £2bn of this is raised through bond issuance there would be a saving of £65m for London's businesses.*

*The issuance was made through a Special Purpose Vehicle (SPV) created by an investment bank. The SPV issued the bonds on behalf of the GLA, which enabled the investment coupons to be paid out gross of tax rather than net of tax. This was necessary as by law local authorities are currently not allowed to pay out coupons in this way.*

*In 2011 the GLA was rated AA+ by Standard and Poor's rating agency.*

## Overview of bond issuance

Councils can pursue bond issuance in a number of different ways:

- A public issue
- A private placement
- A pooled/club issuance

Several different factors will determine which approach is most suitable for a local authority. Across all three of these options there are common features, benefits and disadvantages.

## The rationale for a bond issue

Councils look for the most competitive rate as well as funding diversity when they borrow for capital purposes. The need for funding diversity is now more acute than it has been in the past. The change in rate at the PWLB has made alternative options a genuine necessity. In addition, other forms of traditional market finance are less readily available. Basel III regulations have left banks with less ability to lend on a long-term basis, and there are

fewer structured finance products such as LOBOs on offer. At the same time, institutional investors have a strong appetite for low risk, long-dated assets, which fits well with the type of debt local authorities seek to raise.

A bond issue can provide both funding diversity and competitive pricing. The range of ways a bond can be issued offers options that cover the different scale, size and requirements of English local authorities. The attractiveness of the underlying covenant of a local authority also makes it likely that the eventual yield will be highly competitive with the PWLB rate. In addition bonds have the added benefit of increasing the financial profile of an institution and introducing additional stakeholders. This can help to provide an extra layer of over-sight on the financial management of an organisation which can increase the rigour of decisions relating to capital investment. These additional benefits are not easily translated into immediate financial savings on interest rates or bond yields, but are important to recognise as significant additional benefits for a council.

The benefits outlined above are taken in a slight trade-off with some of the disadvantages of a bond issue. In comparison with other sources of finance, the process can be quite lengthy. The PWLB can make funding available within 2 days of request whereas a bond issue can take 8-12 weeks from the start of the process when issuing an inaugural bond (subsequent bond issues will be quicker as the necessary legal documentation will be in place). The length and form of process and increased number of stake-holders makes the transaction costs of bond issuance higher than some other forms of finance. However, even including these transaction costs, there are still likely to be substantial savings from issuing a public markets bond relative to PWLB at Gilts+100bps. Nevertheless these transaction costs are likely to be a key consideration for a council to factor in. Part of these transaction costs is the requirement, if making a public issuance, for a credit rating which must then be maintained for the lifetime of the bond. The annual costs of each credit rating is likely to be in the region of £25-50k. Finally, the length of time between opting to issue a bond and the eventual date of issuance can leave organisations open to market volatility with adverse affects on the eventual spread. Certain risk management techniques, such as using gilt locks, can mitigate for this volatility. As discussed below however, there remain questions about the local government sector's ability to use these tools legally.

Advantages of bond issuance	Disadvantages of bond issuance
<ul style="list-style-type: none"> <li>● Offers a competitive margin on the current PWLB rate (assuming appropriate market conditions and high credit rating)</li> <li>● Funding diversity.</li> <li>● Improves public profile of the organisation</li> <li>● Increases the number of stakeholders</li> <li>● Extra layer of over-sight for financial management and decision making – helps ensure higher levels of rigour in capital project planning</li> </ul>	<ul style="list-style-type: none"> <li>● Higher transaction costs compared with other sources, such as the PWLB</li> <li>● Longer lead-in time to access finance</li> <li>● Requires maintaining credit rating for life-span of the debt</li> <li>● Market volatility can create uncertainty over eventual price</li> </ul>

**Process and time-scales** (for a public offering, processes may be slightly different for private placements or pooled issuance – these differences are discussed later on in this chapter).

### 1. Mandating a bank

The first stage of the issuance process is to mandate bookrunners<sup>49</sup> and appoint legal counsel. The number of bookrunners involved has a bearing on the future liquidity of the investment, and by extension influences the price. Investors prefer to have more than 1 bookrunner on the transaction as it means that more banks will be creating a market in that transaction,

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<sup>49</sup> Bookrunners are the banks who will run the investor order book on the transaction

creating more liquidity in the bonds and making them a more appealing investment. Most bond issues have 2 to 3 bookrunners involved. It is possible to issue a bond with just 1 bookrunner, as the GLA demonstrated, though this is likely to have a negative impact on future liquidity and there may be a corresponding decrease in investor demand and a pricing premium may even be required. The fees paid to bookrunners will be the same regardless of how many are on the transaction – there is a set fee pot that is split between the bookrunners.

## 2. Documentation

Bond issuance requires formal documentation, either in the form of a prospectus or an information memorandum. The contents of a prospectus is regulated by the Prospectus Regulations. The documentation is required to cover the terms and conditions of the bonds, a description of the issuer and its business, and analysis of the risk factors associated with that organisation and the bond.<sup>50</sup>

## 3. Obtaining a credit rating

For public offerings (and potentially for private placement and pooled issuance) a credit rating is required. This is an assessment of an organisation's ability to pay its outstanding obligations in a timely manner. Each ratings agency has its own assessment criteria but will all make a judgement of the overall financial management of a council, as well as a broader assessment of central government finances. Once the rating has been assigned it is the decision of the council whether to make it public. If the council proceeds with the bond issuance the rating will need to be made public. If a bond is issued, the credit rating must be maintained throughout the lifecycle of the bond.

The ratings and documentation process can run concurrently and take approximately 8 to 10 weeks. It is preferable for a local authority to begin the process as early as possible. Once complete the bond issuance takes less than 1 week. Having the rest of the process complete enables the local authority to take advantage of good market conditions as they appear.

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<sup>50</sup> Trowers and Hamblins *Self-financing for council housing – bond issues* (2011)

#### 4. Initiating the issuance

When the Authority is ready to issue, the bookrunner releases an announcement of the intention to issue a bond. This announcement notifies the investor community of the council's intention to issue and precedes an investor roadshow.

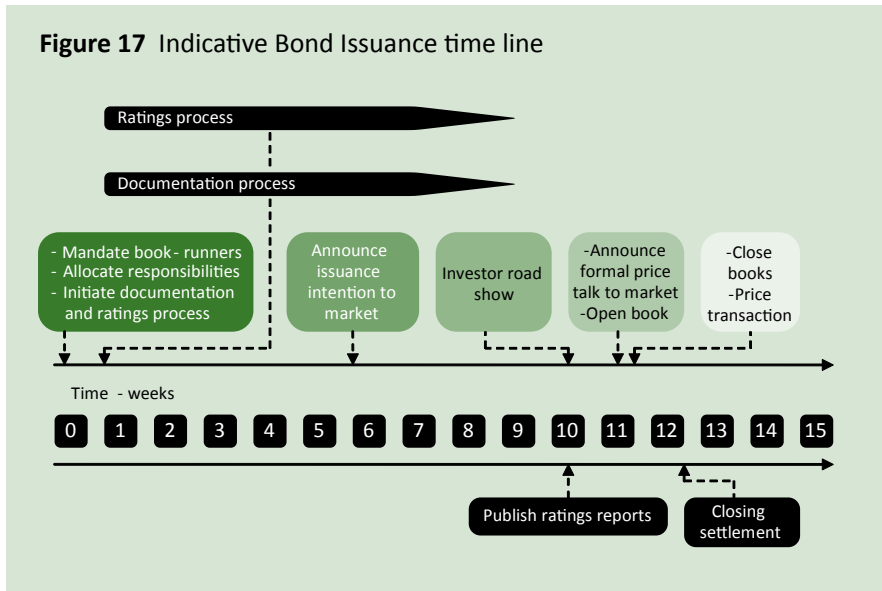
An investor roadshow will typically take 2 to 3 days and cover London, Edinburgh, and Glasgow. In some instances other cities can be targeted. The roadshow involves the authority meeting investors for 1-on-1 and group meetings to describe their credit story and persuade investors to take up the bond issue.

#### 5. Issuance

On the day of pricing, the transaction is announced to the market and an order book is built by the bookrunners. The order book would normally close after a few hours and a size and credit spread are determined for the transaction based on the investor orders.

The credit spread is the difference between the bond's yield and that of the relevant benchmark bond, and typically reflects the credit premium required by investors for holding an asset that is not the sovereign risk free bond. For bonds printed in the GBP market, the benchmark used at the point of issuance would be a similar maturity UK government gilt. The yield on the new bond is a component of the issuer's credit spread and the appropriate benchmark bond yield, reflecting the relative creditworthiness of the issuer. Following this process, the transaction will formally price. The agreed spread is added to the benchmark gilt yield at that time to provide the authority's bond yield. Conventionally, the yield is then rounded down to the nearest 0.125 per cent to provide the bond coupon (with a concurrent adjustment to the issuance price of the bond i.e. the Authority would sell £100 face value of bonds for a slight discount to reflect the fact that the coupon investors are receiving has been rounded down). The funds would arrive with the authority normally within 3 to 5 working days.



**Figure 17** Indicative Bond Issuance time line

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## Differences in process for different routes to bond issuance

### *Private placement*

A private placement involves a single issuer raising debt from a single or small number of investors without a public offering. Terms and conditions of the transaction are negotiated between the issuer and investors prior to the issuance. The time-scales for issuance are broadly similar to that of a public offering, though the eventual issuance is different.

The primary advantage of this method of issuance is that the markets can be accessed for smaller sums of debt than would be possible with a public offering. Local authorities could issue a bond in the region of £25m using a private placement, compared with £150m+ for a public offering. The process of negotiation also offers a greater degree of flexibility in the structure and maturity of the bond.

The disadvantages of this method centre on the limited investor diversification that is available to local authorities if this method of debt issue is chosen. Marketing a bond issue to as wide an audience as possible can stimulate price competition and can help facilitate further negotiations favourable to local authorities. The lack of overt pricing tension in a private placement is likely to add a pricing premium to the eventual bond yield. Another consequence of issuing a bond through a private placement is the failure to establish a pricing benchmark in the market which is helpful if an authority is likely to want to access the bond markets in the future.

### ***Pooled issuance***

For local authorities who do not have the requisite scale to enter into a public offering or private placement there is a third option. A club or a pooled issuance involves the use of a vehicle which issues a bond on behalf of a number of organisations and then on-lends to these organisations. This can allow local authorities to access the debt capital markets for sums upwards of £10m, which would present a better fit for the borrowing profile of many smaller English local authorities.

A variation of this approach is currently employed in some countries, such as the US in form of State run ‘bond banks’ which have been providing small municipal authorities with debt from capital markets since the 1970s. These aim to harness economies of scale by funding multiple small infrastructure projects simultaneously through a single bond issuance by a designated State bond bank. While these normally operate without a State guarantee, there are usually ‘reserve funds’ created which will match a certain portion of the debt raised with State or federal government grant. The State government can also offer credit enhancements on interest rate payments which can mean that the issuance vehicle obtains cheaper debt.<sup>52</sup>

There is the potential for such pooled vehicles to reflect local authorities connected across a functional economic geography, such as Local Enterprise Partnership, and who are all engaged in multiple projects to develop that sub-regional economy. Similarly, local authorities with similar characteristics (either

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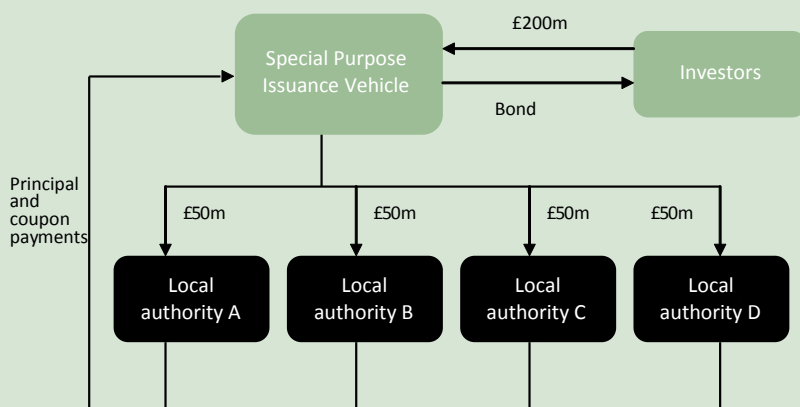
<sup>52</sup> USAID *Introduction to Pooled Financing* (2005)

type, size or geographic location) could join together to undertake pooled issuance. In a model that would be similar to US bond banks, county councils may be of a sufficient size to issue a bond on behalf of their district councils.

The structure of the vehicle will depend in part on the allocation of liabilities. If the local authorities involved are only liable for their own debt within the vehicle it is likely to be a simpler structure which may be attractive to investors. In such an instance, there would effectively be a clear window through the structure to the underlying covenant of the local authority involved. The vehicle itself would be merely aggregating demand for access to debt capital markets.

The structure may get more complex if liability is held jointly. The advantage of joint ability is that from an investor perspective it reduces the probability of a credit event occurring. If one local authority was unable to meet its payments, the others involved would be able to make up these payments. However, joint liability would automatically make the structure appear more complex and less transparent. There is then a trade-off between the complexity of the structure and the risk protection it provides. For a one-off pooled issuance it is likely that a simpler structure with less protection would be the preferred option from both local authorities and investors.

**Figure 18** Pooled local authority bond issuance



Comparison between different routes to bond issuance

	Public Issue	Private Placement	Pooled issuance
Advantages	<ul style="list-style-type: none"><li>- Advantageous pricing relative to private placement</li><li>- Deep investor base</li><li>- Creates a credit curve &amp; ensures liquidity</li><li>-Maturity flexibility</li></ul>	<ul style="list-style-type: none"><li>-No public ratings required</li><li>-Confidentiality terms negotiated with investors</li><li>-Maturity flexibility</li></ul>	<ul style="list-style-type: none"><li>Smaller entry point - £10m +</li><li>- Lower transaction costs for each authority</li></ul>
Disadvantages	<ul style="list-style-type: none"><li>-Minimum size requirement</li><li>-Investor road show required</li><li>-Requirement for rating makes it more expensive upfront</li></ul>	<ul style="list-style-type: none"><li>-Limited investor diversification</li><li>-Fails to establish benchmark in the market<sup>53</sup></li><li>-Likely pricing premium compared with public offering</li></ul>	<ul style="list-style-type: none"><li>-Complexity of structure likely to add a pricing premium</li></ul>

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Local government capacity to issue bonds

As the municipal bond market has lain dormant in the UK for the past twenty years, there are legitimate concerns about the capacity of the sector to return to this method of financing. It is undoubtedly a more complex route than the PWLB. There is an increased number of stakeholders, a higher level of risk and a longer time period. However, the basic process of a bond issuance is not significantly more complicated than ‘traditional’ finance. There is a gap between the perception of the complexity of the process and the reality. Our research has found that public offering or private placement, involving one authority, would not be beyond the scope of most large authorities with a borrowing requirement to match such an issuance. Pooled issuance may present a more complex scenario. However, there is ample evidence from the housing sector and from abroad that it is well within the capabilities of a municipal body.

53 It should be noted that frequency of issuance is a factor in establishing a benchmark in the market with public offerings

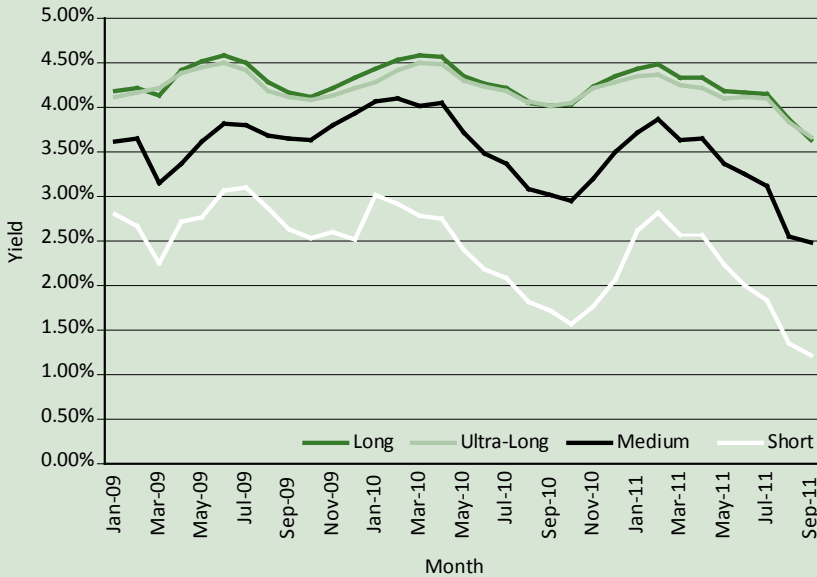
There is undeniably scope for the sector to broaden its awareness and knowledge of financial markets, but this should not be seen as a reason to prevent or discourage councils from accessing the debt capital markets. The markets themselves are by their nature selective – investors won't invest where there is a suspicion the borrower is not financially capable. There is therefore a natural check on deals that are not prudent coming to market. Where investors sense a lack of expertise, the yield they seek will inevitably rise to a point where it is no longer competitive versus the PWLB. Such market selection should ensure that an educative process can occur without councils finding themselves in deals that are not financially prudent.

### Pre-hedging

Prior to issuing a bond, most corporate issuers would use basic derivative products as risk management tools. Products such as gilt locks can help to mitigate against adverse trends in underlying gilt yields.

Gilt locks are a type of hedging product that can be used when issuing bonds. Prior to the issuance the borrower (in this case, the council), would enter into an agreement to 'fix' the yield of Gilts at a specified date in the future (i.e. the date of bond issuance). Should there be changes in the gilt yield in the interim, the movement on the gilt lock hedge will offset the benefit or cost on the underlying bond issue. It effectively means sacrificing a potential upside gain – lower interest rates at the time of issuance – to protect against any downside risks in the form of higher interest rates.

While pre-hedging is not essential as part of bond issuance, it can act as a highly effective risk management technique. There have been large fluctuations in gilt yields in recent years, for instance with a difference of 160bps between the highest and lowest yields on medium-term Gilts between 2009 and 2011. This makes the case for local authorities to take an approach to bond issuance that factors in the risks that are associated with such fluctuations.

**Figure 19** UK Government gilt yields Jan 09 -Sept 11

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The legal situation relating to use of such risk management techniques is however far from clear. As a gilt lock is generally classed as a derivative instrument there is marked uncertainty over a council's legal right to enter into such an arrangement. Use of derivatives by councils has been considered 'ultra vires' (i.e. not permitted) since the Hammersmith and Fulham swaps case in the early 1990s.

