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Development Viability Assessment and the Provision of Affordable Housing. A game of "pass the parcel"?

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Abstract

This paper constructs a hypothetical case study based around the Benchmark Land Value assessments within the landmark Parkhurst Road, London case decided in the High Court in April 2018. It attempts to illustrate how developers were gaming the system and how the 2014 Planning Practice Guidance aided them to do that. The discussion centres on the extent to which new 2018 National Planning Guidance has addressed the identified flaws and what additional changes might be needed to that guidance to solve any outstanding problems.

Keywords: Development Viability Assessment; UK Government; Planning Practice Guidance; Benchmark Land Value.

Introduction

Development Viability Assessment (DVA) has become a core theme within parts of the UK planning system in an attempt to bring sites forward for development while trying to capture some of the land value gains made from the granting of permission to develop. Viability assessments can be required at both plan-making and decision-making stages. In plan-making they are needed to set the policy requirements for planning obligations (POs) across different site typologies within a Local Planning Authority (LPA) area (area-wide assessments). In decision-making they are needed to ratify or vary these requirements in specific cases (site-specific assessments).

The Government response to the Housing, Communities and Local Government Select Committee inquiry on land value capture (MHCLG, 2018a) makes it clear that their priority is to evolve this approach to land value capture rather than change it. They are committed to making the system for obtaining land value capture through developer contributions more 'transparent, efficient and accountable' while continuing to 'explore options for further reforms to better capture land value

uplift'. This is 'providing [the Government] can be assured that the short-run impact on land markets does not distract from delivering a better housing market.' (MHCLG, 2018a, Page 8)

In line with this objective, the most recent National Planning Policy Framework (NPPF), published in 2018 and updated in February 2019 (MHCLG, 2019), has continued to put financial viability at the heart of the system. However, it suggests a number of reforms to the system based on these principles of transparency, efficiency and accountability.

In the previous 2012 NPPF, it stated that planning authorities should pay 'careful attention to viability' to ensure delivery of development and set the framework for the sharing of development gain. It stated that:

> [T]o ensure viability, the costs of any requirements….such as requirements for affordable housing, standards, infrastructure provision and other requirements should… provide competitive returns to a willing landowner and a willing developer to enable development to be deliverable (CLG, 2012: 41)

The 2019 NPPF does not change this basic requirement to balance the requirements of landowners, developers and local planning authorities (LPA). But, through the accompanying guidance (NPG, 2018), it does seek to rectify a number of practices within the detailed operation of the viability system that have been alleged to have reduced the benefits to the LPA and community to the advantage of landowners and developers.

The detailed advice on viability assessments based on the 2012 NPPF is contained in the 2014 Planning Practice Guidance (PPG) (CLG, 2014). The vehicle assessing viability is a standard development appraisal model as practiced by developers and their agents for many years. That standard model is a residual model based on the concept that the land value is a residual of the value of the completed development less the costs of developing that site, including a return to the developer for taking development risk.

One of the costs of the development is meeting the LPA requirements for POs but, as the policy statement above implies, where the extent of POs reduces the returns to landowner and developer below that which is 'competitive', the obligations need to be reduced to ensure viability and hence deliverability.

This paper will briefly review the literature around DVAs paying particular attention to the valuation model and planning policy/guidance in this area. Planning policy sets the framework within which the valuation process operates but valuers are also bound by mandatory standards (in the case of RICS surveyors) and industry best practice guidance. This policy and practice framework underpins

negotiations between landowner/developer and local authority for the provision of, primarily, affordable housing.

The paper will identify some of the more detailed issues around the assessment of land value and discuss actual and potential changes to policy, guidance and appraisal technique to address the issues identified. These changes may enable a more rational distribution of development value between landowners, developers and the community.

The literature surrounding viability has a number of threads and a wide-ranging review is provided by McAllister (2017). He identifies a range of issues and literature including policy innovation, calculative practices (modelling) allied to their application to development viability, and transparency. Some of these themes are progressed in this special issue. For example, virtually all of the papers in this issue (McAllister (2019), Adams (2019), Catney and Henneberry (2019) and Crook and Henneberry (2019)) refer to flaws and biases within the development appraisal model (for example, valuation variation, bias and instability) and the cultural and behavioural environment within which the negotiation of POs take place (Dunning, et al, 2019). This paper accepts the conclusion of McAllister (2019) that:

> Even if an accepted operational definition of BLV [Benchmark Land Value] were to emerge, the use of viability models prone to such levels of error and potential bias to set and implement planning policy is likely to remain vulnerable to opportunistic behaviour and prone to miscalculation.

However, that does not mean that flaws in policy and practice leading to inappropriate application of the model should be tolerated, even if the nature of development appraisal modelling will always leave room for negotiation bias and variation.

This paper concentrates on the technical detail of the development appraisal model operating within the current and emerging policy and practice framework while accepting that these wider ranging issues also have a major impact on land value capture within the UK planning system. It aims to identify a number of problems in the past policy framework, how they were manipulated in practice and how they have been addressed in the new national planning practice guidance (MHCLG, 2018b). The objective is to examine whether the changes will rectify the identified problems and what further changes may be needed to the current framework if that part of the gaming process identified in the MHCLG (2017) consultation is to be finally put to rest.

