

Representation to Oxford City Council Community Infrastructure Draft Charging Schedule Consultation (November 2023) – Royal London Mutual Insurance Society (RLMIS)

We write in connection with the Oxford City Council Community Infrastructure Levy Draft Charging Schedule consultation dated November 2023. We are instructed to respond as part of the consultation process focusing on the impact of the draft policies on scheme viability and deliverability.

This response is intended to assist Oxford City Council ('the Council') in the preparation of its updated Community Infrastructure Level Charging Schedule and we would welcome the opportunity to work with the Council and its advisors throughout the consultation process so that it be may appropriately developed.

The overarching concern is that the proposed employment uses still due to be delivered would be materially affected by the proposed amendments to the CIL Charging Schedule – equivalent to a fivefold increase i.e. from £33.74 psm to £168.74 psm¹. The proposed changes are likely to negatively impact on the delivery of new development within the City alongside increased unaffordability, a reduction in build quality and sustainability commitments, and suppressed economic growth. We have set out below our primary concerns surrounding the methodology and/or assumptions included within the updated Local Plan Viability Assessment supporting the proposed increase in levy.

We have reviewed the key assumptions included by the Council's appointed viability consultants BNP Paribas Real Estate ('BNPP'), and provide comment herein where appropriate. It should be noted that any silence in respect of the Council's supporting viability study does not confirm our agreement to the same, and we reserve the right to make further representations at a later stage where appropriate to do so. Moreover, our professional view may differ from time-to-time in accordance with market movements and changes in professional and planning guidance and our position is therefore reserved.

It should be noted that there are areas at this stage where we have been unable to undertake a full review of the supporting evidence base due to the information made available at this stage and timescales provided for responses.

The overriding response is that the Local Plan should not put in place policies that fetter development opportunities from being brought forward or that mean those tasked with major development investment decisions must operate at the margins of viability. Following recent experience, rapid economic changes such as the recent pandemic, conflict in Ukraine and increases in interest rates can have a significant and long-lasting market impact. It is important that the viability of the development plan is therefore resilient, and that the viability work supports this.

Our response is therefore foremost intended to assist the Council in its consideration of the robustness of the Oxford City Council: Local Plan Viability Assessment ('the Viability Assessment') undertaken by BNPP and subsequently, the Council's updated CIL Charging Schedule. We would welcome the opportunity to respond to any queries which may arise following review.

¹ Assuming Jan 24' figures.

Development Revenue

The adopted commercial revenue assumptions are included within the updated Local Plan Viability Assessment in Table 4.15.1. The relevant allowances are shown for offices within the table below:

Local Plan Viability – Office Revenue Assumptions

Use / Description	Location	Rent £psm (£ psf)	Yield	Incentive (RFP)
Offices / R&D	City Centre	£565 (£52.50)	5.75%	12m
	Rest of City	£340 (£31.60)	6%	

BNPP's evidence base is ostensibly contained under Appendix 3 which sets out a sample data set for office transactions across the authority area. In terms of size, the data suggests a range comprising between 122 sq ft to 25,274 sq ft NIA with a range in achieved rents of between £12.23 psf - £98.68 psf suggested.

Such a range shows the degree of variance in comparable letting evidence within the subject location, and gives rise to a lack of transparency in how the subject evidence has been considered. In summary, from the information provided it is however unclear how the data has been analysed and translated into BNPP's adopted revenue allowance. We note the absence of investment sale data which is fundamental in supporting the adopted yield profile included within the Viability Assessment and would welcome clarity.

It is not clear from the updated assessment whether City Centre or Rest of City revenue allowances would be considered applicable to the subject site allocation. We would however anticipate an application of 'Rest of City' owing to the subject site's geographical location i.e. £31.60 psf given the subject location would not be deemed as 'city centre'

Although a range in potential rental values and investment yields is possible depending on factors such as size and configuration, location and specification etc, we have had regard to a range of comparable letting transactions during 2023 totaling over 22,000 sq with tenants drawn from a technological and life science background. This evidence suggests that the adopted office rental values adopted within the Viability Assessment are overstated.

Development Costs

The adopted commercial cost assumptions included within the updated Viability Assessment are set out in Table 4.17.1. The relevant allowances are shown below for both commercial and residential use:

Local Plan Viability – Office Build Cost Assumptions

Use / Description	BCIS Description	Base Cost £psm (£psf)	Externals	Total
Offices	320. Generally – air conditioned (UQ)	£2,839 (£264) ²	10%	£3,123 (£290)

² Costs as at November 2022.