Between 1987-1989 Hammersmith and Fulham entered into substantial transactions through a capital market fund in the name of the council with a view to making a profit. This involved large exposure to interest-rate swaps. However, as interest rates rose the council ran up substantial losses, owed to 5 investment banks. The House of Lords in *Hazell v. Hammersmith and Fulham London Borough Council* [1992] held that such transactions were ultra vires (i.e. not legal) for the local authorities who had entered into them. Because the council was deemed to have entered into the interest rate

swaps 'ultra vires' it was not liable to pay back its losses. The investment banks involved lost millions as a result. This judgement has caused a significant level of suspicion within financial institutions when dealing with local authorities.

The government's Localism Bill, which gained Royal Assent in November 2011, enhances the possibility that derivatives could become legal for councils to enter into through the introduction of the General Power of Competence. In essence it means that a local authority would be able to do anything that an individual would be able to do, so long as it is legal. The GPC also acts to cancel out any previous rulings that have found council actions to be 'ultra vires'. It would seem to follow that the use of derivatives is legally permissible following the introduction of the GPC.

In 2011 CIPFA released updated Prudential Code guidance, which has statutory backing. This contains advice for the use of derivatives. This states that councils considering using derivatives should:

- Ensure they have the legal power to do so
- Only use the for prudent management, **never** for speculative purposes
- Define how derivatives fit within the council's risk and treasury management strategies
- Clarify which instruments will be used, and when and why they will be used
- Seek advice to ensure that the products are understood
- Ensure that the risks presented to the council as a result of using of derivatives are understood

The problem, however, is that while councils may be persuaded of their ability to enter into derivative arrangements using the GPC, the financial community will not be so easily convinced. While CIPFA's clarifications in their Prudential Code Guidance is welcome, it does not resolve the issue of whether councils are legally allowed to use derivatives. The impact of the Hammersmith and Fulham swaps ruling, which in effect passed hundreds of millions of council losses onto the hands of the investment banks involved in the original deals, remains fresh in the memory. The GPC does not

provide the level of absolute legal certainty that the financial sector would require to consider venturing back into derivative contracts with local authorities. It therefore seems unlikely that the GPC will help to assure both of the sides required to be present for a derivative arrangement to take place. In reality, all that would be required for councils to begin using derivatives legally, and with the full participation of the finance sector, is a short piece of legislation.

In 2008 the Transport for London Act legislated for qualifying TfL subsidiaries to use derivatives in a specified range of instances and for a specified set of purposes. TfL is classified legally as a local authority and can therefore be seen to serve a precedent for the implementation of legislation NLGN urges the government to create. The TfL Act specifies that derivatives can only be used for risk mitigation purposes, and details the type of derivatives that can be used. This enables TfL to employ appropriate risk management strategies should it be considering access to new sources of market finance. The closed nature of these specifications leave no possibility that TfL would be able to begin speculating with derivative products for financial gain and risk another Hammersmith and Fulham situation.

## **The 2008 Transport for London Act – Part 6**

### **49 Power to make arrangements for risk mitigation**

**(1)** The powers of subsection (2) are exercisable for the purposes of the prudent management of the financial affairs of TfL and its subsidiaries.

**(2)** A qualifying TfL subsidiary may enter into any derivative investment in connection with any actual or prospective asset or liability of a TfL body if such derivative investment is entered into:

- (a) for the purpose of limiting the extent to which any TfL body will be affected by changes in the matters specified in subsection (3); and
- (b) with the consent of TfL.



**(3)** The matters referred to in subsection (2) are:

- (a) interest rates;
- (b) exchange rates;
- (c) any index reflecting inflation of the United Kingdom or elsewhere;
- (d) rates or prices applicable to oil, electricity or any commodity which is used by any TFL body; or
- (e) rates or prices applicable to any securities creating or acknowledging indebtedness issued by or on behalf of:
  - (i) the government of the United Kingdom;
  - (ii) any state outside the United Kingdom;
  - (iii) any body the members of which comprise states which include the United Kingdom or another EEA State; or
  - (iv) any body the members of which comprise bodies whose members comprise states which include the United Kingdom or another EEA State.

The government's PWLB policy has made it clear that councils should be developing a more diverse range of borrowing options. For the type of borrowing that councils are likely to be undertaking the debt capital markets are likely to provide the options most cost-competitive with the PWLB. However, in order to access these in the most prudent fashion councils need the full array of risk management tools available to any other type of organisation venturing down this route. The government has indicated via a Ministerial letter that it will not consider implementing legislation for councils to use derivatives for risk management purposes.<sup>55</sup> The policy of central government is to push councils towards the bond markets with one-hand tied behind their back.

It is understandable that a decentralising government considers it contradictory to implement new legislation about what councils can and can't do. However, in this instance it is the only genuine option, however. It would not represent a failure for the General Power of Competence were legislation relating to derivatives be introduced. The uncertainty around

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<sup>55</sup> Letter from Bob Neill MP to Mark Field MP, June, 2011

derivatives is clearly a special case, with an independent constituency in the finance sector that the General Power of Competence was never designed to convince.

There is precedent for the Government to help clarify issues affecting banks as a result of new legislation. The Government tabled an amendment to the Academies Act on 19 October 2011 to reassure banks and PFI contractors that local authorities can legally make payments in relation to PFI academies.

**Recommendation:** *the government should introduce a short piece of legislation, similar to the TfL Act, detailing the legal use of derivatives by local authorities.*

### **Withholding tax**

Convention within the investment community is for bond coupons to be paid out gross i.e including tax. Current legislation – specifically the 1988 Companies Act - would prevent a local authority from paying out on a coupon in this way. This legislation lists local authorities as the only type of organisation not able to do this. It's seen more of a quirk of law than based on any genuine objection to local authorities paying out on bond coupons gross of tax.

An interim solution, while the legislation remains unchanged, would be for local authorities to conduct bond issuance through a Special Purpose Vehicle, which would circumvent withholding tax legislation. The SPV could either be created by the local authority, or created by a bank specifically for the purpose of local authority issuances. This process is not technically difficult, but does add extra work to the bond issuance and can, from an investor perspective, appear to be a more complex structure. This perceived complexity may translate into a higher spread for the local authority.

**Recommendation:** *the government to use the passage of the Finance Bill 2011 to insert a clause stipulating local authorities' ability to pay gross bond coupons*

### The impact of uncertainty

At the time of Treasury Chief Secretary's announcement to reduce the interest rate at the PWLB for the HRA transaction a number of local authorities were in the process of a bond issuance. These authorities had mandated banks as bookrunners, initiated the documentation and rating process and were set for issuance at the time of the HRA buy-out. The special rate of interest announced for the HRA means that all of the mandates for bond issuance have now been cancelled. The incident has served as a reminder to councils and the finance sector of the unique nature of the council borrowing market.

The primary motivation for councils to seek out alternative sources of borrowing is the price competitiveness of these alternatives. This is a feature that is to a large extent determined by the Treasury and the Public Works Loan Board. The Treasury's decision to decrease the rate of interest for the HRA transaction acted as a signal to the market that there is now great uncertainty over the chances of councils pursuing alternatives relating to the capital markets. Uncertainty is rarely a good thing for the investor market and should the rate of interest at the PWLB start to change on a regular basis, the chances of councils being able to access the debt capital markets when required will be limited. If councils are to become a presence in the debt capital markets, this presence will need to be regular and stable for councils to benefit most from this approach.

Central government must be aware of the dangers frequent interest rate changes at the PWLB can bring. If the PWLB becomes seen as a political tap, or as a means of dictating council borrowing habits, the patience of the investment community is likely to be tested. The key is to have constancy of policy from central government. If the government is serious about the need for councils to diversify their borrowing sources and benefit from the rigour of market finance, then it must refrain from tinkering with the PWLB.

## 7 Retail bonds

Discussions about council bond issuance have tended to focus on institutional investors as the primary source of borrowing. However in the US – the largest municipal bond market in the world – two thirds of municipal bonds are held by the general public. In the US bonds present an attractive opportunity for the individual investor because, in the main, the coupon payments are tax exempt, making them very efficient by comparison with other investment options such as equities.<sup>56</sup> As councils begin to explore a wide range of alternative borrowing sources, the question must be raised of whether, individual investors could supply a source of capital for local authority infrastructure.

### Retail bonds overview

The potential for a retail bond issuance in England has been dramatically improved by the creation of the Orderbook for Retail Bonds (ORB) by the London Stock Exchange (LSE). Driven by the increasing demand for fixed income investment opportunities the LSE created an electronic exchange to connect private investors with bond issuances. The ORB establishes both a primary market and adds greater stimulus to the secondary market for fixed income investment. The exchange establishes a primary market by offering investment opportunities in much smaller unit sizes than were previously available. The smallest unit in the primary market is £2k, and in the secondary market can be as low as £1. The ORB provides greater liquidity and transparency for retail investors in the secondary market than was previously available. The ORB stimulates liquidity by allowing investors to buy and sell easily, and also increases transparency by displaying bid and offer prices across the market. This opens up a new source of capital for organisations looking to diversify their funding. The ORB market is expanding with a range of different investment products, including vanilla, fixed, floating and index-linked offerings. The National Grid have provided the largest ORB issuance to date, issuing £260m of inflation linked bonds. The average investment in the National Grid was £12k. The ORB has been utilised

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<sup>56</sup> National Bureau of Economic Research *Build America Bonds* (2010)

predominantly by corporate issuers since its inception in 2010. However, in June 2011 Places for People housing association became the first non-corporate issuer at the ORB.

### Case study

#### *Places for People*

*Places for People (PfP) housing association were the first non-corporate issuer, using the ORB to raise £140m for a combination of new affordable housing supply, operations and debt refinance. The rationale for using the ORB was that PfP wanted to diversify its funding model, which traditionally had been 40 per cent grant and 60 per cent bank finance. PfP aimed to diversify funding sources, investor base and move towards a debt portfolio that is 60 per cent unsecured borrowing.*

*PfP had previous presence in debt capital markets, issuing 3 bonds previously (one in the UK, one in the US and one in Japan). The retail issuance was seen as way of further diversifying the investor base of PfP, while also bringing in debt with a 5-10 year maturity in to the fixed income unsecured loan portfolio.*

*The initial issuance was for £50m, issued at a 5 per cent fixed rate until 2016 and rated Aa3 by Moody's rating agency. This first issuance was so heavily over-subscribed that a further £90m was made available on the same terms.*

*Some of the key success factors identified by PfP were: an extensive investor road show; a media strategy to promote the issuance; strong dialogue and engagement with legal teams and rating agencies. To make the investments ISA eligible a new vehicle had to be formed as 'Industrial and Provident organisations' are the only organisation type not able to issue ISA eligible investments (this would not be a problem for local authorities). Initially the brand profile and reputation of PfP was seen as a potential barrier to the issuance, though the experience demonstrated that the process was very beneficial for the overall brand awareness and publicity for PfP.*

The Places for People bond issuance demonstrated the huge appetite for fixed income investments in the ‘retail’ sector. A council would be expected to present a similar if not better risk profile to PfP, and would in theory have no problem accessing finance from this source. In terms of process, while the number of investors involved in a retail issuance is higher, there are few other substantial differences. If a council had an existing presence in debt capital markets, the transition to retail debt would not be a difficult one. Previous presence in debt capital markets can help because it will have established a pricing benchmark, and much of the legal work and documentation will already be complete.

Our research found a range of advantages and disadvantages from this approach. Choosing the retail market as a source of debt, as demonstrated by PfP, can be justified by the benefits it brings. For a council, the decision is likely to be made on the basis of a combination of financial and political factors.

Advantages	Disadvantages
Issue on small scale - £20m+ Gain a tradeable benchmark cost of capital Potential to target issuance at communities, forming a connection between council infrastructure investment and citizens Increase in stakeholders Brand and publicity enhancement Issue a bond in shorter maturities Further diversification of borrowing	Pricing premium on traditional bond issuance Higher administrative costs (including marketing)

## Barriers to overcome

Our research also found that there were a series of barriers for councils looking at this as a source of debt. Some of these were perceived barriers while some are a more genuine obstacle to retail bond issuance. These barriers are discussed below:

- nature of disclosure
- administrative costs and burdens
- competitiveness of the pricing
- legal issues about withholding tax

## Disclosure

The nature of disclosure was initially considered a barrier, with the level of extra detail that is required to enable issuance unclear. Our research suggested that the requirements are not significantly greater for a retail bond issue than they would be for, for example, a Medium Term Note Programme. The disclosure requirements are also lower on the debt side than they are for equities. It is likely that for a local authority which has previously been active in the debt capital markets accessing finance, there would be no significant challenges associated with the level of disclosure of a retail bond.

## Administrative

A perception of retail bonds is that they entail high administrative costs as there is a much larger pool of investors to pay out to. The administrative costs of a retail bond are higher than those of a wholesale bond offering. Typically a wholesale issuance would involve 40 investors, while a retail issuing would involve a pool of between 8000-10000 investors. This does increase the costs of the transaction, which can be reflected in an overall price of 1 or 2 basis points. In the case of Places for People, these were deemed not majorly significant. For a council, it is likely to be a consideration where the pricing is already close to that of the PWLB (if the primary rationale is financial).

## Pricing concerns

Pricing can be considered a greater risk with this route - compared with standard public offering - as there is less ability to talk to the end investor about price, so 'price discovery' becomes less certain. This is made easier if the organisation involved is already an issuer in the market, where there may be benchmark pricing. The PfP bond issued was a 5 per cent fixed term bond, which is higher than the rate of interest at the PWLB and the GLA benchmark bond issue in 2011.<sup>57</sup> A key difference between PfP and a local authority is that housing associations are not able to access the PWLB. This means that they operate in a more 'natural' market, and the pricing tension created by a government run source of finance is not present. The price of the debt from retail issuance is seen as a bigger concern for local authorities because of this. It is currently unclear that a retail bond would be able to match the rates on offer at the PWLB or through wholesale issuance in the debt capital markets. Therefore there has to be stronger rationale for local authorities of the other benefits that may be associated. However, it is conceivable that there could be a downward pressure on the pricing of retail bonds as the market develops, offering the possibility that this option moves closer to the PWLB and wholesale market in terms of price.

There may be options available which could reduce the price of a retail bond. Retail bonds are so popular in the US precisely because of their tax exempt status. It could in theory be possible to offer tax benefits to investors in retail bonds as a means of reducing the rates sought. In the current political and economic climate, this may prove to be an unpopular move. Retail bonds could also be made attractive to investors through an index-link. As there are currently difficult market conditions even with fixed income investments, an index link is likely to be highly attractive and could also bring down the ultimate rate of interest.

Finally, there could be options for retail debt when placed alongside some of the other measures councils are considering. At some point in the future there may exist a Local Government Funding Agency, raising billions of pounds for local authorities each year. This could offer the opportunity to

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<sup>57</sup> The comparative rate at the PWLB on the same day was 3.1 per cent (for 5-5.5 year maturity loan debt)



divide off small sections of this into retail issuances. When then placed alongside total issuances of several billion, the increased price on a smaller section of debt may be absorbed and still provide a cost effective mechanism for raising debt.

### **Withholding tax**

This is the same hurdle as found with general bond issuance (see previous chapter). The solution is for the Treasury to amend the Finance Bill to enable local authorities to issue bonds directly. In the interim, SPVs can be formed to bypass the current legislation.

### **The prospects for a council retail bond issue**

For a retail bond market to be a viable option for local authorities there is a natural process that must first occur. It may not be a suitable option for a council without a market presence in debt capital markets. In addition, it is something which may require a greater level of expertise than is currently present in all local authorities, so there will need to be an educative process across the sector. This means that it may not be an immediate option for local authorities, but something that becomes more of a reality as councils develop stronger relationships with financial markets. To successfully enter the retail market, councils will need to be able to articulate how their funding and financing works in an understandable way to retail brokers. There will need to be an educative process between councils and retail brokers, who are typically looking for brand, security and rating.

The impact this approach could have should not be under-estimated. There will be ramifications for the dynamic whole authority if this approach is taken. It opens the organisation up to oversight and public perception which will cut across all employees as well as the financial accounts. This can make a substantial difference to the internal culture of an organisation, increasing awareness among staff of the inherently public facing nature of every aspect of a councils operation. In an era in which organisational change is desired but can be elusive, this may prove to be one of the beneficial side-effects of councils exploring greater diversity in borrowing options.

## 8 *Local government funding agencies*

A local government funding agency (LGFA) is an independent financial institution that acts on behalf of its members to borrow capital by issuing bonds on the debt capital markets. The agency then on-lends these funds to its member organisations. It is a model that has been proposed as a solution for the varying scale and size of English local authorities and their borrowing requirements. An LGFA in England (or indeed Scotland and Wales) that was able to achieve sufficient coverage could become an important source of borrowing to complement the PWLB. In an era in which central government is philosophically committed to increased devolution, and in which there are questions being raised in the Treasury about the role of the PWLB, a LGFA could provide councils a locally autonomous lending facility within the prudential borrowing framework. This would be more reflective of an age of local accountability and control. However, there are substantial legal, political and structural barriers that must be overcome for this to become a genuine prospect in England.

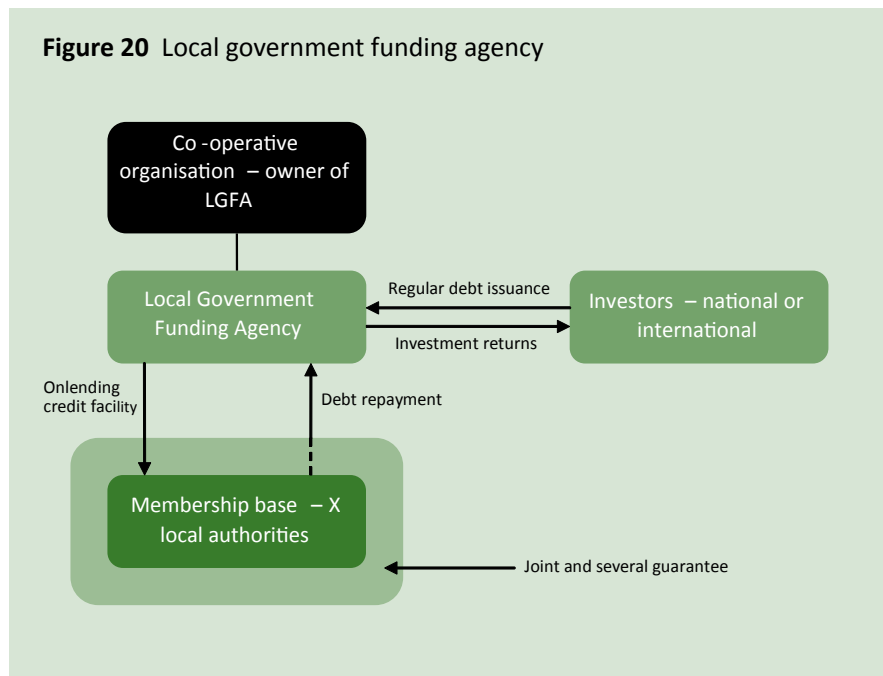
Local government funding agencies have been utilised internationally in Sweden, Holland, Denmark, Finland, France, Belgium, Norway, Japan and Canada. In 2011 New Zealand introduced new legislation to allow local government to borrow through a funding agency.