The 2014 Planning Policy/Practice Guidance

Verdung and van de Doelen (1998) identify circulars and policy guidance as instruments for communicating policy requirements. In the case of development viability detailed planning policy and practice guidance from the MHCLG exists. Pawson et al (2005) suggest that policy innovation leads to the creation of both winners and losers from the system. The 2014 Planning Practice Guidance (PPG) is widely cited as having created a system that favoured landowners and developers over the community in the form of the LPA. Research by, or funded by, stakeholders in the process includes that by Shelter (Grayston; 2017), a consortium of London Boroughs (Sayce, et al; 2017) and the RICS Research Trust (Crosby and Wyatt, 2015). A similar academic literature has evolved (see Colenutt, et al, 2015; McAllister, et al, 2016b; Crosby, et al, 2013; Crosby and Wyatt, 2016). These all identified serious flaws in the viability system leading to the erosion of affordable housing proportions within private sector developments.

This erosion seems surprising. Since 2012 the average return on capital employed (ROCE) of the seven largest housebuilders has increased from 12% to 32% by the financial year end 2017. Over the same period, their completions have increased from 42,000 to 70,000 and profit per plot increased from £19,000 to £62,000. Across the sector as a whole, the provision of affordable housing has declined from 58,000 to 42,000 per annum while the number of residential units built has increased from 135,000 to 217,000. This represents a fall from 44% of completions in 2012 to 13% in 2017 (Crosby, Devaney and Wyatt, 2019).

One argument set out in the literature suggests that major flaws in the 2014 PPG are responsible and they relate to the assessment and use of a Threshold or Benchmark Land Value (BLV). The guidance on the assessment of BLV within a viability assessment was driven by a set of instructions that were similar for both area-wide and for site-specific assessments. Area-wide instructions were contained in paragraph 14 and site-specific instructions in paragraph 23 of the 2014 PPG. Paragraph 14 was as follows:

> Central to the consideration of viability is the assessment of land or site value. The most appropriate way to assess land or site value will vary but there are common principles which should be reflected.
>
> In all cases, estimated land or site value should:
>
> - reflect emerging policy requirements and planning obligations and, where applicable, any Community Infrastructure Levy charge;

- provide a competitive return to willing developers and land owners (including equity resulting from those building their own homes); and
- be informed by comparable, market-based evidence wherever possible. Where transacted bids are significantly above the market norm, they should not be used as part of this exercise.

Paragraph 23 was identical except for one sentence added to the opening statement of the paragraph and a slight tweak to the next sentence. In addition, the word emerging was omitted from the first bullet point.

BLV became a major battleground within planning appeals. Crosby and Wyatt (2015) identified contradictions between the first and third bullet points above as a major cause for the reductions in POs in some planning appeal decisions and they also identified the reliance by planning Inspectors on landowner and developer evidence of land transactions as an issue. These issues were picked up in the landmark Parkhurst Road planning appeal case which ended up in the High Court in 2018. The issue surrounded circularity in the valuation process. This is a major issue for this paper and these arguments will be set out later in this paper.

In addition to the question of the role of land value within the appraisal modelling process, the application of the 2014 PPG raised some governance and transparency questions.

Governance and Transparency

The role of DVA is to apportion development gains between the three parties and Jakeman, et al (2006) identify the issue of asymmetric abilities in modelling.

> The uses of models by managers and interest groups, as well as modellers, bring dangers. It is easy for a poorly informed non-modeller to remain unaware of limitations, uncertainties, omissions and subjective choices in models. (Jakeman, et al, 2006).

McAllister, et al (2016) found that local politicians and planners had a weak understanding of development appraisal[1] and they also found that landowners and developers have major incentives to manipulate the viability system within the 2014 framework. It is the landowners and developers

[1] There is an education issue here not developed in this paper. The development appraisal literature lies completely outside of the mainstream planning literature while the policy framework is firmly embedded in the planning process. Viability could be characterised as bringing the two cultures of real estate and planning truly together for the first time as both disciplines have tended to be educated mostly (not always) apart from each other in the past. This is changing.

who commission viability assessments at the site-specific level. Viability studies are also cloaked in confidentiality and many are not released in full into the public domain.

However, in the run up to the consultation on the revised NPPF, there was an increasing call for greater transparency of information and evidence surrounding viability appraisals. Grayston (2017) identified full transparency of appraisal evidence as one of her five main recommendations for addressing the falling levels of affordable housing and Crosby and Wyatt (2015) called for the disclosure of all viability assessments that aim to reduce the policy level of public contributions.

> Publically available information on these cases varies widely and needs to be made more transparent and consistent. In some cases there is only the basic planning information and the Inspector's report; in others, details of the appraisals and viability assessments are available for scrutiny. If landowners and developers wish to challenge area wide and site specific community contributions, they need [sic] put their reasoning and evidence, including financial details, into the public domain. (Crosby and Wyatt, 2015, p26).

Under the previous NPPF, the conditions were in place for some stakeholders to act under the cloak of confidentiality to potentially maximise their returns and emerge as winners. The lack of transparency and asymmetric abilities and resources leads to the question of whether the lack of transparency contributed to landowners and developers maximising their outcomes.