As shown within the table above, BNPP include an additional 10% allowance for external works to include car parking and landscaping, the latter to support emerging Policy G2.

It is of concern that BCIS fundamentally fails to capture a sufficient level of construction data and that such data is not truly representative of new office development in the subject location. For office costs, BNPP present data from the “Average Prices” section of the BCIS. Such data takes account of UK office construction cost information collected over several years. To make the data location and time relevant, the costs are rebased to Oxford, adjusted to November 2022. In response, we would make the following observations in respect of the limited information base:

- I. The sample size for all offices is 65, for air-conditioned offices this falls to just 19 which we would consider to be exceptionally low;
- II. The Upper Quartile costs of non-air-conditioned offices are higher than air-conditioned which is counter-intuitive and would appear to suggest inconsistent/limited data;
- III. The figure included under the ‘highest’ data set £4,193 psm represents a sizeable uplift of c.48% to the upper quartile figure relied upon the testing purposes and demonstrates the level of fluctuation across the data; and
- IV. The overall spread of costs (for all offices) ranges from £1,210 psm (£112 psf) to £5,907 psm (£548 psf) which would again appear to suggest inconsistent data.

Noting that the BNPP extract is dated November 2022, we have adjusted the criteria to present day for comparison and would make the following observations:

- I. The sample size for all offices reduces to 49, for air-conditioned offices 18;
- II. With the addition of BCIS inflation to rebase to Q4 2023, an adjusted base figure of £2,918 psm is derived. This figure is equivalent to a c.3% uplift in costs when compared to the evidence base, which would also impact on the application of externals, fees, extra policy costs and contingency etc; and
- III. Again, non-air-conditioned offices are shown as more expensive.

The sample size shows a drop from 64 to 49 in just one year which is surprising. The extracts are based upon the BCIS “default period” for “maximum age of results”. The inference is that the BCIS are using project data that is up to 15 years old. Whilst we acknowledge that the data is adjusted for inflation the concern with data over such a long period is that such construction costs do not necessarily take account of changing building practice, specifications driven by market expectations, building regulations etc.

We have further analysed BCIS Average Prices over a five year period selected in order to focus on just recent projects. The sample size returned just two projects i.e. BCIS has collated data for only two new build offices in the last 5 years. Moreover, wider analysis of sample projects suggests that just three of the 86 projects relate to offices measuring in excess of 10,000 sq m GIA with most measuring below 5,000 sq m GIA. This gives further concern surrounding the reliability of BCIS data.

BCIS costs for new build offices are not consistent as to whether they include only Shell and Core specification, or Shell and Core and Cat A fit Out (Raised floors, mechanical ventilation equipment on the floors, ceilings etc), or even elements of Cat B. We consider it would be more typical to consider both Shell and Core and Cat A costs. We would observe that costs associated with the construction of shell and core lab buildings fall in excess of the currently adopted BNPP allowance. Accordingly, to take account of the inherent uplift in cost from offices

to lab specification, including an increase to floor heights; increased amounts of drainage; heavier frames etc a further cost uplift would be expected and we would welcome clarity in this matter.

BNPP include an allowance of 10% for professional fees and 5% for contingency which is considered a reasonable minimum allowance for standard viability assessment. We would query whether a higher contingency allowance should be applied during periods of high build cost inflation, uncertainty and given the absence of a detailed scheme design especially where such allowance is likely to be eroded by build cost inflation over a relatively short term as is shown within the BCIS indexed figures above.

A marketing cost allowance of 2.5% and suggested to include agent's fees, plus an additional 0.25% allowance for legal costs is included albeit it is unclear whether this has been applied to residential uses only. We would welcome clarity in respect of the commercial marketing assumptions included by BNPP.

Finance

Finance cost assumptions affecting commercial development have increased marginally from 6% within the 2018 Viability Assessment to 6.5% within the current Viability Assessment. Notably the adopted metrics effectively show a downward movement from the previous viability assessment undertaken by Avison Young, dated September 2018 where an allowance of 6% for commercial uses was included.

We would draw attention to the respective dates of assessment above i.e. September 2018 vs. November 2023. During this period the economic landscape has changed significantly, and therefore a realistic adjustment to the finance assumptions applied within viability assessment is both necessary and appropriate with BNPP's adopted allowance of 6.5% considered unrepresentative of the current finance market.