### **Local Government Funding Agency – overview**

The structure of an LGFA is relatively simple. An independent organisation – the LGFA – forms with a membership base of local authorities. The LGFA is credit rated, which is a reflection of the financial structure of the organisation and the credit guarantee arrangements between the members. The LGFA would establish a position in the market and make regular issuances of debt. It is considered important to have a constant presence in the market to attract investors so debt is issued at specified intervals and not necessarily in relation to demand from councils. The LGFA should have liquidity arrangements in place that enable it to lend to members as and when required, but which also enable it to carry debt which has not been taken on by members.

In some ways the model is similar to that of a pooled or club issuance, but is distinct in several key ways. Firstly, a LGFA is an established vehicle with a regular presence in the markets. Secondly, it operates with an ongoing membership structure, rather than a grouping of authorities collected specifically for an individual issuance. Thirdly, membership is contingent on meeting the financial management standards of the vehicle. Finally, in some instances the allocation of liabilities is different in a LGFA than with pooled issuance schemes.

**Figure 20** Local government funding agency



Typically LGFAs operate using a 'joint and several guarantee'. This is a form of cross guarantee which means individual members are liable for both the debt that they have accessed as well as a portion of debt accessed by other members. From the point of view of investors this presents a far less risky proposition. Even in the highly unlikely event of default, other members would step in and ensure interest payments were met.

### Case study: Kommuninvest

#### Development

*Kommuninvest is a Swedish LGFA which was founded in 1986. Since then it has raised significant sums for Swedish local authorities. In 2010 it lent £13bn, which was 54 per cent of all lending. Kommuninvest is estimated to have saved Swedish local authorities £170m by comparison with the alternative sources of finance available to those authorities.<sup>58 59</sup>*

*The development of Kommuninvest was met with opposition from three different parties. Swedish central government was concerned by the risk it presented, the banking community saw that it would erode much of their market position and force them to be more competitive, and local government were at first sceptical and reactionary.*

*The agency began initially as a regionally specific body. By focussing on a specific area, it was easier to attract members and enabled a group of founding authorities to be established. It took 5 years to become a national agency. This transition was helped by a Swedish banking crisis in the early 1990s, which prompted more authorities to join. In 2011 membership comprised 90 per cent of Sweden's municipalities, and Kommuninvest has targeted 100 per cent municipal membership by 2015.*

#### Pricing

*Kommuninvest is a Triple A rated issuer of debt, considered to be of an equivalent risk profile to the Swedish government.*

*Loans to Swedish local governments carry low risk, the credit exposure is 0 per cent risk weighted from a capital requirements perspective. Historically Kommuninvest has been able to issue debt of different*

<sup>58</sup> Kommuninvest, *Kommuninvest of Sweden One Pager* 30<sup>th</sup> June 2011, (2011)

<sup>59</sup> Lars Andersson (Founder of Kommuninvest), Presentation at NLGN Seminar 14<sup>th</sup> July 2011

*maturities at between 20 and 50bps above Swedish government debt. This includes the costs of running an agency, which is estimated to be approximately 10-15bps.*

*Kommuninvest maintains a liquidity reserve of 20-40 per cent of lending which enables it to meet lending requirements. It also has access to the Riksbank's (the Swedish central bank) short-term credit facilities. Derivative instruments, mainly interest and currency swaps, are used to mitigate against adverse changes in market conditions.*

### **Membership**

*Kommuninvest performs its own credit checks at sign-up. Each member is subject to 2 credit checks each year and ongoing membership is contingent on these being passed. If the local authority drops below the membership criteria then warnings are issued and if the credit rating does not improve, the authority is expelled. The stringency and frequency of the checks, as well as the undesirable political consequences of falling foul of them, provides a strong incentive for prudent financial management within each of Kommuninvest's members. Each prospective new member must reach a level of creditworthiness which has been determined by existing members. This helps to reduce risk for those already involved.*

*Kommuninvest operates two separate guarantees; a 'joint and several' guarantee and an internal guarantee agreement between members that they will divide all losses evenly. Each local authority is liable for the debt that it raises and the same amount again of other local authorities' borrowing. If there was to be a default, the other members would gain that authority's market share. There has not yet been a default. In addition, Swedish central government is the ultimate under-writer of local authorities – legally no authority can become bankrupt or cease to exist.*

Success Factors

*In setting up a vehicle of this type it is vital to have ambassadors: Kommuninvest benefitted from getting approval granted from Swedish central government and support from politicians. Kommuninvest has also taken a proactive stance in communicating the inherently low risk profile and strong financial management of Swedish local authorities to the investment community.*

Differences between Swedish and English local government

Swedish LAs are more autonomous – they have greater responsibilities and a higher degree of self-financing. Approximately 75 per cent of revenue is raised locally through local income taxes. However it should be noted that in England the 2003 Local Government Act gives creditors access to local taxes in the event of a credit event, which offers a good degree of assurance to investors.

Advantages	Disadvantages
Offers access to DCM for authorities of all sizes Could offer highly competitive margin on PWLB Creates additional stakeholders and incentives for prudent financial management Convenient and relatively quick access to source of finance that is completely independent of central government Financial expertise within agency not possible in individual authorities Watchdog of creditworthiness Stability – funding agencies have proven very stable through crises One credit rating and not many helps reduce transaction costs	Organisation carries a holding risk with debt it raises Cross guarantees can prove politically unpopular at a local level Has to reach a critical mass – needs a critical level of borrowing to cover its fixed costs LGFAs credit rating likely to be influenced by explicitness of central underwriting of local authorities

### The prospects for a local government financing agency in the UK

**As with other forms of finance that will offer a competitive margin on the PWLB, such as bond issuance, there is a strong case for LGFA arrangement in England. Creating an LGFA from scratch in England presents a range of challenges, however. It would not be possible, for instance, to transpose the structure of a LGFA in another country onto local government in England. If a LGFA is to come into fruition, it would have to be a bespoke creation build to reflect the structural underpinnings of English local government.**

The Local Government Association (LGA) has begun work to carry out an assessment of a business case for the creation of a LGFA in England. Advisors have been commissioned to undertake an assessment of the legality of a LGFA within English law. The assessment will also make a judgement about the likely costs of borrowing for councils from such a vehicle. To complement this work, the LGA has surveyed council finance directors to test the appetite for a LGFA within the sector. This found that 75 per cent of authorities are in principle interested in participating in a LGFA, offering strong encouragement to the concept.<sup>60</sup> The feasibility study will be sent out to every council finance director in England. Should the results of this process be positive enough to proceed it is possible, assuming a strong business case can be formed, that an English LGFA could be implemented by 2013.

NLGN supports the work by the LGA to develop a vehicle that could provide competitive borrowing to all local authorities, regardless of size or scale, and which would also be independent of central government.

There are a number of forms that an English LGFA could take. These are to some extent dependent on the legal freedoms of English local authorities to participate in a scheme in the same way as, for instance, Swedish local authorities. At the time of writing, the introduction of the General Power of Competence does not seem to offer the requisite legal clarity needed for some of these options.

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<sup>60</sup> In addition, many of the 25 per cent were authorities which fell into the 'not planning to borrow' category

The type of organisation, in legal terms, can also differ. It is possible it could be any one of a limited liability partnership, company limited by guarantee, a co-operative or a contractual joint-venture. The legal nature will depend on several factors; which organisation/s are in ultimate control of the company; how the liability for debt has been shared and structured; whether the company will make a profit; and what powers the company needs to function properly i.e. the ability to hedge and use derivative products.

### 1. The Kommuninvest Model

This would involve creating a model that is broadly similar to LGFAs in countries such as Sweden, Denmark or Finland. The model would need to have a cross guarantee between local authorities - as well as stringent credit assessment arrangements, a credible board and governance structure and good liquidity arrangements to ensure that it is given a triple A credit rating.

### 2. A Kommuninvest without cross guarantees

The structure would be the same as listed above, minus the cross guarantee structure between authorities. This would increase the perceived riskiness of the organisation, which would likely be translated into higher borrowing costs for the member authorities. As a consequence, the organisation may need a much larger quantity of start-up capital, which local authorities are currently not in a position to input.

### 3. A 'Housing Finance Company' for councils

The organisation could mimic the structure of the The Housing Finance Company,<sup>61</sup> which does not employ cross guarantees. There are two aspects of this which might affect the price of debt it could offer. A lack of cross guarantees could limit the amount of issuance the vehicle is able to do – it's likely that its market access would be less regular and frequent than a Kommuninvest-style vehicle. One benefit of this would be reduced carrying costs, as debt would effectively be raised to order. However, the rates would likely be higher and it may struggle to meet the demand for borrowing from councils or improve upon the PWLB rate.

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<sup>61</sup> The Housing Finance Corporation is a debt issuance vehicle for a membership body of housing associations. THFC has successfully borrowed and on-lent over £3bn to housing associations since 1987



## Barriers to overcome

### *Legal*

The central challenge the development of a LGFA in England is the question of whether cross guarantees, or joint and several guarantees, can be used legally by English local authorities.

Local authorities can only act as permitted by statute and powers conferred on them. Authorities may delegate functions to or act jointly with other local authorities but there are no express powers allowing authorities to provide guarantees or indemnify other authorities. In instances where local authorities have tried to rely on incidental powers under section 111 Local Government Act 1972 to provide guarantees or indemnities these have been held to be ultra vires as they were not calculated to facilitate, or conducive or incidental to, the discharge of any of their functions. The well-being powers have not changed this premise. The Building Schools for the Future programme raised vires issues when local authorities were asked to agree a 'joint and several liability' when jointly entering into strategic partnerships with another local authority. It is not clear that the GPC will be strong enough to challenge this. In a similar way to the derivatives issues discussed previously, it is the confidence of the market/investors that is the ultimate arbiter. Without further legal clarification it is likely they will not be convinced of local authorities' legal right to use cross guarantees.

If it is the case that the GPC is not able to offer the legal clarity required to permit cross guarantees being used, there will be repercussions for the eventual structure the LGFA takes on and the borrowing rates it is able to obtain. It is possible that the consequences of not being able to use cross guarantees translates directly into increased costs of borrowing. In this instance there would be a strong argument for the Secretary of State to take steps to help clarify the legality of the situation.

### *The ability to hedge*

All LGFAs use derivative instruments as a means of hedging. Whether an English LGFA was able to use derivatives would depend largely on the

legal nature of the organisation that is formed. If the legal nature of the organisation is considered legally a local authority it is unlikely to be able to use derivatives (for the reasons discussed in Chapter X). An alternative form of company is likely to be sought, but this might have implications for the ownership of the vehicle.

### ***Establishing an equity base***

If there is a requirement for initial equity to be paid in by councils it may be difficult for the vehicle to reach a critical mass. The LGFA being developed in New Zealand requires authorities to inject \$25m NZ of equity at the start up of the scheme. As English local authorities go through one of the harshest periods of austerity in 50 years it is unlikely that this level of capital would be available for all, if any, authorities. As the financial benefits would only be accrued in any substantial sense in the medium to long-term, the need to inject capital may present a collective action problem that prevents the vehicle becoming operational in the first instance.

### ***Reaching critical mass***

The LGA have found broad support for the concept of a local government funding agency, but drawing these councils in to formally join remains a substantial barrier. While the PWLB remains at Gilts+100bps there is a strong rationale for a LGFA. Councils may have concerns about the liability arrangements, particularly if a cross guarantee is required. Despite the fact that this would reduce the interest rates councils could borrow at, it is expected that a number of councils would be reticent to enter into an arrangement which could see them effectively bailing out another council. The need for an equity input could be a similarly sizeable barrier.

As with Kommuninvest, one strategy might be to limit the LGFA to a geographic region or a set number of authorities at first. It may also prove a more manageable number to co-ordinate. Limiting the number of potential councils involved in the first iteration would also reduce the start up costs and initial equity base needed. The vehicle could then be built up incrementally towards a national 'tipping point'. The positive experiences of the councils which join initially would also help to act as a peer review and encourage other councils to join as the opportunity arises.

### ***Political risks***

The viability of a LGFA, as with bond issuance, rests largely on the PWLB remaining fixed at 100bps above Gilts. If the PWLB was to be returned to its historically low rates then it is highly unlikely that a LGFA would be able to compete with this. The process of establishing a LGFA is not insignificant – it is likely to take 18-24 months from beginning to end. The start-up costs are also expected to be sizeable. Establishing a LGFA in England is therefore a substantial risk for any organisation to take on. If there is a perception that the PWLB is seen as a tap used by Ministers it is questionable whether any organisation would take on such a high level of risk. The rate at the PWLB can be changed overnight and without warning. If the government is committed to encouraging a more diverse borrowing market for local authorities then it must take steps to offer reassurance on what its policy regarding the PWLB will be. The messages from the Treasury have been mixed, with one Minister speaking in a personal capacity about his feelings that councils should not be able to borrow from any sources other than the PWLB. Such public inconsistency on Treasury policy is damaging to the prospects of councils developing cost-effective and prudent means of accessing debt. We urge for this issue of inconsistency to be resolved in favour of councils having flexibility in their sources of finance.

### **Conclusion**

There is a strong rationale for the creation of a LGFA, but only while the PWLB continues to lend at Gilts +100bps. Furthermore, the rationale, which ultimately rests on the competitiveness of the borrowing, could be damaged by an inability for councils to employ cross guarantees to effectively underwrite the vehicle. At some point, if a LGFA is to be created, central government will need to fulfil their role as the body which supports local authorities to move further towards local autonomy. A LGFA is unlikely to form while there remains a risk that the PWLB could change overnight. If the government is committed to local authorities deriving a more diverse range of borrowing options, it will have to state more clearly its intentions for the PWLB. Central government will also need to help local authorities clarify legal uncertainties around cross guarantees. Without this help, local government may only be able to get half the way to a more autonomous system of capital borrowing.

## 9 *Non-market finance*

### **Borrowing from the European Investment Bank**

**The European Investment Bank (EIB) offers two sources of financing. Individual (direct loans) are awarded to public or private sector projects with a total investment cost of over €25 million (£21.7 million). The EIB can offer fixed rates, revisable fixed rates or convertible rates, all dependent on adequate security and a good credit rating. Repayment is usually on a semi-annual or annual basis.**

For projects with a total investment of less than €25 million, the EIB offers intermediated loans. The EIB grants a credit line to an intermediary bank or financial institution in the relevant country, which then passes on the funds to the local authority. A credit line may supply up to 50 per cent of the total cost or, under certain circumstances, 100 per cent of the loan granted by the intermediary bank. Local authorities must contact the participating intermediaries directly and the decision to lend rests with them. The financing conditions are also determined by the intermediary and maturity is normally between 5 and 12 years. The intermediaries in the UK are Barclays Bank, Santander Corporate Banking, The Royal Bank of Scotland and Lloyds Banking Group.

To be eligible for either sources of funding, the project must support EU economic policy objectives:

- Cohesion and convergence of developing nations within the EU
- Support for small and medium sized enterprises
- Protection and improvement of natural environment, and promote social well-being
- Innovation to establish a competitive and knowledge-based European economy
- Trans-European Networks of transport, energy and telecommunications.
- Promote sustainable, competitive and secure energy sources
- Support for human capital, notably health and education

In October 2011, the EIB agreed to provide £500 million over 30 years to the Greater Manchester Combined Authority to complete phase three of the Greater Manchester Metrolink. The project supports the EIB's policy on sustainable transport and the money will be used to fund new trams and infrastructure that will benefit many key district areas. The expansion is due to be completed in 2016 and support from the EIB will lower the total cost through cheaper financing.

### Inter-council lending

The majority of councils hold revenue reserves for unexpected costs, for example flooding, to act as a cushion against uneven cash flows and to build up resources to cover future liabilities. Excluding schools reserves, which are not immediately available to local authorities, the total level of revenue reserves in England was £11.7 billion in 2010/11 and is forecast to drop to £10.8 billion in 2011/12.<sup>62</sup> The size of revenue reserves varies dramatically between local authorities and more than 50 have over £50 million in reserves. The majority are ear-marked to fund long-term projects to improve local services however some councils are able inter-lend.

Inter-council lending is primarily for treasury management purposes rather than capital expenditure, however, the two are interlinked. Short-term investments are often used for cash flow purposes, allowing councils to role short-term debt and diversify their risk portfolio. Rates are typically low and more favourable than the PWLB however borrowing from the PWLB is the long-term replacement. Agreements typically last between 12 to 18 months, certainly no longer than two years, and are arranged through brokers, for example Tradition. Councils may also inter-lend with their local District Authority, Police Authority and Fire Authority however these loans are normally managed in house.

Cambridge loaned over £40 million to 18 other councils in 2011, using them as short-term investments at a low rate. The councils that received loans include Thurrock Borough Council, which received £2 million with a 0.45 per cent interest rate, Aberdeen City Council, Newcastle-upon-Tyne City

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<sup>62</sup> DCLG, *Local authority revenue expenditure and financing England: 2011-12 budget – Individual local authority data*, (June 2011)

Council, Lancashire County council and Salford City Council. It is not unusual for councils to both lend and borrow at the same time, for example, in 2011 Lancashire County Council had £11 million on loan to other councils but was borrowing over £85 million.