The new 2018 NPG has introduced measures for greater transparency of information used in the modelling process. The question of whether greater transparency will lead to wider scrutiny of the viability modelling process, increased awareness and less asymmetry of knowledge is an important one for the future application of viability modelling within the planning system. It is however not a particular question developed in this paper which concentrates on the policy framework and how it drives the modelling process.

The viability modelling process

Viability is assessed within a traditional development appraisal modelling process and there are two basic approaches to the valuation of development land; the market comparison method and the residual valuation method. These are set out in various textbooks and professional guidance notes (Wyatt, 2013; RICS, 2019).

The latest RICS Guidance Note (RICS, 2019) identifies a market comparison approach using direct comparisons of other land transactions. Normally in valuation, direct comparison is the preferred method but RICS (2019) qualifies this for development land and gives equal status to a residual valuation model.

The residual model determines the value of the land as a product of the value of the completed development less the cost of providing this development. The costs include a return to the developer and also any planning costs, including POs. Provision of affordable housing can also manifest itself as a reduction in the value of the completed development, often termed Gross Development Value (GDV).

There are two major variations on the residual valuation theme. The basic residual approach normally uses current values and costs and can be expressed simply as:

> Land Value = Value of Completed Development (net of sale costs) – (Development Costs Incl. Developers Profit).

Development costs include some financing of the build costs and of holding the land through the development period as well as a lump sum profit usually expressed as a simple return on development costs or on the value of the completed development.

However, the basic model can be transformed into a discounted cash flow method where the timing of the inflows and outflows can be considered more carefully. The basic approach of a discounted cash flow is that the future revenues and costs generated by the development are set out for each period through the development. The periods can be daily, monthly, quarterly, etc. The costs and values are discounted at a target rate of return or internal rate of return that should cover any borrowing costs and also compensate the developer for any risks taken. The rate of return represents the profit earned by the development expressed as a periodic rate of return, not as a simple lump sum profit measure as in the basic residual approach. Any discounted surplus of revenues over costs is the amount available for the land purchase at the beginning of the development.

As in the basic residual, planning obligations are part of the costs and can also be represented as a reduced completed development value in the case of affordable housing.

The theoretical model is simple but the application can be very varied and Coleman, et al (2012) identify a number of major issues with some of the inputs; such as the representation of profit, the use of current or forecasted values and costs and the treatment of finance. In addition to these criticisms, which suggest the model can be applied inconsistently, McAllister (2017) identifies issues of uncertainty around the level of inputs. Uncertainty around inputs coupled with variations in approach can lead to an extensive range of possible outputs. This is so even if the uncertainty around the inputs is based on an entirely reasonable range within the context of normal valuation variation; for which an extensive valuation literature exists (See for example, Wyatt, 2013, 349-53). To summarise, the valuation of development land is imprecise and the variation in land valuations can be

significant as it is a small residual value based on some very large inputs (such as the value of the completed development and the costs of development). Hence the conclusion of McAllister (2019) reported earlier.

These appraisal issues are discussed in detail elsewhere (Byrne, et al (2011), Crosby, et al (2013), Coleman, et al (2013), Crosby and Wyatt (2015, 2016), Sayce, et al (2017)).

Consistent conclusions from this valuation literature are that development valuations are one of the most variable and uncertain valuations to produce and, where development appraisal is applied within the 2014 PPG framework for the purpose of assessing viability, there is one additional major issue to be addressed. That is the determination of the BLV caused by the wording of paragraphs 14 and 23 of the 2014 PPG

The problem identified within the literature is formed around the fact that any one of the inputs into a residual, regardless of whether it is undertaken by the basic or the discounted cash flow methods, can be turned into the product or result of the valuation if all the other inputs are fixed. Normally, the land value is the output. Where the land value can be fixed (upon purchase for example where a price is paid), the residual output becomes profit, assuming the other inputs are also fixed. [2]

In the case of viability assessment there is a third potential residual outcome. If both land value and developer's profit are fixed within the model, the POs become the residual. A high land value and/or a high developer return will reduce the POs afforded by the scheme. High costs and low completed values will also have the same impact but the former is the focus of this paper. If the developer can fix both the land value and developer profit the residual becomes the POs. Arguments around other inputs then affect the POs and not the returns to the developer or the landowner.

The modelling problems: circularity and input uncertainty

In April 2018, the High Court agreed with the case made by Islington Borough Council that the approach taken in many planning appeal cases assessing BLV within viability assessments was flawed, citing Crosby and Wyatt, (2015). The Judge strongly recommended the RICS revisit their 2012 (RICS, 2012) viability guidance note to surveyors in an effort to address these flaws. MHCLG also revisited

[2] This is not affected by whether the valuation is carried out by either the simple residual model or the more complex discounted cash flow. Despite the criticisms of the basic residual in Coleman, et al (2012), viability appraisals tend to use the basic residual. Crosby and Wyatt (2016) investigated a number of planning appeals and found that it was used in all but a few larger cases.

their practice guidance and, after consultation in 2017 (MHCLG, 2017), published new viability guidance in 2018 (MHCLG 2018b).