The finance rate represents a total cost of capital in financing the scheme. The rate adopted represents the combined cost of both debt and equity financing. When broken down, the debt element of the cost of finance includes a margin and risk premium above a five-year swap rate. The equity element should in theory reflect an equity return which when combined with the debt element sums to the weighted average cost of capital.

In support of our view that development finance has become both more expensive and less readily available, we highlight the Bayes Business School (formerly 'Cass') Commercial Real Estate (CRE) Lending Report Year End 2022 which collates a comprehensive overview of development finance.

Indicative of market conditions, Bayes reports that senior development finance even for pre-let commercial, considered the 'least risky' asset type, has average loan margins of 458bps which reflects an increase of 23.3% on 2021. Furthermore, Bayes reported that margins for residential developments and pre-let commercial development are at their 20 year period peak.

In terms of the residential development finance market, as at year end 2022 Bayes report average lending margins of 531bps, up 4.7% from year end 2021. The minimum lending margin observed for residential schemes was 275bps, however, considering the average margin it's likely that this lower margin represents a low-risk non-speculative scheme.

At present, the current five-year SONIA swap rate has recently stabilised around 400 bps. When considering the average lending margins being reported by Bayes this would translate to development debt finance costs of above 900bps / 9% which suggests that BNPP's allowance is significantly understated in the present market.

Further to the above we have had regard to guidance from Savills' Debt Advisory team. The 'all in rate' currently used to support market valuations includes the swap rate together with the margin, i.e. for a Regional office development the all in rate is the swap rate, plus an appropriate margin of say 400 bps. We would note that whilst Swap rates have recently stabilised, some commentators believe that they will continue to rise.

In summary, a finance rate of 6.5% is considered unreflective of the UK development market whereby development finance has become increasingly more difficult to obtain. We would maintain that an appropriate allowance now falls in excess of 8.5%. Speculative commercial development is especially sensitive to changes in finance assumptions and we would consider that finance costs are understated and should be revised upward.

Developer's Return (Profit)

A target return of 15% is included within the Viability Assessment in respect of commercial development.

The adopted metrics effectively shows no movement from the previous viability assessment undertaken by Avison Young, dated September 2018, therefore inherently failing to address the significant changes which have taken place during the same period.

A profit margin should be reflective of the inherent risk in the construction and sales process taking account of macro and micro economic risk factors. The criteria to consider in arriving at an appropriate figure for developer's return (profit) include, amongst other things, location, property use type, the scale of development, the weighted cost of capital and the economic context. Developers, banks and other funding institutions maintain minimum expectations in terms of financial returns that are aligned with the risk profile. Simply, there must be a reasonable prospect that the return will be commensurate with the risks being undertaken.

The development market has become increasingly uncertain with an increasing level of risk faced by developers at the present time. At a macro level the conflict in Ukraine has had an acute impact on the global economy including a significant impact on rising oil and gas prices and the restriction of exported goods from Ukraine and Russia. This has added to the ongoing inflationary pressure already being experienced by developers and it still remains to be seen what impact inflation will have on the UK economy. As a result, borrowing costs have increased, surpassing prime real estate yields.

Key economic indicators currently give rise to material uncertainty and risk across both the development sector and wider UK economy. As a result of continuing inflationary pressure, the Bank of England further raised interest rates during August 2023 to 5.25%, notwithstanding these interest rate hikes inflation remains well above target.

For commercial real estate, the market has felt the impact of the above whilst experiencing a correction in prices. Many sales have been withdrawn as vendors' price expectations were not met, while buyers have adopted an opportunistic pricing approach. Real estate lenders are exercising caution when it comes to financing new lending opportunities, except for the most exceptional assets and sponsors.

Consequently, transactional volumes and liquidity have significantly declined, leading to a relative scarcity of comparable evidence to inform the valuation process. Market sentiment has gained increased importance in making informed assessments, given the limited availability of data. Stakeholders in the market, including

occupiers, investors, and lenders, are attaching heightened significance to environmental, social, and governance (ESG) considerations and the associated costs, in their decision making.

While there is still liquidity in the market, ongoing geopolitical uncertainties, economic challenges, and the cost and accessibility of debt finance are expected to further impact pricing. As a result, the potential for future value erosion cannot be discounted, particularly for properties outside prime markets where more significant declines can be anticipated as real estate markets and values continue to recalibrate to elevated levels in the of cost of capital, subdued transaction volumes and a cautious lending environment.