## 10 Spectrum of financing options

	PWLB	Bank Loan	Structured bank finance	Benchmark issue	Private placement	Pooled issue	EIBB
<b>Pricing</b>	Gilts + 100 bps	c. Gilts + 100 bps for short-term borrowing	35 non-call 10 year LOBO, Gilts + 90 bps	c. Gilts + 80 bps (depending on rating)	c. Gilts + 90 bps (depending on rating)	c. Gilts + 90 bps (depending on rating)	c. G + 50 bps (depending on rating)
<b>Optimal Size</b>	n/a	£10 MM+		£150 MM+	£25 MM+	£10 MM+ per individual LA	€25m
<b>Is a rating required</b>	No	No	No	No—but better pricing with rating	No - but better pricing with rating	LA not rated, but issuance entity is rated	No
<b>Tenor</b>	1-50 years	Short-term only	35+ years	30-50 years	30-50 years	30-50 years	30 years
<b>Additional considerations</b>	Margin may increase again going forward	Banks have less balance sheet to offer	Lack of visibility over value of optionality sold	Costs are incurred in setting up docs & obtaining a rating	Depth of investor PP demand has yet to be tested	Agreement needed over tenor and timing of issuance	Needs to be tied to a specific, eligible project
<b>Pros</b>	Flexible PWLB is lender of last resort Ease of access	Source of floating rate borrowing Flexible: can be repaid early	Pricing is relatively attractive	Potentially most attractive pricing Full control over the issuance process	Enables access to capital markets for smaller issue sizes Bilateral negotiation with investor so degree of structural flexibility	Enables access to capital markets for smaller issue sizes	Cheapest cost of funds
<b>Cons</b>	Risk of funding dependence on central government Pricing potentially not as attractive as benchmark issue (depending on market conditions)	Short-term borrowing early Lack of available lenders	Refinancing risk LA exposed to embedded derivative products Difficulty of exit costs Less control	Minimum size requirement	Pricing premium compared to benchmark issue	Reduced control over the issuance process Pricing largely determined by weakest credit Legal complexity	Minimum size requirement Use of funds must be for eligible project Only lends 50 per cent of project value

## Section III *The new capital finance landscape*

Section 3 explores a number of key facets of this new capital finance landscape. We aim to highlight the key areas of capital finance over the next five years, drawing on the key themes that emerged from our research. In some instances the intention is to start what we hope will become a bigger conversation, and in others we seek to offer insight for local authorities and the private sector in the development of effective strategies for maintaining investment. Finally, we aim to develop some core principles of a capital finance landscape in 2012 that is in a number of crucial ways markedly different to that which has preceded it.

These core themes should not be seen as operating in isolation. In many instances capital investment will only be possible where a number of mechanisms or concepts are combined and blended together. For instance, large regeneration projects are likely to involve combinations of capital grant, borrowing, developer contributions, private capital and public assets (for instance through a LABV). One aim of this section is to understand how these mechanisms can be used together most effectively. It is a key message of this report that understanding the ultimate objectives of the investment and the context that it will happen in is crucial to understanding which approach/es to adopt.



## 11 Managing risk in capital finance

Central government reforms are changing the financial dynamics of councils in a way that means we must start a new discussion about risk in the public sector. Pressures on revenue budgets and mechanics such as the proposals to enable councils to retain growth in their business rates are incentivising councils to actively pursue economic growth. A lack of capital availability means councils are implicitly being nudged towards new infrastructure delivery mechanisms such as Tax Increment Financing (TIF). As the Deputy Prime Minister stated when announcing the legislation which will enable TIF, “[TIF] is the first step to breathing life back in to our greatest cities”.<sup>63</sup>

TIFs, like other mechanisms which can enable investment in the absence of grant such as Local Asset Backed Vehicles (LABVs), are inherently more risky than traditional local authority approaches. The reductions in grant levels, however, mean there is little other genuine choice than to use these riskier mechanisms, particularly where capital investment is needed to aid growth. It is at this juncture that the local government sector may find a tension that is hard to reconcile. As a sector it is, by its own admission, highly risk averse. While this means local government may be good at avoiding policies that are markedly too risky, it may also be missing out on the benefits of policies that are risky, but perhaps not critically risky. A ‘business as usual’ approach means potentially sacrificing the benefits of not using new innovations. But merely relaxing the controls and adopting a greater risk appetite may cause recklessness and the misuse of public money.

This is a highly nuanced debate. It is not desirable for councils to see new incentives and mechanisms as a green light for reckless behaviour. Similarly it would be counter-productive, in terms of national and local economic strategies for growth, to view increased levels of risk as an insurmountable barrier to investment. But for implementation of TIF to be successful, something has to give. The solution therefore has to lie in the ability of councils to approach risk in a *different* way.

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<sup>63</sup> Nick Clegg, *Speech to Liberal Democrat Annual Conference, 2010*

It is beyond the scope of the report to design new risk management strategies for the sector. The aim of this chapter is to open a vital discussion about approaching risk differently. It is hoped that by fundamentally reappraising approaches to risk, the transition to a new capital finance landscape can bring sustainable benefits and opportunities for local authorities and their communities.

### Local Government and Risk

It is widely accepted that historically councils have tended to err on the side of caution rather than risk. In a survey of councils in 2011, 50 per cent of respondents rated their organisation as either 'risk averse' or 'very risk averse'.<sup>64</sup> A theme that recurred throughout our interviews and one research seminar was that councils are currently not well positioned, in terms of organisational culture, to take on new innovation or delivery mechanisms: as one respondent noted when discussing the potential of using derivatives, "we are a very risk averse organisation".<sup>65</sup>

With councils now facing a range of new partnership arrangements, delivery mechanisms and incentives this suggests the sector may struggle to adapt confidently and successfully. It is recognised that a failure to adequately manage risk is a major barrier to successfully adapting to new circumstances. For instance, research from the Audit Commission found that innovation in councils often fails because of poor implementation and ineffective risk management.<sup>66</sup>

There are contextual factors behind such risk aversion. Central-local relations that have developed since the 1980s have created numerous dynamics which have encouraged financial and strategic centralisation. The result of this has been a creeping sense of dependency on central government within the sector. This organisational mindset is easily translated into a lack of confidence, which automatically makes trying new approaches more difficult. Though this has not been the case in every instance, and the extent of this phenomenon differed from authority to authority, this broad

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<sup>64</sup> LGIU *Risk and Reward* (2011)

<sup>65</sup> Interview respondent A

<sup>66</sup> The Audit Commission *Seeing the Light* (2007)

trend was reinforced by our research interviews and seminars.

These dynamics are being unpicked by a range of localist reforms that challenge the culture and mindsets of councils as much as the structural basis of financing. The General Power of Competence aims to free councils from the ‘vires doctrine’. Importantly, one of the major forces of council scrutiny over the past two decades, the Audit Commission, has been abolished. The Ministerial view from DCLG appears to be that as elected democratic bodies it should be the local electorate that provide this scrutiny and over-view function for local authorities rather than non-departmental public bodies.<sup>67</sup>

There is the potential that this will create a framework which is more accepting of risk and lends councils greater latitude in the way that they pursue innovative financing techniques. Councils have demonstrated consistently their sound financial management abilities and prudence. This places them in a strong and legitimate position to now explore new approaches that present a higher level of risk in a way which reduces the chances of failure to a minimum.

However, councils inhabit a world which is almost totally unforgiving of failure. As Michael Power, an LSE academic who has written extensively about risk management, argues (2004, 2007), there has been a shift in societal attitudes towards the importance of accountability within public sector organisations for risk mitigation, and a corresponding increase in the perceived ability of councils to successfully manage unknowable risks.<sup>68</sup> This tension was summed up by one interview respondent:

*“We’re a very nervous and risk averse sector. We have an issue. Local government tries to protect itself as a brand, partly in the event of failures, and at the same time central government is pushing blame with responsibility down to local levels”*<sup>69</sup>

This has tended to weight decision making in councils towards the least risky option. Generally the risk of not doing something is perceived as being

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<sup>67</sup> Rt. Hon. Grant Shapps, speech at NLGN reception, June 2010

<sup>68</sup> Michael Power *Organised Uncertainty* (2007)

<sup>69</sup> Interview respondent I

far lower than the risk of doing something new or different and it failing. The challenge for councils is therefore to take on the risks associated with the new growth agenda, new roles and new financial mechanisms in an environment in which embracing additional risk is politically, financially and culturally difficult. As an illustration of why this may prove challenging some of the risks associated with a LABV and a TIF scheme are outlined below.

Project selection	Project finance	Design	Construction	Operation
<b>• Tax Increment Financing (TIF)</b>				
<ul style="list-style-type: none"> <li>- Growth potential of selected site</li> <li>- Expected level of demand / impact of investment</li> </ul>	<ul style="list-style-type: none"> <li>- Availability of affordable finance</li> <li>- Interest gap before tax increment is generated</li> </ul>	<ul style="list-style-type: none"> <li>- Planned infrastructure does not meet business needs</li> </ul>	<ul style="list-style-type: none"> <li>- Project over-runs deter businesses</li> <li>- Quality of work deters business</li> <li>- Cost over-runs jeopardise business case</li> </ul>	<ul style="list-style-type: none"> <li>- Shortfall in incremental revenue does not cover investment</li> <li>- Drop in investment outside TIF area</li> <li>- TIF displaces activity from other areas</li> </ul>
<b>• Local Asset Backed Vehicles (LABV)</b>				
<ul style="list-style-type: none"> <li>- Selecting assets of appropriate value and potential</li> <li>- Market saturation with low supply of private partners</li> </ul>	<ul style="list-style-type: none"> <li>- Council unable to match capacity of private partner</li> <li>- Fluctuations in asset value</li> <li>- Asset not valuable enough to leverage project finance</li> </ul>	<ul style="list-style-type: none"> <li>- Conflict of interest between elected members and joint venture board</li> <li>- Change in council regeneration policy</li> </ul>	<ul style="list-style-type: none"> <li>- Incomplete development cannot leverage asset</li> </ul>	<ul style="list-style-type: none"> <li>- Delay to regeneration outputs prevents increase in commercial returns</li> </ul>

As these examples demonstrate, there are a wide number of potential risks associated with non-traditional capital financing techniques. In light of the inherent risk aversion within the local government sector, it is eminently possible that such techniques may not be implementable where they would be successful. Risk aversion will not permit intrinsically risky projects. This is not to suggest all risks should be accepted. The answer is in understanding which new risks are tolerable and necessary to take on.

### ***Current approaches to risk in local government***

The discipline of risk management is constantly developing and the majority of local authorities now have some form of risk management in place. In 2004 the Treasury published *The Orange Book*<sup>70</sup>, an ongoing review of the risk management process, to act as guidance for government departments and public organisations. Another source of risk management guidance is the Risk Management Standard.<sup>71</sup> The key conclusion from both publications is that risk management should be a continuous process that evaluates an organisation's activities past, present and future.

In 2011, the National Audit Office published a report on managing risk that identifies the key principles that departments should follow.<sup>72</sup> In the same year, Alarm published a review of the core competencies in public service risk management.<sup>73</sup> In addition, a report by McKinsey on risk management in the US public sector drew similar conclusions.<sup>74</sup> The key recommendations from these reports are collated as follows :

The Board should set the importance and tone regarding risk management for the whole organisation.

1. A risk management infrastructure or “constitution” that codifies decisions and creates continuity is required

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<sup>70</sup> HM Treasury, *The Orange Book – Management of risk principles and concepts* (2004)

<sup>71</sup> The Institute of Risk Management (IRM) in conjunction with The Association of Insurance and Risk Managers (AIRMIC) and Alarm (The Public Risk Management Association) *A Risk Management Standard* (2002)

<sup>72</sup> National Audit Office, *Managing risks in government* (2011)

<sup>73</sup> Alarm, *Core competencies in public service risk management* (2011)

<sup>74</sup> McKinsey & Company, *Strengthening risk management in the US public sector* (2011)

2. Response to risk is most proportionate when the tolerance of risk is clearly defined and quantified
3. Risk management is most effective when accountability is clear
4. Good decision-making is underpinned by robust, objective information, which requires effective systems in place to capture it
5. Risk management will only improve by implementing past lessons
6. A risk management strategy should evaluate internal and external risk factors in line with an organisation's objectives
7. Identify the risk management tools to analyse and evaluate risks, and to manage, monitor, review and set up effective responses
8. Maintain strong relationships with stakeholders to communicate and manage current risks

### ***Striking the right balance in managing risk***

There has been substantial development of risk management as a discipline and most councils now have dedicated risk registers and processes for managing risk. Despite this, our research pointed overwhelmingly to a sense that local government has not struck the right balance in the way it addresses risk. It was felt that the level of risk tolerance that councils have is currently too low to sustain capital finance in a period of low or negative economic growth.

This report does not comment on individual risk management processes in operation across local government. The intention of this report is to prompt councils to question whether they would benefit from an internal discussion about the need to approach risk in a different way in future. By questioning whether approaches to risk will enable innovation, in capital finance and in other areas, this period of reducing budgets may be more easily navigated. Our research has highlighted a number of factors it would be beneficial to consider.

## Factors for consideration in risk management

### *Insights from behavioural science*

In recent years studies of behavioural science have challenged conceptions of the rational actor model in economics. There are implications for risk management processes because individuals have been shown to be susceptible to various biases which influence their decision making. As risk management decisions are ultimately a collation of a series of human decisions, it is important to be aware of such biases and understand how they can be corrected. Two biases in particular – disaster neglect and loss aversion – represent opposing ends of the risk management spectrum that councils must strive to avoid.

**Disaster neglect:** This refers to a failure to adequately anticipate the worst possible, or all possible, outcome/s from a decision. Neglecting to include such information in a risk appraisal document can lead to a failure to consider these when an eventual decision is made. Such a bias can lead to decisions that are not fully calibrated with the total level of risk present. Potentially the outcome could be the failure of a project.

To avoid this, the psychologist Gary Klein suggests performing a pre-mortem, the hypothetical opposite of a post-mortem. The difference is that a pre-mortem is performed at the beginning of a project so it can be improved rather than autopsied. Once a project plan has been completed, relevant staff should be asked to write down all the possible reasons it could fail dramatically. While in a group, each person should read out one reason, with everyone stating a different reason until they have all been recorded. The risk manager should then review the list and look for ways to improve the plan before the project starts.

**Loss aversion** refers to the tendency for people to treat losses more seriously than equivalent gains, for example the decrease in satisfaction from losing £10 is considered to be greater than the gain

in satisfaction from receiving £10. Loss aversion is the converse of disaster neglect and can explain partially why organisations can be overly cautious in approaching risk. Nobody wants to be responsible for a failed project, especially people in the public eye, but loss aversion can often lead to missed opportunities and a lack of innovation. Loss aversion is exacerbated if people are uncertain about what level of risk is acceptable. To correct for this the council executive must provide a clear indication of what risk level is acceptable. The way that a risk is dealt with can influence risk appetite, especially if responsibility is shared and there are adequate procedures in place. Building a risk aware culture is crucial for dealing with excessive conservatism.

Most organisational risk management will inevitably suffer from both of these biases at times. In a local government context they may help to explain why generally there is widespread risk aversion: loss aversion is high where there is public money at stake, public accountability and press scrutiny to report examples of policies failing. Disaster neglect helps to explain that even while there is pervasive risk aversion, councils still encounter failure, such as with the Icelandic banking crisis. It is worth noting that the consequences of disaster neglect are highly visible, whereas the negative consequences of loss aversion are invisible. While the Iceland incident, which in reality affected only a small minority of councils, is now well known, the lost opportunities of not implementing innovation, which are likely to be far more pervasive, are frequently unquantified and unacknowledged.

### ***How can councils harness innovation in capital finance?***

Many new financing techniques represent, in broad terms, the concept of innovation. Councils have been found to struggle with implementing new innovation. But in reality across local government and other sectors, new ideas are turned into a workable reality on a day to day basis. There has been work to help understand how this happens.

*Seeing the Light* (2007) by the Audit Commission aimed to challenge the features of local government which inhibit innovation. The report



makes an important distinction between generating innovation and implementing innovation. It is the latter that is of more interest to this report. It is recognised that it is at the implementation stage that the benefits of innovation are most commonly lost. It is important to note that the Commission's research found some innovation failed because of poor risk management. Other success factors for implementing innovation identified by the Audit Commission included strong political leadership and management, flexibility in approach and managerial capacity.

In *Adapt*, Tim Harford addresses the issue of innovation and argues that success always involves some degree of initial failure. Highly centralised organisations are implicated as an obstruction to implementation of new ideas as they inhibit experimentation, reduce the use of individual judgement in favour of process, and reduce the sense of responsibility held by employees. Centralisation in this context can be seen either in terms of an individual organisation, or in governmental terms, both of which are relevant to local authorities.

Harford establishes three key principles of successful innovation:<sup>75</sup>

- seek new ideas and experiment constantly, expecting a high degree of failure
- ensure that any failure is survivable
- learn from the experience of failure and success through feedback

In reality local authorities may not have the luxury of the first principle. With public money in use, it is not realistic to expect councils to experiment widely simply to learn what works and what doesn't. But there remains an instructive point here – councils can use pilot studies, and try things on a small scale. Communication can then feed learning from these experiences across the network of councils, essentially multiplying greatly the degree of 'experimentation' that is occurring across local authorities.

For capital investment there are useful parallels with other complex and high-stakes fields where risk containment is vital. Nuclear power stations for instance are highly risky and it is hard, taken as a whole, to keep a failure

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<sup>75</sup> These are based on those developed by Palchinsky, a Russian engineer in the 1950s

within one 'survivable'. The complexity of the operation can mean that a small failure in one area can quickly become a total systemic failure. For that reason nuclear power stations are designed with in-built firewalls which prevent a failure in any particular area from carrying forward into other areas. It demonstrates that the risk of failure can never be removed, but mechanisms can be included to prevent individual failure becoming systemic failure.

### ***Lessons from other organisations***

In the private sector all organisations must take risks in order to succeed. Private companies share with councils the concept of 'downside risk' i.e. that the expected returns of an investment do not materialise. However, private companies also consider upside risks, i.e. that the returns may be higher than expected. Government reforms, such as the retention of business rate growth, will prompt a mindset in councils that is closer to that of the private sector than is currently present.

Private companies will typically make risk management processes central to their core business. Any risks identified in planning stages will involve a sensitivity analysis to understand what changes in relevant variables will mean for potential outcomes. The organisation is then in a position to make a judgement on whether a risk is material and requires 'pricing', mitigating (such as with stress tests or restructuring) or no further action. Corporate risk is then reviewed generally on a twice yearly basis, with monthly updates on all major investments .

This prompts an important question about whether councils are currently equipped to address risk in this way. With capital finance, much of the risk analysis can be quantitative and objective. However this requires specialist expertise and tools to do this. The sector undoubtedly has some mechanisms, but would arguably benefit from more sophisticated tools to conduct sensitivity analyses of future investments. In addition, there may be work required to develop a better understanding of Gross Value Added measures so that investment criteria can be established and project outcomes analysed against this. There is a role for organisations such as Local Partnerships to help councils develop new tools for managing risk in different ways where necessary.