The circularity problem is not straightforward. It is set out in both Sayce, et al (2017) and Crosby and Wyatt (2015; 2016). Development land value is a residual of the development process and the price paid for land should be the product of the value of the completed development less the costs of providing the development. If POs are fixed then it is a cost and if the value of the completed development falls, the land value should fall. Changes in house prices should drive land values, not the other way around (Ball, 1996).

Once the land is purchased, land becomes a fixed price and the development profit should become the residual. Changes to the market environment and any unexpected construction issues over the development period will alter expected cash flows and change the residual, in this case profit. Development profitability should be highly volatile and because of that development profits are targeted at ROCEs of 20% plus and internal rates of return of 15% to 20%. This is a huge risk premium as a risk free internal rate of return is barely 1% in the UK in 2019 (Crosby, et al, 2019).

The circularity argument is that this risk, for which the developer is rewarded via these returns, has been transferred to the LPA via the application of the PPG 2014. Within viability assessments, this is achieved by making sure the residual amount falling out of a residual valuation is the POs. As the developer's profit is virtually fixed, the developer also needs to try and fix the land element (BLV).

Developers relied on bullet point three of paragraph 23 of the 2014 PPG to deliver this outcome. It stated that the BLV should:

> be informed by comparable, market-based evidence wherever possible. Where transacted bids are significantly above the market norm, they should not be used as part of this exercise.

Under PPG 2014, developers successfully argued that this statement allows comparable market evidence to fix the land price as it shows the market norm level of values. Put more simply, where the comparable land transactions are available, this is the primary basis for assessing BLV. Planning Inspectors tended to agree.

However, bullet point one suggests that all BLVs should reflect policy requirements. Until the Parkhurst Road decision, developers had successfully argued that policy compliant just meant the delivery of viable levels of POs and that each agreement was evidence of the viable level of POs on that particular site. These arguments revolve around the definition of policy compliant. Is it the full

plan requirements or is it POs that are deemed viable? When the latter assumption is used, the unadjusted land transaction evidence fixes the BLV, the developer is allocated a profit, and the POs become the moveable residual value.

This situation is identified within much of the literature and within some LPA supplementary planning guidance, including the Mayor of London's Supplementary Planning Guidance, and now within the High Court. Circularity was introduced as a result of the fundamental flaw within the 2014 PPG that policy compliant wasn't defined, coupled with the interpretation put on the two bullet points within paragraphs 14 and 23 by planning inspectors and other decision makers.

The land price should be the outcome of the residual model. But if the land price is taken outside the model by the use of comparable transactions, and the developer's return is held constant, the residual of the model becomes the POs. At this point, the developer knows that they can pay more for land and this increases the *landowner's* return. Despite the fact that the developer pays over this surplus to the landowner, it does not reduce the developer's return. Instead, the developer uses the PPG to argue for an increase in the BLV within the viability assessment, making the POs unviable. Until recently, the Planning Inspectors upheld this approach.

Crosby and Wyatt (2016) concluded:

> In a policy context that requires planning obligations to be set at a level that does not jeopardise developers' and landowners' competitive returns, a developer can outbid others to acquire a site knowing that the price paid (or market valuations that use this price as evidence) can be used as evidence to reduce the level of planning obligations.
>
> (Crosby and Wyatt 2016, 1731)

These discussions in previous papers are predicated on the developers *overpaying* for the land and then clawing this overpayment back by passing it onto the LPA in reduced or even zero POs. This argument relies on developers all overpaying and creating the evidence base to stop the actual price being unsupported by other transactions.

The existing literature does not identify another possible explanation. There may be another force at work based on inappropriate choice of model (or more accurately inappropriate application of inputs into the model). Development takes place over time and developers will price development options, which may not be identifiable within the residual model, and also they may project changes in costs and values over the development period. Not using value and cost change in the modelling can lead to undervaluation in markets that are expected to grow over the development period. There are provisos to this conclusion as it depends on the relative growth rates in values and costs

and the relationship between values and costs (for example, high land value areas will benefit from this effect more than low land value areas).

The 2014 PPG made it clear that the modelling process should use current costs and values only. PPG Viability (CLG, 2014) Paragraph 8 refers to area-wide plan-making and states that viability assessments for that purpose should not include any future increase in costs or values.

> Current costs and values should be considered when assessing the viability of plan policy. Policies should be deliverable and should not be based on an expectation of future rises in values at least for the first 5 years of the plan period.

When it comes to site-specific assessments, the guidance is contained within paragraph 17 and is unambiguous. The only context in which value and cost change can be included is when schemes are large enough to be phased.

> Viability assessment in decision-taking should be based on current costs and values. Planning applications should be considered in today's circumstances.
>
> However, where a scheme requires phased delivery over the medium and longer term, changes in the value of development and changes in costs of delivery may be considered. Forecasts, based on relevant market data, should be agreed between the applicant and local planning authority wherever possible.

