RE: Oxford City Council Community Infrastructure Draft Charging Schedule Consultation (November 2023) – Meadowside Retail Park

We write in connection with the Oxford City Council Community Infrastructure Levy Draft Charging Schedule consultation dated November 2023. We are instructed by the landowner, Shell Trust to respond as part of the consultation process focusing on the impact of the proposed increase in CIL 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. We would welcome the opportunity to work with the City Council in relation to the proposed increase in CIL.

The overarching concern is that the local plan proposals for employment uses such as Policy SPCW8 (Botley Road Retail Park) would be adversely affected by the proposed changes to the CIL Charging Schedule – equivalent to a fivefold increase i.e. from £33.74 per square metre to £168.74 per square metre[1]. 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 CIL.

We have reviewed the key assumptions included by the Council's appointed viability consultants BNP Paribas Real Estate ('BNPP'), and have provided relevant comments. 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 the timetable of the consultation.

The overriding response is that the proposed level of CIL should not undermine the financial viability of development opportunities 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 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.

Site Context

The site which is the subject of these representations is the Meadowside Retail Park. This is a non-food retail park south of Botley Road.

[1] *Assuming Jan 24' figures.*

The site is subject to Policy SPCW8 of the draft Oxford Local Plan 2040 which encourages employment development such as research led employment and complementary uses such as community and learning uses (Class F).

As part of this local plan review process the Council is undertaking a review of the existing CIL Charging Schedule. The consultation suggests that '*new viability evidence'* has been produced to support this review and in line with this evidence, partial amendments to the existing CIL Charging Schedule are proposed.

The CIL Consultation document sets out that "use classes E 'business', and B2/B8 industrial can demonstrate viability at higher rates of CIL and therefore recommends that rates can be increased for these uses to the higher CIL rate to match residential (C3) use i.e. from the current £33.74 per square metre to £168.74 per square metre. The CIL consultation suggests that "*over time the capital values of business and industrial developments have significantly appreciated, and higher rates of CIL can now be accommodated".* The purpose of this consultation is to seek views on the proposed rates of CIL as set out in the Draft Charging Schedule.

<u>Site Value Benchmark</u>

Site Value Benchmark (SVB) – also known as 'Benchmark Land Value (BLV)', is key to assessing viability because ensuring an appropriate premium to a landowner is key to ensuring the delivery of the Local Plan. Should this be set at a level that is too low, land will not come forward and development will not take place.

An existing non-food retail park such as the Meadowside Retail Park with existing tenants has a significant existing use value.

<u>Development Revenue</u>

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:

<u>Local Plan Viability – Office Revenue Assumptions</u>

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 Net Internal Area with a range in achieved rents of between £12.23 per square foot and £98.68 per square foot 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 unclear from the updated assessment whether City Centre or Rest of City revenue allowances would be considered applicable to the subject site allocation south of Botley Road. We would however anticipate an application of 'Rest of City' owing to the subject site's site specific location i.e. £31.60 per square foot 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 recent comparable office letting transactions. This evidence suggests that an average headline rent achieved is generally less than £31.60 per square foot which would suggest BNPP's adopted office rent to be 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)

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

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 presents 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 per square metre represents a sizeable uplift of circa 48% to the upper quartile figure relied upon the testing purposes and demonstrates the level of fluctuation across the data; and

[2] *Costs as at November 2022.*

IV. The overall spread of costs (for all offices) ranges from £1,210 per square metre (£112 per square foot) to £5,907 per square metre (£548 per square foot) 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 per square metre is derived. This figure is equivalent to a circa 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 Gross Internal Area with most measuring below 5,000 sq m Gross Internal Area. 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 Category A fit Out (Raised floors, mechanical ventilation equipment on the floors, ceilings etc), or even elements of Category B. We consider it would be more typical to consider both Shell and Core and Category A costs and welcome clarity from BNPP 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 (Basis Points) 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. On this basis an overall rate in excess of 8% is comfortably supported. 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.

<u>Developer's Return (Profit)</u>

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. Notably, a divided market is emerging, differentiating "best in class" properties from those facing challenges due to locational factors and the overall quality of the real estate. 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.

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 not justified 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:

- Site Value Benchmark;
- Development Revenue;
- Development Costs;
- Finance Costs; and
- Developer's Return.

We are concerned that the proposed increase in CIL levy will undermine the viability of the site at Meadowside Retail Park taking account of other Council policies including energy efficiency. The proposed increase in CIL therefore fundamentally detrimental to both scheme viability and the potential deliverability of the site. The consequence of adopting this increase in CIL, could preclude the site from being brought forward for development during the Local Plan period fettering the delivery of new investment and employment opportunities.

We remain of the opinion that the Council is unable to reasonably demonstrate that the proposed increased CIL rates 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 we would welcome further engagement to assist the Council with any further technical work being undertaken.