### ***Communicating risk***

Making data on key decisions publicly available can lead to greater accountability. In the private sector, organisations have a responsibility to their shareholders and will report to stakeholders on a regular basis to ensure their interests are protected. Local authorities do not have traditional stakeholders, however central government and tax payers are both liable for any failures in risk management. Each council is required to publish a list of key decisions occurring in the near future, though not all councils highlight the risks involved. There is a strong argument that local authorities should make risk management a public activity and consult those that will be directly affected by any failures.

It is also useful to reflect on the different dynamics that exist between a council and its stakeholders and a private organisation and its stakeholders. Stakeholders of private companies judge decisions on their likelihood to yield future returns. This is a different lens to the one through which taxpayers judge council decisions. Here a wide range of factors are considered, and are likely to be dominated by service delivery standards rather than the provision of infrastructure. It is important therefore for councils to be able to have a dialogue with their community about the rationale for investing in infrastructure. Community approval of investment that is seen as risky may be easier to obtain if it is framed in the context of the jobs it will create and direct benefits it will have for individual's lives or the operation of businesses.

**Recommendation:** *councils should make risk management a public activity and communicate downside and upside risks to citizens*

### **Conclusion**

The discussion of risk management prompts important questions for councils considering new approaches in capital investment.

Experimentation across the local government sector in capital finance policy should be actively encouraged. Experimentation, most likely in the form of pilots, should be undertaken on a small-scale basis with an effort to reduce risk factors to a minimum, but also with an acknowledgement that no

successful experimentation can occur without at least some risk of failure. The small-scale of these pilots should ensure that in the worst case scenario, the failure is survivable. Councils should also look to reduce the complexity, where possible, in approaches to capital finance. Where necessary, efforts should be made to insert barriers between pilots or new approaches so that individual risk does not become systemic risk. But this is not to support innovation for innovation's sake. Where tried and tested methods are successful, these do not need changing. Experimentation is required where there are differences in circumstances and/or existing methods do not work. Crucially, councils will require central government to support them in delivering new innovation. The Coalition have rightly targeted sections of localist reform at changing organisational cultures within councils, such as with the General Power of Competence. We warn against slipping into a belief that this represents the end of central government's role, however. Changing organisational cultures is complex and difficult – councils will be given confidence to do this if they are certain that central government is there to support and facilitate this. This is not a call for greater central government oversight. It is an acknowledgement that in some instances councils will need legal, technical and public support in order to harness innovation. An interview response neatly summarised this point:

*"If we're pushing boundaries things will go wrong. We have to be in a position where government supports innovation. We want central government to be willing to come in and back us up legally in case law if needed"<sup>76</sup>*

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<sup>76</sup> Interview respondent I

## 12 Rethinking approaches to Public Private Partnerships

*“I think days of private public separation are long gone. If the UK wants growth, it [the public and private sector] has to be joined up”<sup>77</sup>*

It is certain that the private sector will play an integral part in sustaining capital investment over the coming years. The way that the public and private sectors work together on capital projects is changing, however. Councils are keen to work in partnership, but there is a growing sense in the sector that the way they do this needs to change. Our survey found that 62 per cent of respondents felt the public and private sector could work better to increase capital investment. At the local level this is likely to mean a decline in the use of the Private Finance Initiative, and an increased use of Local Asset Backed Vehicles and strategic partnering arrangements.

### Changing format of Public Private Partnerships

The use of private capital in public infrastructure projects has produced a mixed experience in recent years. It has levered in huge sums of extra capital, approximately £56bn worth, and consistently delivered projects on time and on budget a higher percentage of the time than traditional procurement approaches.<sup>78</sup> The involvement of the private sector does not just bring additional capital. The closer working of the public and private sectors over recent years has introduced enhanced project management disciplines and efficiencies to capital investment. It has also enabled each sector to focus on its primary areas of expertise. But use of private capital also attracted significant criticism: the charges range from poor value-for-money to highly complex and time consuming procurement processes and inflexible use of built assets.

Following some of these criticisms the Comprehensive Spending Review 2010 cancelled the use of PFI credits. PFI credits provided central government

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<sup>77</sup> Interview respondent I

<sup>78</sup> See for instance PwC *the Value of PFI* (2008), and NAO *Private Finance Projects – report to the Lords Economic Affairs Committee* (2009)

funding to local authorities to deliver PFI projects. These were seen as weighting decisions about financing routes unduly towards the use of PFI, including where this wasn't the most cost effective choice. Central government departments will now have to provide funding to councils in grant form, giving local authorities a greater degree of flexibility in the choice of financing route.

Our research has indicated that this change is likely to herald a major reduction in the use of PFI by councils. Our survey found that 22 per cent of top tier authorities we surveyed had plans to use the PFI as a financing mechanism in the next three years. This compares with 50 per cent of authorities planning to use TIF and 33 per cent planning to use a Local Asset Backed Vehicle (the most comparable alternatives).

Our interviews also reflected a lack of local support for PFI. A number of respondents stated their authority had made use of PFI, but only where it has been accompanied by central government given PFI credits, implying that councils were merely chasing the sources of funding. This reinforces the sense that the PFI has been a method driven by the centre with minimal buy-in from local authorities.

*"The motivation in PFIs was the credits. Take that away and the councils are not as motivated. And this will create a different relationship, with councils in a stronger position"*

*"With PPPs yes there is potential, some are being used on the highways contract where there is lots of sharing between the public and the private sector and trying to bring in alternative finance. But not PFI, we're looking for more PPPs"*

*"I see potential in arrangements with the private sector that are not PFI, as they [PFI] were expensive to set up"*

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79 Interview respondent G

80 Interview respondent E

81 Interview respondent A

***Improving the use of private capital in public infrastructure projects***

In November 2011 the government announced a consultation exercise to design a new model for private finance. This is a welcome opportunity to recognise the benefits that private capital can have for the public sector, but also to readdress some of the aspects of the PFI that were most criticised. Our research indicated that any new model devised should aim to improve on two key areas: reducing the cost of the capital and a different approach to risk transfer.

***Decreasing the costs of capital***

Breaking a PFI project down in to three contractual phases has been proposed as a means of improving the functioning of PFI, helping to reduce capital borrowing costs and increase flexibility. The three contractual stages comprise the construction phase, the operating phase and the financing phase. The capital project is taken on and completed, at which points it is re-financed by the government, with the asset going into a regulatory asset base where it earns a smaller marginal cost on the debt than is currently the case.<sup>82</sup> This re-financing reflects the change in the risk profile: the risk changes to being one of a political or regulatory risk. Principally, whether the government and/or regulators will remunerate the completed asset as contractually agreed.

The end result could be a substantial decrease in capital requirements. It directly transfers risk from 'managers' to politicians and regulators without removing the benefits that are derived through in-built efficient delivery and operational incentives crafted by PFI contracts. In PFI projects there is no institutional structure to embed this commitment to (re)financing, instead the contract relies on charges for the projects to recoup capital costs.

In the event that the private sector requires a higher return on the completed asset the government is positioned to step in and either purchase the completed asset, or to remunerate the capital. This system provides flexibility. In PFI contracts the private sector provider can often be tied in

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<sup>82</sup> Dieter Helm to the Committee Oral Evidence, Ev 7

to 30-year contracts and need to be so in order to refund the cost of their capital expenditure. With this approach there is far greater flexibility in contracts because the capital expenditure and operational expenditure are separated out into different contractual stages.

The Government's announcement in the 2011 Autumn Statement to bring in pension fund investment in infrastructure is implicit support for this concept. The Government plans to work with institutional investors at the stage between operation and financing. This approach requires the public sector to take on the refinancing risk of a project. This could lead to better value-for-money for the public sector, but there are questions about whether it is ready to assume these risks.

### ***Risk transfer***

*"Councils can never outsource risk. There's been too many instances where the private sector has gone belly-up and the local authority has been left to pick up the pieces"*<sup>83</sup>

A core part of the rationale for using private finance is the transfer of risk that can accompany it. Our research suggested there is a concern among local authorities that risk transfer does not happen as fully as theoretical arguments suggest. While risk transfer can work successfully as an incentive for efficient delivery there is a sense that on a more fundamental level responsibility for public infrastructure can never be fully divorced from the state. This prompts a chance to reassess whether the risk transfer that is sought through the use of private finance is ultimately a worthwhile exercise. It is clear, for instance, that there are some risks that simply can't be absorbed by the private sector.

As a starting point, it must be noted that on a number of levels risk transfer in PFI has been successful. Reports from HM Treasury suggest PFI has consistently delivered projects on budget and on time a higher percentage of the time than conventional procurement. In addition, responsibility for the future management of an asset is a good incentive to ensure appropriate

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<sup>83</sup> Research respondent A



design and build quality is present. There have also been numerous instances of the private sector taking a financial hit for failing to deliver as contracted. It is risk on a more fundamental level where there is greater doubt over the efficacy of risk transfer.

*“We have to accept that risk transfer never actually happens and stop pricing for it”<sup>84</sup>*

Transferring policy, regulatory and planning risks can be attempted, but the scale of the risks are likely to be represented in higher upfront costs or unitary charges. For instance, in waste projects there is an amount of development risk relating to planning policy. The private sector is likely to ‘price’ for this risk, essentially meaning the price of the capital increases. It is questionable whether this is value-for-money and arguably we should not aim to transfer risks such as these to the private sector.

There are also instances in which the private sector simply cannot take the risk transfer on, particularly relating to policy risk. It is possible that a government decision could make the use of a certain asset defunct. It would not be reasonable or worthwhile to look for ways for the private sector to take this risk on and the risk is one that should be held by the public sector.

### Alternative PPP approaches

The government is set to develop a new model for using private finance to fund public infrastructure. This is likely to be used for centrally mandated capital delivery schemes, such as the Department for Education’s Priority Schools programme. At a local level, however, the use of private capital is more likely to be in the form of LABVs and strategic partnering arrangements.

A LABV involves the formation of a joint venture. The council assigns key assets to the vehicle, and the private sector is able to borrow against the value of these. The capital raised is then used to achieve the specified aims of the vehicle, usually in the form of regeneration work in town centres.

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<sup>84</sup> Interview respondent I

*“Local asset-backed vehicles are close to the top of the list. We see it as a key regeneration mechanism – we have a large property portfolio that hasn’t yet been sweated. This is largely in our gift and an LABV can be very flexible”*

*“We have to look at LABVs. The only pools of money available are private sector money, and the only way they’ll invest is when they see a return. So putting in land and bricks and mortar, some sort of deal with this resource to entice private sector money in, is needed”*

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In 2011 there has been procurement activity on over 12 new LABV schemes, mainly oriented around housing and regeneration or business/science parks. Our survey found further evidence of a growing appetite for the use of LABVs, with 33 per cent of top tier authorities we surveyed indicating they would be pursuing this approach in the next three years. This is a clear reflection of the levers each sector has at their disposal in current economic conditions. There is significant potential that can be unlocked if these levers are brought together.

Many councils continue to possess large asset bases and LABVs offer a chance to leverage these without having to dispose of them. Through rationalisation of office space, for instance, there are ways in which far greater value can be derived from this asset base. The private sector does not face the same restrictions as councils in terms of borrowing against the value of an asset base, but is likely to have fewer disposable assets. Bringing these together into a shared vehicle, against which capital can be borrowed and then invested, represents a way for common objectives to be pursued in a way that would not be possible without collaboration.

Our research indicated that councils see such approaches as a means of leveraging in capital, but also unlocking innovation in delivery, and maximising the value of the offer each sector is able to make. Councils are now starting to look at long-term partnering vehicles with the private sector with a much wider focus than in the past.

In recent years LABVs have transitioned from primarily capital delivery vehicles to being strategic partnering arrangements. It is reflective of the changing nature of partnerships. There is a gradual evolution away from narrow contractually focussed partnership to one in which there is a longer term relationship covering a range of key outcomes. New models are emerging that are oriented around strategic partnering principles – capital investment is delivered but this is just part of the partnering arrangement. In line with emerging theories about regeneration policy which see it as about investment in people as well as investment in physical infrastructure, such partnering arrangements can bring together approaches to workforce, capital investment and regeneration in one integrated strategy.

Previous NLGN research found councils reluctant to enter into LABVs while the property market was heavily depressed.<sup>86</sup> It is notable that despite the property market making no significant recovery, the appetite for LABVs has grown. This is perhaps a reflection of the need, post-Comprehensive Spending Review 2010, for councils to pursue all strategies that can bring in extra capital and the increasing availability of surplus properties as services and support processes are reconfigured (and often reduced).

LABVs are also seen as a way of bringing the public and private sector together in a way that is collaborative rather than contractual with clear incentives for both partners to deliver their input to the joint venture. It has clear advantages over a PFI deal in the form of reduced procurement time-scales and costs and greater levels of flexibility.

### ***Challenges***

While innovative PPP arrangements offer significant potential, their implementation is not always straightforward. The challenges speak of perennial problems in forming contracts or partnerships between the public and private sector, often relating to public sector projects which still have missing ingredients such as resolution of 3<sup>rd</sup> party land interests and a lack of early win schemes. Our research found that there are ways both sectors can make it easier for the other to partner with them.

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<sup>86</sup> NLGN Capital Contingencies (2009)

### ***Simplified contracts with strong governance arrangements are vital for building trust***

There is a strong demand from councils for partnerships with the private sector to be less complicated. Councils and private sector would like to move away from complex and highly contractualised relationships to more straightforward outcome based approaches.

*“There’s nothing new in any of this – it’s what the private sector does day in day out. We need to get rid of all the stupid things about what a contractor can and can’t do”*

*“Also we have developers coming up with schemes that are way too complicated. They need to be much clearer”*

87, 88

More transparent and simplified arrangement would help to promote greater levels of trust between the two sectors. Across the long time span of an LABV partnership the need for strong trust is vital. Lengthy contracts with very specific conditions can be both stifling of innovation and damaging to trust. Conversely, simpler and shorter contracts which focus on outcomes without lengthy attention to process can give both sides much greater flexibility and reduce any lingering sense that there may be ulterior motives present.

However, in some instances a simplified contract is not sufficient on its own to build trust. The structure of the partnership and the governance mechanisms that will underpin it can be crucial in helping to foster this trust at the early stage of the process - as the case study below demonstrates.

#### **Case study**

##### ***North-East Lincolnshire Regeneration Partnership***

*The North East Lincolnshire Regeneration Partnership is a 10 year programme worth £250m. The Partnership, formed between Balfour*

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87 Interview respondent I

88 Interview respondent J

*Beady Workplace and North East Lincolnshire Council, focuses on 4 areas; highways transport and planning; asset management; renaissance and architectural design. This combines capital expenditure with service delivery and facilities maintenance. The partnership comprises a wide range of outcomes:*

- *secure over 4,200 jobs;*
- *manage the delivery of a programme of key regeneration and renewal projects incorporating 3,500 new and improved homes;*
- *reduce the number of people killed or seriously injured on the roads by 33 per cent (adults) and 50 per cent (children) respectively;*
- *attract £170m of public and private investment in development projects and a further £400m of inward investment;*
- *provide training, apprenticeships and work placements for 400 local children and young people; and*
- *reduce carbon emissions of the services by 20 per cent*

*The Partnership has brought together a wide range of skills from Balfour Beatty and the council. It has helped to improve project management disciplines and a brought a business focus to help close deals. The Partnership has succeeded in closing a number of deals to bring in additional capital investment in testing market conditions.*

*The Partnership has also had wider benefits by integrating areas of the councils that previously suffered from departmentalisation. Planning and economic development are now united within the partnership, helping to create a framework which is more facilitative of further capital investment. So far the partnership has levered in £570m of inward investment.*

*A key component of the initial success of the partnership has been the clear governance arrangements and dialogue that exists between Balfour Beatty and the council. There are a range of key outcomes – targets – which the partner must deliver. These are monitored using a range of interim targets, and if these are not met the council is able to withhold or reduce its monthly payments. Every 2 months*

*the Partnership Board meets. This is a combination of the council executive, Balfour Beatty management staff and operations staff. At these meetings progress is monitored and future work discussed. This enables both parties to have an active voice in the work of the partnership. The Partnership Board is able to utilise the flexibility built into the contract in the event of unexpected external factors.*

A clear governance framework can enable trust to be built. Elements that protect the public sector include equal profit share and clear pre-conditions to be met prior to transfer of public sector land. These require accompanying valuation principles, which fairly recognise mismatches between value transferred and private sector exposure, typically achieved via loan notes. Protections for private sector include public sector commitment to make decisions according to pre-defined timetables – delay by public sector in committing is a key means through which trust is lost – and agreed processes.

### ***Clarity of responsibility and objectives***

There also needs to be clarity over what each party is bringing to the partnership and what they intend to achieve. Typically the public sector will bring property and the private sector finance, delivery capability and expertise. However, the willingness for the private sector to provide finance will depend upon the quality of the property assets provided and the existence of a coherent and deliverable plan. The private sector also aims to manage its risk by retaining the ability to delay or accelerate the regeneration programme to reflect changing market conditions.

The flexibility of the LABV structure does mean that different contributions can be accommodated – for example where the public sector contribution from property and land exceeds the private sector equity requirement, this can be recognised in the sharing of returns through the public sector receiving higher priority loan notes.

### ***Understanding the right circumstances for using LABVs helps to reduce development risks***

New forms of financing arrangement often bring new types of risk. With LABV structures councils typically will share the gains where there is uplift

in values, but will also share in the losses if the scheme does not deliver the benefits it is intended to. This essentially equates to a commercial risk exposure for the council, even where there are elements of risk transfer built in to the contract. However, this level or type of risk should not be seen as a reason to avoid this approach. The levels of risk are heavily influenced by the appropriateness of the underlying context of the local authority and this should be the main consideration for assessment of the overall risk. By viewing the risk assessment through the prism of an LABV's suitability for that particular area a decision can be reached that is more likely to weed out the good schemes from the bad. This is opposed to a narrow focus on the risk of an LABV *per se*.

LABVs are a tool for delivery of specific project(s) and not a useful project in their own right. LABVs' primary purpose is to use existing asset bases to leverage in private capital and initiate a partnership to regenerate an area – along with any other partnering objectives – over a period of time. This requires an amount of untapped potential within an asset base, as well as an expectation that there will be externally stimulated improvements to the economic wellbeing of an area.

For maximum benefit to be derived from using LABVs there are a number of basic underlying conditions that must be present.