Research Questions

The viability literature identifies a fundamental flaw in the viability modelling process under the 2014 PPG. That literature suggests it can lead to overpayment for land and that overpayment can be clawed back through a viability assessment. The developer can use land market transaction evidence to prove that the "overpayment" is in fact a market norm under policy compliant assumptions that are based on delivery rather than requirements. Under this regime, developers have successfully argued that sites are unviable at the full policy requirements in the plan and these should be reduced.

In April 2018, the High Court case concerning the Parkhurst Road site partially rejected this approach and confirmed a different approach to transaction analysis. The first aim of the paper is to examine this decision to determine the implications.

The UK Government have also attempted to change the approach to viability and produced new planning guidance in 2018. The second aim of this paper is examine the new National Planning

Guidance (NPG) (MHCLG, 2018b) and examine it in the context of the two modelling issues relating to circularity and the use of growth models.

In order to address the questions the paper constructs a case study of a viability assessment based on the valuation inputs cited in the Parkhurst Road case. This site is used to illustrate the application and potential outputs of viability models and illustrate in detail how the appraisal process works within viability. The modelling is simplistic and does not represent the true complexity surrounding development appraisal modelling in general and the particular aspects of Parkhurst Road. A very basic residual valuation based on typical real estate valuation texts (Wyatt, 2013) is adopted.

The rest of this paper proceeds as follows.

First the simple residual model is set in context with a short discussion of the treatment of the three major inputs of gross development value (value of completed development), construction related costs and developer's profit. Second, the relevant details of the Parkhurst Road case are set out and discussed and third, the changes to planning guidance which impact on BLV are identified

This sets the context for the case study modelling exercise. That is followed by a discussion of the results and conclusions around whether the changes to the policy and practice framework will create the environment for more balanced negotiations around POs or whether further changes are necessary.

Residual model

The model inputs

(a) Gross development value

Gross development value is normally constructed from a simple comparative model of transaction evidence from the current market. In the residential market, this can range from a comparison with the sale prices of owner occupied housing to a more sophisticated comparative process for rented accommodation using a rent/capital value ratio based on initial returns of similar types of property (see, for example, Wyatt, 2013). It is not the objective of this paper to delve more deeply into the construction of these valuations but they are based normally on current sales values even if in a real development appraisal some forecasting would take place. This point is important for this paper and it is unrealistic to assume that developers take no notice of possible price changes through a development period when framing their bid for the land at the commencement of the development period.

(b) Construction Costs

Construction costs are often based on comparative information and at first sight it might appear that costs based on comparative indicators of the current cost of construction contracts also exclude any forecasts of how those costs may change over the life of the project. However, construction costs can be based on current tender prices and constructors making bids for a project may well include any prospective cost increases in their current bids. So what may appear as a current cost could have some future expectation of cost change already built in.

Changes in costs may not, and probably will not, be at the same rate as the changes in values. However, where they are assumed to change at the same rate, the impact on any model outcome is to increase the residual amount. Modelling under the assumption that values will grow over the development period but costs have already been subject to a growth factor, and don't need further projection, will increase the residual still further.

(c) Return to the developer.

The third major component of the residual model is the developer's profit. There is little debate as to what those returns should be in the literature (Crosby, et al, 2019). The new 2018 NPG has virtually fixed the return to the developer in viability studies. Return to the developer is not the focus of this paper except as an outcome of the analysis.

Development Viability Assessment Hypothetical Case Study based on Parkhurst Road High Court Decision (Parkhurst Road Limited v Secretary of State for Communities and Local Government and The Council of the London Borough of Islington [2018] EWHC 991 (Admin) Case No. CO/3528/2017.)

This case study is a former Territorial Army base on Parkhurst Road, North London. The original application Ref P2013/4950/FUL, dated 6 December 2013, was refused by notice dated 17 October 2014. The developer appealed and the appeal was dismissed by a decision of the planning inspector on September 22nd 2015 (Appeal Ref: APP/V5570/A/14/2227656).

However, in dismissing the appeal, the inspector considered the viability assessment, in particular the BLV and in effect found for the developer's side of the argument. In summary, the inspector grounded the determination of the BLV in the comparable evidence of other sites sold and an external valuation of the actual site. He upheld the developer's assertion that the price paid for the site of £13.25 million was in line with land values in the vicinity and should be used as the BLV, even though it did not leave enough surplus development land value, according to the developer, to provide the developer with any more return than 16.5% on costs. The local authority had argued that a policy compliant land value to secure a 50% affordable housing provision was around £5

million and that a price of £13.25 million was an overpayment due to the circularity issues identified in the literature.

Despite *winning* the overall appeal (the submitted scheme was rejected), the London Borough of Islington appealed the BLV part of the decision and the subsequent appeal hearing in June 2017 (APP/V5570/W/16/3151698) found for Islington's approach and reversed the BLV findings.

The developer appealed and the case went to the High Court. Judge Holgate accepted the overpayment arguments citing the Crosby and Wyatt (2015) paper on circularity. The original Parkhurst Road appeal decision was evidence that the Planning Inspectorate had at last begun to realise the problem (APP/V5570/W/16/3151698). Paragraph 39 of the inspector's decision explicitly discusses the tension between the two bullet points in PPG paragraph 23 where comparables should be used but the land price should be policy compliant. The High Court judicial review confirmed that part of the decision. Both accepted that the land value had to be policy compliant and that policy compliant meant the provision of plan levels of POs. All land transactions have to be adjusted to that assumption.