The RICS Guidance Note “Assessing Viability in Planning Under The National Planning Policy Framework 2019 for England” (2019) notes that an assumption of profit within the range of 15-20% of GDV is considered a suitable return to developers. We would stress that the market has become significantly more volatile since this Guidance Note was written, and therefore a figure at the highest end of this range is more appropriate.

In summary, given the severity of market risks at present we think that 15% on GDV (market residential) is increasingly considered to be unrepresentative of an appropriate margin with there being reasonable basis for this to increase to adequately compensate developers for the risks currently taken in the market. This is particularly relevant in the subject location which accommodates a relatively large volume of early-stage companies and longer term development timings and where pre-let opportunities are uncommon.

Viability Buffer

It is unclear whether sufficient provision has been made for a viability ‘buffer’ when interpreting the viability evidence resulting in the proposed increase in CIL levy. Such buffers are recommended within the current CIL regulations which state the following:

“It would be appropriate to ensure that a ‘buffer’ or margin is included, so that the levy rate is able to support development when economic circumstances adjust. In all cases, the charging authority should be able to explain its approach clearly.” (Paragraph 020 Reference ID: 25-020-20190901)

The economics of development will vary over the course of development which is inevitable given the varied nature of commercial development. It is therefore important to consider such factors when proposing a simplified ‘one size fits all’ rates across a significantly diverse location in terms of market and development characteristics.

The viability buffer is used to mitigate against fluctuations within the market to ensure that the rates are not set at the margins of viability. This is especially pertinent for schemes with high existing use values typically associated with existing commercial assets. During periods of political and economic uncertainty, changing market assumptions it is fundamental that sufficient and often increased leverage is allowed for within the proposed rates.

The proposed revised CIL charge is five times greater than the adopted levy including the prevailing rate of indexation which represents a significant increase in potential cost for schemes coming forward. It is fundamentally unclear whether BNPP have sufficiently taken into consideration this additional burden on schemes when undertaking their viability modelling which would clearly have significant commercial implications.

It is essential that an appropriate viability buffer is incorporated within the Viability Assessment and we would request that the Council confirms that this approach has been undertaken in justifying the proposed CIL Charging Schedule.

Summary

The consultation concludes that use classes E business and B2/B8 industrial are able to demonstrate viability at higher rates of CIL and recommends that rates can be increased fivefold for these uses to the higher CIL rate suggested to match residential (C3) use.

It is considered that the above conclusion is without reasonable justification and evidence as required under Regulation 13 of the CIL Regulations 2010 (as amended) which stipulates that “*any differential rate should be justified by economic viability evidence*”. Our overarching concern is that the Council has at this stage not published an appropriate evidence base on which to rely upon.

Notwithstanding the above, we have reviewed the recently prepared Viability Assessment and have identified a number of variances in key inputs that, in our opinion, do not reasonably support the basis for the proposed increase in CIL charges contained within the draft Charging Schedule. Specifically, we believe the following assumptions and/or methodology are not reflective of current market conditions:

- Development Revenue;
- Development Costs;
- Finance Costs; and
- Developer’s Return.

We have material concern that sites will not be able to viably support the delivery of the proposed increase in CIL levy whilst also taking into account the Council’s relevant policies. The draft amendments are therefore fundamentally detrimental to both viability of schemes and the potential deliverability of sites. The consequence of adopting this, would most likely preclude sites from being brought forward for development fettering the delivery of employment opportunities and the delivery of planning obligations within the City.

We remain of the opinion that the Council is unable to reasonably demonstrate that the proposed increased CIL rates strike a suitable balance, or are supported by accurate viability evidence. It is therefore essential that additional testing is undertaken and that the CIL rates are reviewed through further consultation and welcome further engagement to assist the Council with any further technical work being undertaken through due process.

The importance of flexibility is reinforced when taking account of the many changes regularly taking place in the development industry, not only related to the recent global pandemic, but also in respect of the building regulatory system and substantial cost inflation and market uncertainty etc. For a plan that operates over several years and whose next review may not take place for some time, it is important to consider the likely impacts now to avoid unnecessary viability issues in future years through flexibility.

We trust that the information provided is useful and would welcome the opportunity for further engagement with the Council to ensure the appropriate evidence informs due process.

Should you have any queries in relation to the above please do not hesitate to contact us. We would be pleased to provide additional comment and support discussions with the Council and its appointed advisors in due course.