- Empowered, well resourced internal public sector team
- Location and viable local property market
- Positive value sites
- Attractive sites without complications e.g. 3rd party interests, contamination
- Comparatively little early infrastructure required (unless combined with TIF or similar financing)
- Strong covenant tenants for early commercial developments including public sector organisations
- Critical mass and pipeline

There must also be a clear over-arching vision for the council that an LABV can credibly contribute to. Without most of these factors present it is

unlikely an LABV is suitable. By using these factors as a check-list of the appropriateness of the approach councils will be able to understand how high the risk level is. The more factors that are present within the proposed LABV the lower the level of risk is likely to be.

## Conclusion

Recent developments look likely to give councils a greater degree of choice, flexibility and control over how they work with the private sector. This will be of major benefit when using private capital in public infrastructure. However, the decline of PFI, and rise of other forms of PPP arrangements may potentially have an impact on the type of infrastructure that is delivered. PFI was typically used for social infrastructure, whereas LABVs are more commonly used for regeneration and economic development. As councils become more familiar with the use of LABVs, there is scope to explore how LABVs could be used to help finance schools or housing. It is only when this transition is made that LABVs could begin to be viewed as a genuine alternative to the PFI.



## 13 *New Strategies for self-financed borrowing: value capture*

The pressure on council revenue budgets is forcing reductions in the level of self-financed capital expenditure that councils can undertake. As the Localism Bill, Local Government Resource Review and other reforms are implemented there will be increasing ways for councils to finance borrowing for capital investment. Combining these options with a standard principle of capital investment – ‘value capture’ – councils can design new strategies to enable them to continue vital investment in infrastructure.

Such strategies are not without their challenges. In many instances they will be a substantial test for councils’ appetite for risk. They will also require careful judgement of underlying market conditions and the suitability of the approach for the context they are operating in. There is also a need for expectations management within the sector. This chapter explores some new strategies for combining value capture and borrowing, such as Tax Increment Financing (TIF), and the impact these can have on investment.

### Capturing Economic Value

*“The key question is how do you capture economic value created by investment?”<sup>89</sup>*

‘Value capture’ is a concept that is intrinsic to a number of new financing models that are emerging as solutions to capital grant shortfalls. The basic premise is that capital investment in infrastructure creation or improvement leads to increases in the value of other factors or assets. This could be uplifts in land or property values, or increases in tax bases as a result of business or population increases associated with development. It is therefore possible to recover some of the costs of this initial capital investment by ‘capturing’ the additional value that it creates. Councils have a number of ways in which they can do this, such as development contributions, taxes and incentives.

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<sup>89</sup> Interview respondent K

As a concept it is not inherently new for local government. Some forms of value capture, such as Section 106, are already used widely by councils in England. Several models enable capital investment in the absence of grant by capturing future economic value.

Tax increment financing	TIF models aim to capture the uplift in future tax bases that result from capital investment. The projected gains in business rate income that would arise from, for instance regeneration or a new transport facility, are hypothecated and funding raised on this basis to make the capital investment. The gains in the taxation base are ringfenced and used to repay the borrowing needed to fund the development.
Land auctions	Land auctions are a means of capturing the value that is conferred when planning permission is granted. In the UK private developers currently capture the full value of gaining planning permission. However, under a land auction model a local authority is able to act as a middle-man between land owners and developers and take a slice of the increases in value. By designating certain areas as favoured for development, councils can then speak to land owners about selling their land and agreeing a reserve price at the point of sale. The land is then auctioned off, with any proceeds above the reserve price of the land owner (technically the consumer surplus), being retained by the local authority.
Developer contributions	For instance Section 106 or Community Infrastructure Levy. These require developers to use some of the revenue generated from a development to pay for the infrastructure required to support it, such as link roads, health care or education facilities. It has been proposed by some that local authorities could hypothecate future S106 or CIL revenues to fund upfront investment which would then de-risk schemes sufficiently to enable private investment. The Government is considering allowing city mayors to borrow against future CIL receipts where this can make a significant contribution to national infrastructure.
Land value taxation	LVTs are levied to capture the increase in property values that result from public investment (in either services or infrastructure). The tax can be targeted specifically at properties which have directly benefitted. As the tax is levied whether the building is in use or not, it can also be a means of increasing the productivity of buildings as owners of vacant property are incentivised to either sell or find a productive use. LVT is currently not operated in the UK, but have found success in other countries such as Singapore, Taiwan and Estonia.
User-charging	Using tolls and fees to capture value directly from individuals who utilise new infrastructure

At present, councils are actively considering two different forms of value capture – TIF and land auctions. The former has been developed over a number of years and it is explored in detail in this chapter.

## **Tax Increment Financing**

The main barrier to use of TIF has been the centralisation of business rate income. A series of developments have meant that there are now a number of different ways in which councils may be able to use the TIF model. In 2010 the Labour government announced a £120m pilot programme for TIF. Following the formation of the Coalition, the prospects for TIF have been strengthened by pledges to legislate for it, the introduction of Enterprise Zones and the Local Government Resource Review (LGRR). It is as yet unclear which will be the eventual route to TIF for councils, but it is highly certain that it will be a tool that is available before the end of this Parliament. It is also likely that the levels of borrowing that could potentially be unlocked by TIF make it probable that central government will seek to regulate its use in some way.

Our research identified 6 key themes which will be relevant for councils as they look to implement TIF

### **1. Choosing the right route for TIF – Option 2 in the LGRR Consultation**

The Government's LGRR consultation specified two alternative options for TIF within a model of business rate retention. The first was to allow borrowing from a local authority wide area to fund TIF schemes. This gives greater flexibility and is not subject to government control. However, it also means that TIF schemes would be dependent on other mechanisms within the growth retention model, such as resets and revaluations at specified frequencies. The second option is to allow borrowing against growth in a defined area. This would essentially ringfence TIF areas and exempt them from the localisation of business rate growth retention. This would mean they are not subject to revaluations or resets, making it more likely that the typical 25 year funding model of a TIF scheme could operate.

NLGN's response to the LGRR consultation stated a preference for Option 2 on the basis that it is a better fit for the funding time horizon and mechanics

of a TIF scheme.<sup>90</sup> Option 1 would make TIF schemes harder as resets are needed for distributional purposes. Even if set at 10 year intervals resets would make the use of TIF very difficult, as each reset would effectively level off any benefits in business rate uplift. Option 2 is the preferred option on the basis that it is the only one that enables TIF to function properly. However, it also means that the government would be required to permit TIF areas, and by extension would be regulating their use.

NLGN supports other calls from within the local government sector for any regulation of TIF to be light touch and without arbitrary limits on the number of schemes permitted.<sup>91</sup> The ultimate decision about use of TIF must be made by local authorities as they carry the risk, and for this reason the system of regulation must be as localised as possible. If it is necessary for the centre to regulate use of TIF there should be clearly defined, stringent criteria which enable any local authority to use TIF if met. The roll-out of TIF schemes in Scotland provides some instructive lessons for how this could be managed. This has begun as a pilot process with a fixed limit of schemes, but with potential for a more locally driven system in the future assuming these are successful.

### Case study

#### *Tax Incremental Financing in Scotland*

*The introduction of TIF in Scotland is governed by a pilot process that came into effect in 2011. The regulations permit up to six pilot projects and allow the participating local authorities to retain a proportion of business rates within a designated 'red-line area'.*

#### **Approval of a TIF scheme**

*Once a potential project is identified, the relevant local authority must complete a comprehensive Business Case that addresses a series of key criteria:*

- *the context of the scheme, including the regeneration vision, key stakeholders, and likely revenue sources created by the TIF;*

<sup>90</sup> Sommer and Kuznetsova *The Devil in the Detail* (NLGN, 2011)

<sup>91</sup> Centre for Cities *A Taxing Journey* (2011)

- *the infrastructure investment plan and prioritised assets, including how the proposed infrastructure will maximise regeneration and growth;*
- *an economic analysis of the revenue generation and debt service capability of the TIF area over 25 years;*
- *a financial analysis and modelling of the tax increment available for financing;*
- *a full consideration of risk identification, allocation and management;*
- *proposed management structures; and next steps.*

*The Scottish Futures Trust provides advice on the process but the final submission to Scottish ministers is the responsibility of the local authority. Most importantly, for a pilot project to be approved, the council must clearly demonstrate how improvements to infrastructure in the red-line area can generate the required growth, regeneration and associated public sector revenue to pay for the financing requirements.*

In line with the approach taken in Scotland, the government must detail requirements to demonstrate how capital investment will generate business growth, including an assessment that demonstrates that growth is currently held back by lack of appropriate infrastructure. Considerations must also be made that demonstrate the scheme will have additionality and not lead to displacement of existing business activity. Assuming these conditions are met, the use of TIF should be permitted, without any caps on the total number of schemes in operation.

**Recommendation:** *if the Government implements regulation of TIF use this must be light-touch and localised as a system, with no arbitrary limits on the number of schemes allowed*

## **2. TIF is not the solution for all councils**

Our interviews with finance directors and chief executives suggested that councils are questioning whether the TIF model is applicable in all areas. TIF requires a robust and established private sector base to function. Furthermore, in many areas where growth is needed the main factor is not a shortage of

inadequate infrastructure. Increased increase private sector demand cannot therefore be generated solely by new infrastructure provision.<sup>92</sup>

Many interview respondents felt that the model is one which would not work in areas where growth has been identified as most needed. The Local Growth white paper placed large emphasis on ‘rebalancing’ the economy in areas where there is a high proportion of public sector employment, such as the North East, Yorkshire and the North West. However, interviewees felt it was these areas where it is least certain that the underlying conditions needed for TIF are present. The Core Cities<sup>93</sup> have previously demonstrated an interest in utilising TIF and are likely to have the established private sector base for this to be workable. However, there are a number of cities in the north of England that require economic growth, but may not have the pre-requisite foundations of a private sector to enable TIF.

There is a potential for negative consequences if these dynamics are not adequately understood and addressed. The Government’s strategies to incentivise growth are legitimate and could prove to be a strong driver for a better relationship between councils and businesses. However, there is a danger that the need for additional revenues will drive councils to pursue growth strategies that are not calibrated with local circumstances in order to plug gaps in service provision. Councils must ensure that there is a clear vision for the overall objective of capital investment, and assurance that the models being used to pursue this are the correct ones for the context they are in.

### **3. The initial interest payments gap**

The pilot TIF in Edinburgh waterfront illustrates that in the early years of a TIF scheme there will be an initial gap in the level of business rate growth and the amount needed to pay back the borrowing used to fund the capital investment. In Edinburgh this is expected to be £1.34m per year for the first three years. Councils will need to respond to this gap by either bringing in resources from other sources or ‘sculpting’ the interest payments they make to smooth out payments from the early years to the latter years of the scheme. Either of these options involves the council paying more for the

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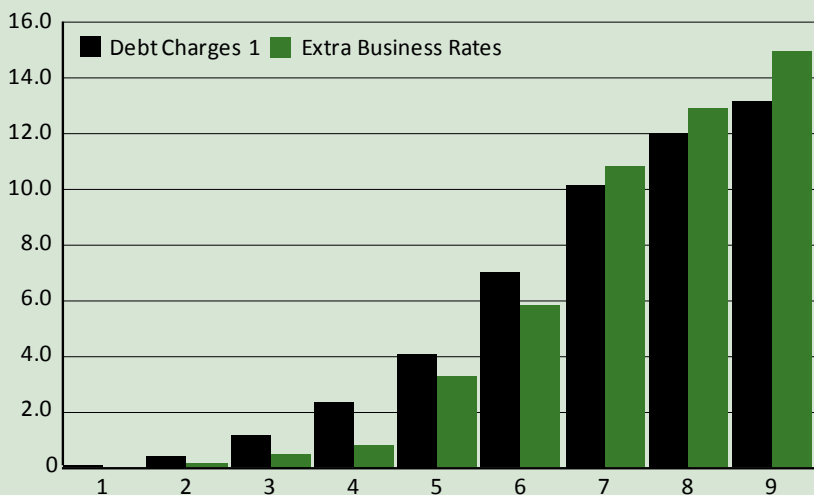
<sup>92</sup> Ibid

<sup>93</sup> The 8 largest cities outside London

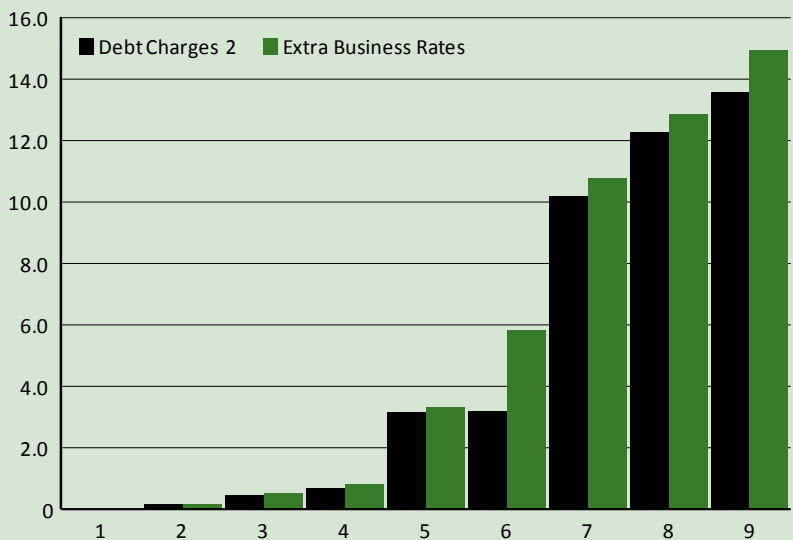
TIF scheme that it may first appear. While this is likely to be marginal in the context of the scheme as a whole, it must be understood at the outset.

Figure 21 below shows the cash flow of debt charges and estimated extra business rate income over the first 9 years of a £143m TIF project designed to bring in £395m in business rate growth over 22 years. Figure 21 uses the annuity method of calculating debt charges. Debt charges exceed estimated annual income in years 1 to 6, which would place a significant and probably unacceptable strain on the council's revenue budget. Figure 22 shows the impact of 'sculpting' the capital financing costs to better fit the estimated income stream, by deferring the start of principal repayments on 'infrastructure' investment and by capitalising some interest costs in years 1 to 3. This reduces the revenue charge in the early years and the strain on the revenue budget. The total amount paid back is higher in the second option than in the first. Whether to defer payments and pay more in total, in order to protect services in the short-term, or pay a lower total amount of debt, will ultimately be a judgement call for a council's political and executive leadership to make.

**Figure 21** Cash flow of debt charges 1 and extra charges



**Figure 22** Cash flow of debt charges 2 and extra income



**4. Financing the upfront investment**

The method councils use to address the initial interest payment gap may have implications for the source of capital that is used to fund the infrastructure. A range of potential borrowing sources are discussed in Section 2, each with their own discreet benefits. The scale of some of the larger projects proposed when the previous government initiated a pilot scheme showed that there would be a number of projects within the appropriate scale for a bond issuance. If the PWLB remains fixed at Gilts + 100bps then this is likely to be an option which saves councils money in overall financing costs. However, if councils need to retain the ability to sculpt interest payments in the first years this may limit their choice of borrowing, potentially excluding the use of bond finance.

**5. The relationship between risk and scale**

Proceeding with a TIF scheme requires first and foremost an understanding of what the risks are and the probabilities of them occurring. In many



instances, these are risks that cannot be transferred to the private sector and are hard to mitigate. It would be impossible to eliminate these risks therefore to the point at which failure can be considered sufficiently unlikely as to be discounted. The decision to proceed must ultimately be a judgement that accepts failure is an option and regards the overall benefits of the scheme working as great enough to justify this.

While it is beyond the control of a council to mitigate for risks around future private sector demand that are external to the scheme, there are methods councils could use to help mitigate other risks associated with TIF schemes. The concept of systemic risk within larger TIF schemes should play an important role in the way they are constructed. If possible it would be prudent to build in firewalls to larger TIF schemes so that small failures do not become larger failures. As an example, a £100m scheme could be broken down into a number of smaller ringfenced elements it would prevent failure in one small aspect rippling out and threatening the viability of the scheme as a whole. This could enable failures to be limited in scope, and any remedial measures required could be again limited to rescuing a much smaller part of the scheme than if systemic risk was left addressed.

Alternatively, councils could look to form a collective risk-pooling arrangement to spread out the risks of TIF schemes on a sub-regional or even national scale. This could take the form of a cross guarantee between councils. By pooling a number of schemes together, it might be possible to cushion losses or shortfalls in one scheme using a collective fund paid into by other schemes. Participating authorities may be attracted to the level of insurance that a risk pool could offer, but would be nervous about becoming liable for liabilities run up by other authorities perceived as more profligate. For this reason entry requirements into the scheme would have to be highly stringent. By making entry into the risk pool dependent on entry criteria designed by all member authorities, it may help to improve the rigour of TIF business cases and ensure that they have been robustly calibrated with their local circumstances.

## **6. TIF as part of a larger capital investment programme**

Where growth of the private sector is heavily linked with a regeneration project, TIF could be considered in conjunction with other financing mechanisms such as a Local Asset Backed Vehicle. A TIF scheme that spans

the same geographic space as a LABV, and contributes to the same overall objectives of a regenerated area that creates economic growth and jobs, could be used to address the need for supporting infrastructure such as transport links, broadband or housing. The LABV element could be used to make improvements to the broader public realm, creating an environment that is more attractive for people and businesses. The benefit of this could be the mutual reinforcement of the TIF and LABVs outcomes. Regenerating the public realm may make businesses more likely to grow, while supporting infrastructure can increase land and property values, helping the LABV to succeed. As discussed above, it would be important to understand the implications of the inter-connectivity between the LABV and the TIF and the levels of systemic risk it presents. De-coupling the two may not be possible, which would test the appetite for risk and ultimately the rigour of the business case.

### Land Auctions

The Government announced in its Budget 2011 that it would permit the piloting of land auctions using public sector land. While this has the potential to bring in greater capital receipts, the benefits for councils would be far greater if the pilots were extended to cover privately owned land. The model of land auctions was developed originally as a means of helping the public sector capture development gain in an alternative way to 'contributions' mechanisms such as Section 106 and CIL. Land auctions are also a way of bringing forward more land for development, as they are able to reduce the risk presented to sellers of land by guaranteeing them a set price for the land that is higher than market values without planning permission. It is a model that is therefore beneficial to the three major stakeholders. Landowners are paid more for their land without having to incur any greater risk. Developers have a greater supply of land coming forward and lower levels of risk relating to planning permissions and price. Councils get to benefit from the differential between the landowners reserve price and the sale price. This is undoubtedly a model that could be used to great effect in some instances. Since the original announcement there has been little progress from central government on this agenda.