Changes to National Planning Guidance (2018)

In the light of the increasing anxiety expressed in the literature, fully represented in the arguments around Parkhurst Road, the Government consulted in 2017 and produced new guidance in 2018. BLV is addressed in paragraphs 14 to 16 of the new NPG (2018) and developer's profit is addressed in paragraph 18. Profit is now virtually fixed at between 15% and 20% of gross development value which means that either land value or POs are the potential residual value.

Paragraph 14 introduces the concept of existing use value plus a premium as the main approach to assessing BLV:

> Benchmark land value should:
>
> - be based upon existing use value
> - allow for a premium to landowners (including equity resulting from those building their own homes)
> - reflect the implications of abnormal costs; site-specific infrastructure costs; and professional site fees and
> - be informed by market evidence including *current* uses, costs and values wherever possible. *Where recent market evidence is used to inform assessment of benchmark land value this evidence should be based on developments which are compliant with policies, including for affordable housing.* Where this evidence is not available plan makers and

> applicants should identify and evidence any adjustments to reflect the cost of policy compliance. This is so that historic benchmark land values of non-policy compliant developments are not used to inflate values over time.
>
> (CLG, 2014, Paragraph 14) (*emphasis added*)

The last bullet point in paragraph 14 raises a number of issues. Policy compliance is not defined elsewhere so arguments about what it means may continue. However, it does relate the market evidence of transactions to adjustments for policy compliance, picking up on the Parkhurst Road rulings. In some previous cases market evidence was used with no reference to policy compliance.

It also uses the word *current* which appears to rule out any growth modelling. The implications of that will be highlighted by the modelling process.

There is limited guidance in NPG 2018 on the EUV plus premium basis of BLV and the evidence required to determine the premium element. Paragraph 16 is set out in full below.

> **"How should the premium to the landowner be defined for viability assessment?**
>
> The premium (or the 'plus' in EUV+) is the second component of benchmark land value. It is the amount above existing use value (EUV) that goes to the landowner. The premium should provide a reasonable incentive for a land owner to bring forward land for development while allowing a sufficient contribution to comply with policy requirements.
>
> Plan makers should establish a reasonable premium to the landowner for the purpose of assessing the viability of their plan. This will be an iterative process informed by professional judgement and must be based upon the best available evidence informed by cross sector collaboration. For any viability assessment data sources to inform the establishment the landowner premium *should include* market evidence and *can include* benchmark land values from other viability assessments. Any data used should reasonably identify any adjustments necessary to reflect the cost of policy compliance (including for affordable housing), or differences in the quality of land, site scale, market performance of different building use types and reasonable expectations of local landowners. Local authorities can request data on the price paid for land (or the price expected to be paid through an option agreement).
>
> MHCLG, 2018b, paragraph 16 (*Emphasis added*)

The important phrases concern the data sources and suggest that it *should* include market evidence and *can* include evidence from other viability assessments. At present, although MHCLG want the primary basis to be EUV plus the premium, the evidence base is still biased towards market transactions and that will open up the use of land transaction evidence. The implications of that are set out below.

Circularity and growth modelling.

A residual valuation with simplified valuation inputs from the Parkhurst Road appeals is utilised below to identify how the circularity question works and whether a growth model would have produced a different set of outcomes.

The important components of the residual model are:

- the value of the completed development;
- the costs of development including construction, finance and fees;
- a profit to the developer;
- any section 106 and other payments to the community; and
- the land value/price.

The figures are hypothetical but broadly based on the actual figures used in the Parkhurst Road valuations. Table 1. sets out the basic inputs.

Table 1 - Parkhurst Road Current Values and Costs

Insert Table 1 here

In this particular case EUV plus a premium is an irrelevant concept as the EUV was deemed negligible. Additionally, both parties agreed that the profit level should be about £7,000,000.

Table 2. sets out four possible approaches to the development viability assessment.

Table 2 – Valuation Scenarios

Insert Table 2 here

Valuation 1 is a policy compliant land valuation based on a residual approach assuming the delivery of the full complement of POs. It has ignored the transaction price. It suggests the BLV should be £7 million. It is the policy compliant market value assessed by a residual approach.

However, the developer had paid £13.26 million for the site and the developer argued for £13.25 million as the BLV. Using RICS guidance and the PPG as authority, they argued that other sites had sold for similar figures and therefore that proved that the purchase price was also the norm and should be used. In the first appeal the inspector agreed that the BLV should be £13.25 million.

Valuation 2 sets out the consequences of that decision. With a fixed land value and a fixed profit level, the residual component becomes the POs, and they are halved.

The second inspector overturned that and found for a BLV of £6.75 million. The High Court agreed that £6.75 million was the policy compliant BLV. By finding for a BLV of £6.75 million, the second

inspector and the High Court judge implied £13.25 million was an overpayment. But is it really an overpayment or is there a modelling issue here?