**Recommendation:** *that the government injects new impetus into the use of land auctions by permitting the use of privately owned land in a series of pilots in early 2012.*

### Where else might councils be able to approach value-capture?

Value capture can also work in reverse. Councils can use the ability to capture future value as a means of incentivising the private sector to bring in capital. Our research found an example of a council which is using this approach to enable the development of a road into a dual-carriageway for economic purposes. The Highways Agency does not have available funding to carry out this work. The council has proposed a deal to a consortium of developers to carry out this upgrade work. It is anticipated that once it has been completed there will be a significant uplift in surrounding land values. The council has offered this land to the consortium to develop on, so that once the road has been completed value can be derived by the private sector from building new housing or other developments on it. Examples such as this demonstrate the creativity of some local authorities in exploring new ways to tap in to the value created by capital investment.

### Conclusion

The local government sector must be given the freedom to use emerging mechanisms designed to help capture economic value. TIF, if it must be regulated, should be done in a light-touch way. Land auctions must be brought forward and pilots allowed using private sector land. However, the sector should continue to explore further options for value capture. More councils may decide to take London's lead in using the Business Rate Supplement as a means of financing infrastructure that will have a direct benefit for business profits. The continuing need for growth could represent a chance to open a discussion about Land Value Taxation. More fundamentally, engraining the concept of capturing the economic value of investment in the way that councils think about capital expenditure is part of the transition towards being the more entrepreneurial and creative organisations that economic conditions demand.

## 14 *Creating the conditions for private investment*

**The unexpected severity of the 2008-9 recession, followed by low levels of domestic demand and uncertainty in the Eurozone in 2010-11 have created highly challenging conditions for privately-led capital investment in public infrastructure. A lack of underlying growth has stalled many developments that are predicated on increasing market values to succeed. The fact that some of these investments are a core component of generating future growth risks a vicious cycle emerging.**

To prevent this, there is a role for councils to step in and avert some of these market failures. Local authorities do not have the same capacity as a national government to stimulate investment, but their role in economic activism is gradually developing. While this role is at present comparatively underdeveloped compared with that of a central government, councils' size and presence can enable them to play a vital facilitative role in bringing in investment from the private sector. Our research found a number of examples in which councils are in a position to make interventions which can help to make the difference between the private sector investing and schemes stalling. It is a role that will be increasingly important for councils to fulfil over the next five years.

To bring in much needed investment councils must start to use their other resources and abilities to support the private sector. Councils have the ability to diffuse development and market risks which help to encourage investment. Through their access to borrowing at low rates councils can pump prime or seed-fund investment that is too risky in its initial stages to bring in the private sector. Whole schemes and business opportunities can be unlocked through the acquisition of pieces of key strategic infrastructure. And the astute use of council-owned assets can help correct market failures that stem from lack of economic confidence and low growth rates.

## Pump-priming

Pump-priming is by no means a new concept for the public sector. It refers to state actions to stimulate private investment. Councils and other public agencies are in a strong position to use the capital grant and borrowing capacity available to them to make investments that will unlock significant further private investment. In some instances it can act to create a new market for the private sector.

Our research found several examples of councils using capital grants to ensure that there was land available to the private sector to develop on. This included one authority which was using its New Homes Bonus revenues to develop rural exceptions sites in order to facilitate new affordable housing.<sup>94</sup> Use of the NHBs released additional revenue streams from the county council and a local housing association.

Councils also have access to comparatively cheap and plentiful borrowing options, as well as reserves and investments. Some councils, for instance Shropshire County Council, have used access to this to help local housing associations acquire the upfront borrowing they need to begin housing development work. Using powers conferred by the 1996 Housing Act, Shropshire is lending a total of £30m to three housing associations at a rate equivalent to that of the PWLB. The loan is made from existing councils investments which are making minimal returns and is secured against existing assets owned by each housing association.<sup>95</sup> The borrowing is being used to fund new affordable housing and shared office facilities for the housing associations.

To pump-prime to maximum effect councils require a strong relationship with the local private sector and understanding of the challenges it faces. It also requires an entrepreneurial mindset to see where small interventions can help to catalyse larger investments. Our research found examples of councils working with local businesses to gain an understanding of how the

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<sup>94</sup> The Rural Exception Site Policy enables small sites to be used, specifically for affordable housing in small rural communities that would not normally be used for housing because, for example, they are subject to policies of restraint

<sup>95</sup> Shropshire County Council *Treasury Strategy 2011/12* (2011)

council could use its resources to assist with the development of a market or to create business opportunities and jobs.

### Case study

#### ***Newcastle City Council***

*In March 2011 Newcastle City Council made a £4m investment in upgrading the capacity of a large hammerhead crane on the dock of the Tyne. The investment was driven following dialogue with local businesses, who had received a portion of the Regional Growth Fund to help build a facility to manufacture wire rope. The facility is expected to create 700 jobs but its success was dependent on the council's ability to fund the upgrade of the crane. The facility has since been able to win contracts that are only possible because of the upgrade. This demonstrates the positive impact on the private sector of intelligent state interventions.*

### Using seed-funding

Our research also found examples of the public sector at the local level using seed-funding to invest in capital infrastructure that could in turn become a functioning part of the market economy. In many ways this goes beyond the usual conception of a council's role in provision of infrastructure but can be an important way of creating more efficient public assets than can lead to financial and environmental efficiencies for individuals, businesses and the public sector. The case study below of the Greater London Authority's investment to create a decentralised heat network illustrates such an approach.

### Case study

#### ***London Development Agency (LDA) decentralised energy heat networks*** *Summary of the London Thames Gateway Heat Network*

*The aim of the London Thames Gateway Heat Network is to create a hot water transmission system between homes, schools, businesses, hospitals throughout the Thames Gateway. This involves the*

*construction of a new energy infrastructure. The project will encourage efficient use of energy, create jobs, address fuel poverty and deliver a resilient system that can evolve over time.*

*The Network reduces CO<sub>2</sub> emissions by transmitting low carbon heat produced by Combined Heat and Power plants, via a transmission 'spine' of pipes, directly to any buildings connected to the heat network. This takes heat that would otherwise be expelled as waste heat into the atmosphere and transfers it to buildings that would otherwise need to consume energy from other sources to generate hot water. The network will begin as a series of loops which have the potential to expand further and connect with other heat loops. This could ultimately lead to a decentralised heat network that covers all of London.*

*There is the potential that the heat network could eventually become self-funding. However, at the inception stage the level of risk that the development presented meant that initial seed funding was deployed by the LDA. This has helped to leverage additional capital from UK and EU sources. In addition to match-funding from the EU, it is hoped that private capital can also be drawn into the project. To illustrate the funding challenges and the role of the public sector in delivering the capital investment that is required more detail is given of one of the 'heat loops' below.*

### ***The Olympic Park CCHP Scheme***

*The Olympic Park CCHP scheme connects developments on the fringe of the Olympic Park to provide low-carbon heat, and in the long run provide greater diversity of load and higher CO<sub>2</sub> savings.*

### ***The role of the public sector in creating a decentralised heat network***

*With no guarantee that any future development on the fringe will take place, the business case to supply heat beyond the Olympic Park was commercially uncertain. This meant it was not possible for the private sector to take the capital investment further. However, it was expected that once the district heating network was extended, a number of*

*fringe developments would connect. The first successful connection was a new residential development at 150 Stratford High Street. Without the work of the LDA, roll-out of the network was not expected to reach this point for approximately 10 years.*

*Capital grant was therefore used to forward fund 'enabling works' on and off the Olympic Park. This was provided by the LDA and London Thames Gateway Development Corporation (LTGDC) to help ensure that supply capacity is available. The main works the grant support include the deployment of new district heating network and an increase in pipe diameter. This brings forward connections that would not otherwise have been available.*

*A total grant of £600k was provided to secure a minimum of 20MW of low carbon heat for the Olympic Fringe developments. This comprised contributions from the LDA and LTGDC, split 50/50. The grant will be repaid through a claw back mechanism to the LDA and LTGDC following additional connections that result from the grant. If the grant leads to new connections and revenue (connection and heat sales), which would have otherwise been unavailable to Cofely, the private sector partner, then the amount of capital investment that these revenues streams would justify is paid back. The overall amount of capital investment is based on a discounted cashflow approach of the new connection (NPV). The NPV calculation therefore represents the amount of grant to be repaid. This approach was adopted to ensure that funding was compliant with state-aid regulations.*

### ***The allocation of risks***

*Before the grant was awarded risks were allocated to those best placed to manage them. Because The LDA and LTGDC agreed to grant fund the network enabling works, this meant that they effectively took on development and connection roll-out risk. Cofely agreed to bear risks relating to capital cost overruns; planning; way leaves; and operational performance.*



## Using assets

In March 2011 the government announced a scheme to promote private sector-led housing development. The 'Build Now Pay Later' scheme enables developers to start work building new housing units of publicly owned land, without having to pay for it until the properties are sold. This represents a way for the public sector to remove one of the barriers to privately funded infrastructure – the development risks associated with low levels of market growth – by using its own assets to greater effect. The government has since identified land it believes could lead to up to 100,000 new homes being built, many of them through the 'Build Now, Pay Later' scheme.

This diffusion of risk helps to unblock market processes and set in train further development work. There is significant scope for councils to employ similar principles and use their own assets as a means of correcting market failure. Figures from DCLG show that the number of houses which could be built on land owned by councils in London and which is currently unused is 26,720.<sup>96</sup> Across the wider public sector in London, there is unused land which could support a further 116,919 houses. This is an example of another use of council assets, in addition to sales and LABV structures, that councils could utilise to help stimulate further investment.

Councils are in a strong position to work with the private sector in instances of market failure. Even when there is limited grant funding available, councils have a range of tools available to them which can help release private funding for key elements of infrastructure. More broadly, the council can use its position and size to nurture the correct conditions for private sector investment. While this implicitly involves the council taking on risks, it is often far easier for the council to assume these risks than it would be for the private sector.

## Conclusion

The role of councils as economic stimulators is currently in its relative infancy. However, it is a role which is set to expand over the coming years as

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<sup>96</sup> DCLG *Previously developed land tables – disaggregated data for 2009*

councils' focus and responsibilities shifts towards economic growth. The tools available to councils are not insubstantial – access to cheap finance, control of planning and access to a large asset base – and combining these interventions can help private development projects over the last stages to reach financial close.

## **15** *Strategies for self-financed investment - invest-to-save*

**A more strategic approach to the long-term social and economic benefits accruing from investments has been heavily advocated in discussions of service transformation in councils in recent years. Total Place, shared services and Social Impact Bonds are all united by their focus on using upfront investment in preventative services, or in achieving ‘scale’, in order to make significant savings later on down the line. However, such an approach has not been mainstreamed in capital financing strategies and has often been undermined by a narrow focus on easily quantifiable financial returns. There have been some good initiatives, such as Total Capital (discussed below), but this must become a far more common activity in order for the public sector to ensure that it is investing the right amounts in the right infrastructure to get maximum value. In this chapter we explore how discussion of capital finance can be framed by a strategic approach to reducing future expenditure on further capital or revenue services across the whole public sector.**

The use of capital investment to make future savings can take many forms. Indeed, some of these are already common practice for councils. Strategic asset management and planned maintenance already represent major components of current best practice in the management of capital stock. But the scale of capital investment across the whole of the public sector, and the level of interconnectivity between revenue funding and capital financing, suggests that there is considerable untapped potential for capital financing to not only deliver modern, improved infrastructure, but also lead to future efficiency savings. In some instances, even if the capital investment requires borrowing to fund it, the savings generated can more than pay for this borrowing, meaning that the council is spending significantly less than it was prior to the investment.

## Using capital funding to reduce revenue pressures

### ***Preventative Capital Finance***

There are some instances in which scaling back capital investment to a reactive ‘make-do and mend’ approach can in fact cost the public sector more in the long-run. This is a core argument behind the call for continued capital investment in order to avoid repeating the mistakes of the 1980s and 90s, when lack of investment led to large backlogs in investment across health, transport, education and housing services.<sup>97</sup> However, preventative capital investment goes beyond the narrow view of the costs of maintaining the infrastructure itself. It is possible for preventative capital expenditure to reduce the overall expense of managing an asset, but also reduce other associated costs to the council. The case study below illustrates this with the example of Northamptonshire’s preventative approach to road maintenance.

#### **Case study**

### ***Northamptonshire County Council Road Maintenance Scheme***

#### ***Overview***

*In April 2010 Northamptonshire implemented a preventative approach to address the short-term pressures of dealing with the increasing numbers of potholes on the network, caused by a deteriorating network and a succession of severe winters.*

*A preventative maintenance strategy can reduce overall costs by up to five times compared with the reconstruction costs required if roads are left to deteriorate. It can also reduce the need for large scale reconstruction schemes. In Northamptonshire far fewer are now undertaken as sites are now being managed through the use of targeted patching works.*

*The council adopted a £30m investment strategy which is helping to reconcile short-term problems as well as long-term priorities. The*

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<sup>97</sup> NLGN Capital Contingencies (2011) p.30-31

*funding comprised £20m of funding from the Department for Transport, supplemented by £10m of funding raised by the council through prudential borrowing. The overarching objective is to maintain a steady state so that road conditions do not deteriorate any further.*

### **Outcomes & Value**

- *The per centage of permanent & semi-permanent repairs against all repairs has increased by 50 per cent compared to the previous 12 month average*
- *The initial investment has freed up £1.7m per annum in revenue funding*
- *The number of customer reports of potholes has fallen by 23 per cent - representing 2,579 less reported defects*
- *Initial figures indicate that the numbers of insurance claims made against the Council originating from poor road surfaces have reduced by 48 per cent on the previous 12 months. This equates to a reduction of 419 claims received*

The potential for invest-to-save capital investment is not limited to transport. In the waste sector new technologies enable the generation of energy from waste. This enables councils to match up their waste services with energy consumption needs, or alternatively to 'sell' the energy back to the national grid through the feed-in tariff. This can have the dual benefit of improving the efficiency of waste services, while also either generating a new income stream or saving on revenue costs relating to energy usage.

## **Integrated Capital Finance approaches**

### **Case study**

#### ***Homes and Communities Agency 'Total Capital Programme'***

*Total Capital began as a series of 5 case-studies initiated by the HCA to apply the same principles of Total Place to capital financing. The*

*HCA has found that local authorities can accrue major benefits from taking an integrated approach to planning and investment within their region, aligning thinking about funding streams to ensure that they are used effectively. The HCA also argue that this approach could help encourage private sector investment by reducing risk and uncertainty, and increasing returns.*

*Total Capital comprises consideration of the following funding streams:*

- *Capital investment from DCLG delivered by the HCA;*
- *Funding through RDAs;*
- *Use of other resources, particularly land, as part of leverage and equity investment;*
- *Funding from other government departments in particular education, transport, energy and health;*
- *Other public agencies, including the Highways Agency, Environment Agency, English Heritage and Natural England;*
- *Local authorities' resources;*
- *EU funding;*
- *Utilities investment;*
- *Other institutions such as universities, faith groups and cultural organisations;*
- *Private sector including, industry, commerce, retail, leisure, sport, finance institutions;*
- *Lottery Funding;*
- *Any specific projects such as airport expansion or major power stations.*

*The pilots covered 5 areas: Birmingham, Swindon, Greater Manchester, Leicestershire and Leicester City, and Durham. These case*

*studies highlighted common themes relating to the mis-alignment of public funding and activity. Multiple funding streams all targeted at the same outcomes were found to be uncoordinated. Similarly, different parts of the public sector were identified as operating in isolation when aiming for the same goal.*

*All involved in the process agreed that there would be more efficient use of public capital funding were a Total Capital approach to be used. The initial case studies helped to highlight the need for shared investment strategies and financial planning across the public sector. It also emphasised the need for clarity of policy and governance decision making at different spatial levels.*

The HCA's work is a clear example of the need for public agencies to ensure that there is integration across their capital investment programmes. Better co-ordination can help reduce duplication, combine funding to reach appropriate scale and simplify development opportunities for the private sector. As publicly funded capital investment becomes increasingly sparse, such approaches will be essential for the public sector to make its limited resources go as far as possible. This will be a challenge that must primarily be addressed by strong political leadership and appropriate governance. A number of other reports and research processes have capably tackled the complexities of successfully implementing integrated funding approaches across local government. This research does not attempt to repeat this work. Total Capital is a concept that will provide significant opportunities for infrastructure finance, provided it is enabled to flourish through a receptive response from all government departments.

Our research has also shown that there is scope for the Total Capital and Total Place concepts to be integrated. Better alignment of public agencies does not just help to maximise the value of the funding it provides. It is also possible for capital investments to lead to reductions in service demand and easing of revenue pressures. What these examples show is that councils may be investing in infrastructure, public works or facilities from which significant financial benefit may be derived from another agency or part of the public sector. At present this financial benefit is gained without any funding being made by the recipient of the benefits. Resolving this then links back to the

concept of 'value capture'. In these instances, if councils, or other public organisations, were able to find a means of capitalising this value it would create more funding opportunities and a system in which the benefits of investment are more aligned with its financing. Understanding the proportional value of investments across departments important alongside a conception of the total value.

We believe there is potential for the public sector to explore a range of instances in which service pressures could be alleviated by strategic capital investment. There are a range of areas in which this concept could be explored:

- **Roads:** Investments to fix potholes, widen dangerous corners or change the road surface can help to reduce frequency and severity of accidents. A positive externality resulting from this is reduced service demand in hospitals and the health service.
- **Housing:** Good quality housing can help to improve a number of wellbeing, health and environmental measures. For instance in some areas of London, such as Tower Hamlets, tuberculosis has a far higher prevalence than in any other part of the country. Its transmission is aided by poor, damp housing conditions and over-crowding. Using capital investments to improve the quality of this housing, or to build new housing, would help to alleviate the spread of TB and reduce the pressures on local health care services. Better quality housing could also help to alleviate mental health conditions such as mild depression.
- **Leisure, youth and sports facilities:** Wider provision of sports and youth facilities could help reduce the burden on police and health services. Providing positive and constructive activities for young people could help to reduce anti-social behaviour and low-level criminal behaviour, such as theft, joy-riding and drug use. More accessible sports facilities could also help to encourage healthier lifestyles, which would reduce the strain on health services caused by obesity and inactivity.
- **Public transport:** by making public transport more accessible, increasing its convenience or extending its reach the demand for cars and road usage may be reduced. This could potentially lead to lower CO<sub>2</sub> emissions and less wear-and-tear damage to roads. This could lead to



lower maintenance costs for the Highways Agency, and could ease some of the pressure on DECC to reduce the UK's total carbon emissions.

- **Social care facilities:** provision of facilities could prevent individuals' conditions from deteriorating towards high needs groups and ultimately placing further strain on expensive and over-subscribed hospital and primary care services.
- **Environment:** investment in more efficient street lighting can help to reduce energy costs, promote public safety, reduce accidents and crime. These benefits may be felt by health and police services, among others.
- **Education:** improvements in school and learning facilities have been shown to improve a number of measures of educational success, such as test results, progression and achievement.<sup>98</sup> This may therefore help to produce better qualified individuals who won't need the high levels of support from organisations such as Job Centre Plus in order to enter sustained employment.

In order to do this councils and the wider public sector will need the ability to accurately quantify the benefits that some forms of infrastructure and investment can have in terms of reduced demand on other service areas. It is likely that much if not all of the data required for this exists somewhere in the public sector, but is unlikely that it is currently accessible in the way that is needed. Part of the process must be co-operation and open data to assist with the creation of such quantitative modelling.

Without a more integrated approach that attempts to make genuine financial connections between these relationships there is a greater chance that public money is not spent in the most efficient way. Furthermore, without integration to initiate this dialogue about how areas of the public sector could use capital investments made by other areas to reduce demand for their services there will continue to be market failures in the public provision of much needed infrastructure.

There are risks associated with a lack of capital investment. The benefits of strategic capital investment can be widespread and therefore not to make

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<sup>98</sup> CABE The Value of Good Design (2002)

some investments made mean that opportunities are missed. We must start to recognise where inefficiencies may develop if we don't continue to invest to ensure that much needed infrastructure has as much chance as possible of being funded.

**Recommendation:** *To make the needed advances the work that takes forward Total Place and Total Capital concepts, such as Community Budgeting, must build the use of capital resources into its scope.*

## Conclusion

In this chapter a number of ways for capital spending to produce revenue account savings have been discussed. These are unlikely to be the only instances in which this is the case. The public sector as a whole must be collaborative and creative in exploring further instances where this may be the case. This is not an argument to justify more capital spend for the sake of more capital spend. It is an argument designed to create a more integrated approach that better aligns the benefit of capital investment with who funds it. It is also a chance to understand where strategic capital investment now can lead to substantial savings later on.

## 16 Conclusion

**The overarching theme of this report is the challenge presented by the transition to new roles for both local and central government. As councils adopt new responsibilities and powers, the centre must support them in this and adjust to relinquishing the top-down levers of control.**

The pressing need to improve the nation's infrastructure, coupled with decreases in grant funding and increased rates at the PWLB, demands that councils begin to make use of new financing mechanisms available to them. There is a strong potential for councils to access new sources of finance directly from the capital markets at rates which are highly competitive with the PWLB. Councils can also seize the opportunity to use Tax Increment Financing, and a range of other approaches, that can sustain investment in the absence of grant.

The benefits of this would be more than just new, high-quality infrastructure. It would help to affirm a new self-confidence for the sector accompanied by more mature relationships with financial markets and the private sector. While this transition presents many opportunities it also presents a new level of risk for local authorities.

Though councils have demonstrated sound financial competence in recent years and are well placed to manage this, there will come points where central government will be needed to provide support. Crucially, where councils have genuine and legitimate need for legal clarification this must be provided. It is vital that the centre does not view the localism agenda as a cue to withdraw totally from the work of councils.

This report aims to help local and central government with this transition. If the shift is successful it could be the start of a new settlement between councils and the centre. But there is more at stake than just capital investment. It is a chance for councils to demonstrate their capabilities with the new freedoms devolved to them. For DCLG, it is a chance to make a compelling case for localism across other central government departments.

## Appendix 1 *The capital futures taskforce*

**This research was supported by a taskforce. The taskforce helped to shape the focus of the research, discuss its content, test the rigour and relevance of its findings and review drafts of the document. The members of the taskforce were:**

Chair: Paul Woods, Director of Finance, *Newcastle City Council*

Helen Bailey, Chief Executive, *Local Partnerships*

Euan Blair, *Morgan Stanley*

Matt Bowmer, Director of Finance, *Northamptonshire County Council* / Glenn

Hammons, Head of Corporate Finance, *Northamptonshire County Council*

Elizabeth Cooper, *Nabarro*

Susan Curran, Director of Finance, *Liverpool City Council* / Tim Povall, Head of Finance, *Liverpool City Council*

Jonathan Hunt, Director of Finance, *Westminster City Council*

Mark Luntley, Director of Programmes - Finance, *The Local Government Association*

Paul Mahony, *Morgan Stanley*

John Mothersole, Chief Executive, *Sheffield City Council*

Alison Scott, Assistant Director of Local Government, *CIPFA* / Mandy Bretherton Technical Manager, Local Government Finance, *CIPFA*

James Snape, *Nabarro*

David Swarbrick, *Balfour Beatty*

Tom Symons, *New Local Government Network*

**The taskforce met 5 times in total, on the 18<sup>th</sup> April, 6<sup>th</sup> June, 18<sup>th</sup> July, 5<sup>th</sup> September and 10<sup>th</sup> October 2011**

## Appendix 2 *Methodology*

**The research aimed to answer three key questions:**

- 1.** What has been the impact of the 2010 Comprehensive Spending Review 2010 on local authority capital investment?
- 2.** What are the range of cost-effective alternatives to the Public Works Loan Board following the decision in the 2010 CSR to increase its rate of interest?
- 3.** How can local authorities sustain capital investment over the Spending Review period?

**A number of primary research methods were used, including:**

- Semi-structured interviews with a range of finance directors, chief executives and council leaders
- A survey of 47 finance directors (for survey results please see the NLGN website)
- Case-studies of new and innovative approaches to capital investment
- Three research seminars with experts from the public and private sector

## Appendix 3 *Sources of funding available for capital expenditure*

Capital expenditure by local authorities is used for buying, constructing or improving fixed assets, for example building new schools and houses, developing land and maintaining roads. Assets that are acquired or enhanced by the local authority, for example buildings, land and machinery, are classed as tangible fixed assets, while assets of value that do not have a physical presence, for example franchises, licences and patents, are classed as intangible fixed assets. Local authority capital expenditure is mainly funded through central government grants, capital receipts, revenue funds and borrowing.

### Central Government Capital Grants

Local authorities receive grants from multiple government departments mainly for specific transport, housing or regeneration projects. The majority of grants come from the Department for Education and the Department for Transport. Ringfenced grants must be spent on the project stipulated by the central department but unringfenced grants have more flexibility. Of the 13 new capital grants listed for 2011-12, only the Devolved Formula Capital for Schools grant is ringfenced<sup>99</sup>. A record of capital grants from each department can be found on the DCLG website<sup>100</sup> however many departments are currently undergoing a full review of their capital grant programmes. Although the bulk of capital grants come from central government departments, local authorities also receive grants from the European Union, National Lottery and non-departmental public bodies (NDPBs).

### Capital Receipts

A capital receipt is the income received by a local authority following the sale of a tangible fixed asset, for example an area of land, or from the repayment

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<sup>99</sup> DCLG, *Summary of capital grant programmes 2011-12 and 2012-13* (2011)

<sup>100</sup> <http://www.local.odpm.gov.uk/finance/1112/capgrants/index.htm>

of a grant or loan made by the authority to someone else to use for capital expenditure. Since 1 April 2004, local authorities are required to pay the Government a proportion of their capital receipts from the sale of housing land and dwellings. Capital receipts are forecast to be £1.7 billion in 2011-12<sup>101</sup> with most coming from the sale of tangible fixed assets (97 per cent in 2011-12).

### Revenue Financing

Local authorities have separate revenue and capital budgets however some capital expenditure is financed from the revenue budget, specifically the general fund (CERA), the housing revenue account and major repairs reserve. Each of these accounts is in turn funded by central government current grants, council tax and non-domestic rate payments. Capital expenditure charged to the revenue account is forecast to be £2.5 billion in 2011-12, of which the general fund and major repairs reserve account for 45 per cent each.

### Borrowing

Local authority borrowing (also called prudential borrowing) can be split into supported capital expenditure (revenue) and unsupported (i.e. self-financed) borrowing. Supported capital expenditure (revenue) refers to when central government provides a revenue stream, or revenue support grant, to support interest repayments on loans or other forms of credit. Following the Spending Review 2010, supported borrowing is declining dramatically however local authorities no longer need government approval to finance capital expenditure by borrowing or other forms of credit. Using the Prudential capital finance system, local authorities are free to borrow to fund additional investment as long as they are able to demonstrate that this borrowing is sustainable, prudent and affordable.

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<sup>101</sup> DCLG, Annex A (3): Capital receipts: all services: England 2011-12: forecast (2011)

## Appendix 4 *New and existing funding models for capital expenditure*

### Community Infrastructure Levy (CIL)

The CIL came into force on 6 April 2011 and is a new levy that local authorities can impose on landowners who benefit from new developments in their area. The CIL uses a formula to calculate the contributions due from the developer, based on the size and type of the development, with the proceeds used to fund the surrounding infrastructure necessary to support the development. The aim is to give local authorities more freedom to set their own priorities and provides developers with much more certainty about how much money they will need to contribute. Considered controversial, there are doubts over the amount of revenue it will generate over and above Section 106.

### Enterprise Zones

In March 2011 the Government announced that 21 new Enterprise Zones will be established in LEP areas around the country. The focus is on regions that have been neglected over the past 10 years as and have potential for growth. Businesses in the Zone will benefit from simplified planning, superfast broadband and business rates discounts, allowing them to develop new solutions to local economic needs. The aim is to create 30,000 new jobs by 2015 however there is criticism that the scheme will simply move jobs rather than increasing the total. To reduce local displacement of businesses, LEPs will play a major part in deciding the range of incentives on offer and will be expected to link Enterprise Zones with other planned infrastructure.

### Green Deal

The Green Deal is a new energy saving plan launched by the Department of Energy and Climate Change to make homes and businesses warmer and cheaper to run. In 2012, people will be able to apply for up to £10,000 up front to pay for energy efficiency work, which will be repaid through savings



on energy bills. The scheme is expected to reach millions of homes and play a major role in meeting the Government's carbon reduction targets. It is not a centrally-controlled strategy and the private sector is expected to access Government funds and manage the Green Deal themselves.

### **Growing Places Fund (GPF)**

The GPF will provide £500 million to enable the development of local funds to address infrastructure constraints, promoting economic growth and the delivery of jobs and houses. All 38 LEPs are eligible to apply for funding to get stalled projects back on track and the money will be allocated from January 2012. Decisions about what to prioritise will be taken by the LEPs but projects must facilitate economic growth, jobs and new houses in the local area, providing returns that can be re-invested locally. The aim is to kick start local development across the country, from building strategic link roads to reducing congestion.

### **Housing Revenue Account (HRA) Reforms**

HRA Reforms will give local authorities full financial control over their housing stock by April 2012, allowing them the independence to build new affordable housing or improve the condition of existing stock. Over time, this should give local authorities control of more than £50 billion in rental income. As part of the 30 year business plan, local authorities will also be required to handle the estimated £21 billion public housing debt, which is expected to be serviced through loans from the PWLB. The main benefit is that increased borrowing power will allow local authorities to focus on local needs and more effectively increase their stock of social housing.

### **JESSICA (Joint European Support for Sustainable Investment in City Areas)**

JESSICA is an EU scheme that enables Managing Authorities to use some of their structural fund allocations to accelerate development via Urban Development Funds. Principally aimed at securing additional resources for PPP schemes it is also applicable generally to urban renewal and development projects.

### **Local Asset Backed Vehicles (LABV)**

LABVs are public private partnerships whereby a local authority or other public body invests its assets into a joint venture, formed with a private sector partner/s. The private sector partner can then borrow against the value of the assets and use this to fund development. Usually used for mixed use regeneration schemes, partnerships are typically for 10-15 years and enable a range of development objectives to be met within the context of an area-wide strategic vision. Low property values can make LABVs less viable, and there can be lengthy procurement processes.

### **New Homes Bonus**

The New Homes Bonus (started in April 2011) provides an incentive for local authorities to build new houses and reuse empty properties by match funding the additional tax raised for the following six years. The increased strain on public services and reduced amenities used to be a disincentive for local authorities however the New Homes Bonus should alleviate these problems and create a more positive attitude towards building new houses to promote local economic growth.

### **Private Finance Initiatives (PFI)**

PFI is a form of public private partnership and a way local authorities can pay for the use of new capital assets rather than having to build or buy the assets themselves. Payment from the local authority to the contractor is dependent on agreed performance metrics. PFI has come under intense scrutiny recently following two critical Parliamentary reports (from the Treasury Select Committee and the Public Accounts Committee). In the Spending Review 2010 the government scrapped the use of PFI credits, making its use at a local government level less likely. In November 2011 the government opened a consultation to explore a range of alternative ways to use private capital to fund public infrastructure as a means of replacing the PFI.

### **Regional Growth Fund (RGF)**

The RGF is a new £1.4 billion fund to support projects and programmes that promote private sector investment across England up to 2014.

Bidding finished in July 2011 and at the time of writing the government was evaluating 492 submissions with a combined value of £3.3 billion. Approximately 60 per cent of bids came from the North West, North East and Yorkshire and Humber, while only 12 per cent of bids came from London, the South East and South West.

### Section 106 Agreements

Section 106 of the Town and Country Planning Act allows local authorities to enter into an agreement or planning obligation with a landowner that requires them to invest in the local community as a prerequisite to planning permission. For example, when a private developer is offered land on which to build a new block of flats, it may be asked to contribute a community centre, gardens, or improvements to local roads to improve access and mitigate population increases. The advantages of S106 agreements include local control, a strong connection between development and the local area, and the flexibility for local authorities to shift and change demands. The agreements depend heavily on the strength of negotiations, which can often be costly and time consuming for the local authority.

### Tax Increment Financing (TIF)

TIF is a public financing method that seeks to capture incremental tax revenue (non-domestic rates) in a designated area that would not have arisen without enabling infrastructure investment. The main principle is that local authorities are able to raise the finance to unlock planned regeneration by pledging to meet debt repayments using the incremental revenues and other income created by the resultant development. The success of TIF depends on a project's ability to deliver enough regeneration and sustainable economic growth to fund the future debt repayments. TIF has been used extensively in the USA and the Scottish Government is in the middle of a pilot project following a change to regulations in December 2010.

### The Affordable Rent Programme (ARP)

The ARP enables housing associations to finance new affordable housing based on future rental income set at 80 per cent of market levels. This in essence means using future housing benefit contributions to pay for private borrowing.

## Appendix 5 *Survey questions*

1. Over the coming three year period, where will capital investment rank as a priority for your authority compared with other expenditure?  
Rank 1-10 : 1 = lowest priority, 10 = highest priority
2. Is there a capital investment shortfall between what your local authority is able to do with current resource levels and what they deem necessary to promote local economic growth and ensure high-quality physical infrastructure?
3. Please rate the following in terms of capital investment need in your local authority (see figure 8):  
1 = Low Priority    5 = High Priority
4. What is the main concern for your authority when considering borrowing for capital investment?
5. In the past 3 years what percentage of your local authority's borrowing has come from the PWLB?
6. Will the decision to increase interest rates at the PWLB affect future decisions about sources of borrowing for your local authority?
7. Which of the following capital finance mechanisms, reforms or freedoms is your local authority actively considering over the next 3 years for capital investment purposes (see figure 9)? (Tick all that apply)
8. Is your local authority considering greater usage of user-charging as a means of financing capital investment?
9. How confident are you that Local Enterprise Partnerships will be able to assist in driving capital investment bearing in mind the current powers they have been given?  
1 = Not at all confident 10 = Very confident
10. Do you feel that local authorities and the private sector could work together better to help drive higher levels of capital investment?

**11.** What type of local authority do you work for?

**12.** Which region is your local authority in?

## *Balfour Beatty*

Balfour Beatty is a world-class infrastructure services business operating across the infrastructure lifecycle, with leading positions in major markets. Within the UK we provide the full range of infrastructure services to local authorities from design and project management, through privately financing, constructing the assets themselves and then providing long-term maintenance and support. From highways maintenance services and major street lighting investments, as the biggest school builder in the UK and as a strategic partner to local councils we play an important role alongside local authorities for the communities which we serve.

For more information, please visit [www.bbcap.co.uk](http://www.bbcap.co.uk)

## *City of London*

**The City of London Corporation is a uniquely diverse organisation. It supports and promotes the City as the world leader in international finance and business services and provides local services and policing for those working in, living in and visiting the Square Mile.**

It also provides valued services to London and the nation. These include the Barbican Centre and the Guildhall School of Music & Drama; the Guildhall Library and Art Gallery and London Metropolitan Archive; a range of education provision (including three City Academies); five Thames bridges (including Tower Bridge and the Millennium Bridge); the Central Criminal Court at Old Bailey; over 10,000 acres of open spaces (including Hampstead Heath and Epping Forest), and three wholesale food markets. It is also London's Port Health Authority and runs the Animal Reception Centre at Heathrow. It works in partnership with neighbouring boroughs on the regeneration of surrounding areas and the City Bridge Trust, which it oversees, donates more than £15m to charity annually.

For more information, please visit **[www.cityoflondon.gov.uk](http://www.cityoflondon.gov.uk)**



## *London Stock Exchange*

**The London Stock Exchange is at the heart of the global financial market and is home to some of the largest, most successful and dynamic companies in the world.**

The Exchange has built on a long history of integrity, expertise and market knowledge to become the world's most international stock exchange. In October 2007 the Exchange merged with Borsa Italiana, creating Europe's leading diversified exchange business, London Stock Exchange Group.

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## *Morgan Stanley*

**Morgan Stanley has earned a worldwide reputation for the excellence of its advice and execution in financial markets. With more than 1,300 offices in 42 countries, the firm is truly global — and a market leader in the U.S., Europe and Asia as well as in emerging markets.**

Morgan Stanley's success rests on the talents and passion of our people, who share a common set of values and bring excellence and integrity to everything they do. We seek to grow long-term relationships by virtue of our consistently rigorous thinking and the unsurpassed access to financial markets that Morgan Stanley can bring. This means providing leadership in specific areas such as investment banking, debt and equity underwriting, research, and sales and trading.

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**Nabarro is a major commercial law firm renowned for its positive and practical approach to its clients' business needs. It operates in a number of industry sectors and legal disciplines with a single aim: to deliver the highest quality legal advice as clearly and concisely as possible, no matter how complex the situation.**

The firm: Nabarro is an energetic, growing partnership with over 500 fee-earners/lawyers, offering a broad range of legal services to major national and international clients.

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