Valuation 3 sets out an alternative solution that suggests that, if a growth model is used, both the overpayment for land and full planning requirements can be explained. Say, for example, residential sales values are expected to rise over the development period and the costs are based on a partially fixed price tender contract over the development period (which still normally allows for some changes). The residual valuation would throw up a higher residual land value. If we assume a completed sale value at say £66,387,500 (17.5% increase on current sale value) and costs at perhaps £33,000,000 (10% increase), what will the valuation look like?[3]. Despite having really paid £13.25 million for the site, and producing the full policy compliant POs, the development still produces a profit of over 7,600,000. There is no overpayment. But the existing modelling framework for viability can't identify this more rational explanation of the actual viability of the site.

Valuation 4 illustrates the pre-2018 situation and how it ended up when the planning inspectors made decisions to use the unadjusted prices paid for sites as the basis for BLV. In this hypothetical case, it leads to excessive developer and landowner returns. Instead of the LPA getting the full policy compliant amount of £12,500,000, they end up with half that at £6,250 and the developer walks away with a basic profit level at £7,000 plus another hidden additional bonus of almost £7,000, virtually doubling the profit to nearly £14 million. The landowner still gets £13.25 million. While the proceeds of the development increase by £7 million approximately, the LPA gets a reduced amount of over £6 million. A £13 million windfall shared between developer and landowner.

If this pre-2018 process was seen to be a game it would be likened to "pass the parcel". The parcel is the residual value that is left after all other development costs have been paid for out of the development proceeds. Developers usually hold this residual parcel and therein lies the risk of development (for which they are richly rewarded by a massive risk premium above the risk free rate).

The case study has shown that the residual parcel amount within any appraisal is originally in the hands of the landowner (Valuation 1). Normally, when the land is purchased, the residual passes to the developer. But in the case of viability assessments, the developer, by getting a (virtually) fixed level of profit within the assessment, can pass that parcel through to the LPA. The parcel holds the development risk (Valuation 2). Valuations 3 and 4 show an added perspective to the circularity issue with the addition of value change. Having used the system to shift the additional land costs onto the

[3] The growth factors are exaggerated here to illustrate the point. They have no grounding in market evidence around Parkhurst Road at the particular time period

LPA, the developer has improved their position. They still hold the up-side benefits of risk taking without all of the downside and if variation is positive (growth) they are in a position to keep it all.

The case study is partial. However, there is evidence that land has been sold above the prices suggested by the viability appraisals with policy compliant POs, that developers require their returns to be protected and that the model being used in viability assessments is the basic residual model.

The evidence for prices above valuations is not systematic but there are instances of sites, having gone through viability appraisals which reduced the affordable housing content, being sold with the planning permission for significantly above the BLV in the viability assessment. For example, Crystal Palace Road in East Dulwich. In July 2015 the existing use value of the property was argued to be £1.4m and the development land value only £383,000 by the appellant in a planning appeal. The inspector accepted the valuations and agreed that the site was not viable, and removed the affordable housing. But in February 2016 the Land Registry recorded a price of £5.1 Million for the sale of the site. Why would anybody bother to get planning permission if the development value was just over 20% of existing use value? The answer is the residual development value was not £383,000. It was realised at £5 million with the benefit of a permission that had no affordable housing. Even allowing for the reinstatement of the full policy level of affordable housing, there is a likelihood that the site is viable with a land value residual above the existing use value.

There is also anecdotal evidence of developers arguing that their returns should be protected through time. A prime example is a large site in Battersea where the LPA agreed to reduce the affordable housing content based on the developer's arguments that an existing project has fallen in value relative to costs. The developer argued that they needed a reduction in affordable housing contributions to *maintain* their target IRR of 20%. Review mechanisms such as this, which allow development return shortfalls to be reclaimed, appear quite bizarre within the normal risk/return framework. In effect, the developer's downside risk has been passed to the LPA. Development returns are high to allow for high variation in those returns so they should accept that they win when the market goes with them and lose when it does not.

Discussion and Conclusion.

There is little doubt that the 2014 PPG created a market place that could be distorted and impact on the level of land prices. Developers could argue that that there is no proof that land prices are distorted and that current market levels are justified but it is obvious that the mechanisms exist for some sort of clawback within the modelling process. If the viability model presented here is accurate, the Parkhurst Road land transaction was grossly over-priced. If the price was the proper

justifiable price, the viability model as applied within PPG can't recognise it. Regardless of the correct interpretation, the landowner and developer won the gaming process until the second Parkhurst Road decision, confirmed in the High Court, and the publication of the new NPG.

While the old regime developed to allow developers to pass on increased payments for land to the LPA in the form of reduced POs, the new planning policy and practice guidance attempts to stop the gaming process and reframe the negotiations. The emphasis on assessments at the local plan-making stage is designed to stifle arguments at the decision-making stage. Unfortunately, BLV assessments, the target for the gaming issues, is more complicated at the plan-making stage as the policy requirements are not yet fixed.

Although NPG has recognised some of the issues surrounding the operation of the old PPG, it is not clear that it has found the correct solutions. The first point of contention is the meaning of policy compliance. NPG (2018) has not defined clearly what is meant by policy compliance and so arguments will persist that land transaction evidence is policy compliant as policy compliance is the delivery of viable POs. Policy compliant needs to be unambiguously defined on the basis of planning requirements in the plan, not what is being delivered on the ground.

Second, despite attempting to place major emphasis on EUV plus a premium, there is no recognised evidence base for premiums under the new policy regime. Reliance on existing policy requirements and viability assessments for the premium will only be workable when the new regime is established. Even then, developers/valuers will continue to place more emphasis on market evidence and land transactions. However, assuming definitions of policy compliance related to plan requirements are adopted, Parkhurst Road and the new NPG require that transaction evidence is adjusted to plan policy levels of POs. If this definition prevails, it will solve one part of the circularity issue. However, there is still the problem of a lack of any stated planning requirements at the plan-making stage so arguments need to be based around emerging new plan policies rather than existing policies.

The new NPG has not solved the other issue related to growth modelling. It persists with the use of current costs and values. Even when transaction evidence is adjusted, if LPAs allow the adjusted land price to be inserted into the residual model without allowing for growth, they will allow the POs to become the residual amount. The POs will still be eroded. Viability modelling guidance must make sure that under no circumstances is the land value, found from market comparison of land transactions, used as a BLV in a residual valuation. The residual land value and the transaction based land value must be assessed separately and should become part of the iterative process outlined in

paragraph 16 to identify BLV. If that provision is not included, circularity and growth modelling issues will continue to distort the modelling process.

The Parkhurst Road decision is still fundamentally flawed. The question is how, even when the EUV was a meagre £750,000, the site still did not deliver a full complement of POs within a very high value residential market in London? If the residual development land value is above EUV, there is an argument for saying it is viable. Development values are created by the planning regime, the planning regime needs to work within a market environment but not be subservient to it. This will only be possible if land transaction evidence is relegated to the role of cross-checking other evidence of BLVs.

Both problems discussed in this paper, the use of comparables and the use of current values and costs, have a similar source, the old PPG. The 2014 PPG was fundamentally flawed. Paragraphs 8, 14, 17, and 23 of the Viability section of PPG appeared to be a major cause of the reduction in the provision of affordable housing provided through POs and needed redrafting to:

- Define policy compliance
- Place the emphasis away from the land transaction comparables, and
- Allow the model to be applied as it is in the market place with due regard to expected events over the development period.

The new NPG has addressed the first and second issues, up to a point, but has seemed reluctant to act on the third. The emphasis has changed so that policy compliance dominates the assessment of comparable evidence. There is an explicit requirement to use land sales in evidence of sites that are delivering policy compliant POs (or are adjusted to policy compliance for any non-policy compliant sites). The lack of a definition of policy compliant still leaves the door slightly ajar.

Regarding the use of current costs and values, the new PPG has not (yet) solved the problem and needs one word deleting from it, *current.*

There is no doubt that the new NPG has responded to many of the flaws identified in the application of viability modelling. It accepted that the 2014 PPG had been used to game the system to the benefit of landowners and developers. It may have left other flaws alone and introduced some new areas of debate and negotiation. Overall, the improved transparency regime under the new NPG should enable any issues to be addressed more quickly than under the more opaque past regime of development viability modelling. Hopefully, the new NPG will be successful in reversing the trend of a diminishing ratio of affordable housing provided through POs.

Author Note

This paper has been developed during a period of rapid policy and practice change. At the time of the first draft, Government was consulting on proposed changes to the 2012 NPPF and 2014 PPG and the evidence and conclusions within the paper were developed for and submitted to that consultation. The arguments put forward in the paper were partially accepted within the revised NPG. Subsequently the author was co-opted onto the RICS committee working on the revised Financial Viability in Planning Guidance Note and these issues have been addressed within that committee, observed by the MHCLG. At the time of submission of the final version of this paper, the RICS Guidance Note was still under discussion, as were possible changes to the viability section of the NPG on account of these arguments. By the date of publication it is hoped that the RICS Guidance Note will have been published and NPG may have changed and it remains to be seen if any of the recommendations are included in a new NPG or the RICS Guidance Note.

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Table 1 - Parkhurst Road Current Values and Costs

Value completed development	£56,500,000 net of any agency costs
Costs of development	£30,000,000 including fees and finance costs[4]
Policy compliant planning obligations	£12,500,000 including CIL, AH, Section 106.
Development profit	£7,000,000
Existing use value (EUV) of the land	£"negligible" (agreed at £750,000)
Price paid for the land	£13,260,000

Table 2 – Valuation Scenarios

Valuation 1 £'000		**Valuation 2 £ '000**		**Valuation 3 £ '000**		**Valuation 4 £ '000**	
GDV	£56,500	GDV	£56,500	GDV	£66,387	GDV	£66,387
Costs	- £30,000	Costs	- £30,000	Costs	- £33,000	Costs	- £33,000
Profit	- £7,000	Profit	- £7,000	POs	-£12,500	POs	-£6,250
POs	- £12,500	Land price	-£13,250	Land price	-£13,250	Land price	-£13,250
Land residual	**£7,000**	**Residual POs**	**£6,250**	**Residual Profit**	**£7,637**	**Residual Profit**	**£13,887**

[4] There is a strong argument that finance has no part to play in development appraisal and these arguments are set out in, for example, Coleman, et al (2013).