GAP FUNDING FOR LAND AND PROPERTY DEVELOPMENT

The support that's needed in Britain's older industrial areas

Summary

In much of older industrial Britain, where property values are low, the private sector often fails to invest in industrial and commercial floorspace. This restricts local economic growth and works against the UK government's levelling up agenda. 'Market failure' hinders the reclamation of brownfield sites, impedes the flow of new quality workspace, makes it more difficult to protect historic buildings and is an obstacle to re-purposing buildings. This note calls for a plentiful supply of gap funding to address the problem, including making use of the new Levelling Up Fund and the forthcoming Shared Prosperity Fund. It also calls for grants rather than loans, and for new mechanisms to share the risks that otherwise fall on local authorities.

What's the problem?

The UK government has made a welcome commitment to levelling up. For the cities, towns and smaller communities of older industrial Britain, hit hard by years of job loss, the commitment is long overdue.

Delivering levelling up requires action across a broad front but an important part of the jigsaw is making sure that property markets work to deliver the investment in land and buildings that is a key to economic growth. At present, this is not happening. Indeed, across much of older industrial Britain private sector developers typically avoid investment in speculatively-built industrial and commercial property. They see the financial returns as too low, and the risks too high.

These days most businesses, especially small and medium-sized enterprises (SMEs), either rent the buildings they occupy or in some cases buy property that is already on the market. Building their own premises, from scratch, simply takes too long. A healthy flow of property to rent or buy is therefore important. Without the physical space to accommodate new and growing firms, local economic growth can be stymied.

For a private developer working without public subsidy, the viability of industrial and commercial property development depends on the rent that a building will command, which in turn drives its capital value. If rents are high the developer can normally afford to buy land, make any necessary investment in clean-up and infrastructure, put up a building and still make a profit. If rents are low the amount a developer will to pay for land is lower but once spending on clean-up, infrastructure and building is added in the developer's total costs will often exceed the value of the completed development.

The problem in most of older industrial Britain is that rent levels are low – too low in many cases to make private sector investment viable without public sector support. To illustrate this point, Table 1 compares rateable values for office, industrial and retail floorspace in a selection of local authorities across England and Wales:

- Six London boroughs

- Six cities and towns in prosperous southern England

- The nine main cities in the Midlands, North and Wales

- Fifteen local authorities covering older industrial areas – three in each of the North East, North West, Yorkshire, Midlands and Wales

Rateable values are based on rents. The figures here come from the UK government's Valuation Office Agency and whilst there is no comparable published data for Scotland there is no reason to suppose that the relative position of older industrial areas in Scotland will be any different.

What is clear is that property values – measured here by rateable value per sq. metre – are far lower in older industrial areas than in London, than in the prosperous South, and all but a few cases than in the main regional cities. The differences are sometimes huge:

- In Westminster, each sq. metre of office space is worth thirteen times as much as in Redcar & Cleveland in North East England

- In Cambridge, Guildford, Brighton and Reading, industrial floorspace is worth almost three times as much as in Barrow in North West England or Neath Port Talbot in South Wales

- In all the main regional cities, retail floorspace is worth up to twice as much as in this group of older industrial areas

These differences have profound implications for the way the industrial and commercial property market operates. Put simply, the returns to development are too low in much of older industrial Britain to justify private sector speculative development. If land can be bought at rock-bottom prices and if a big-name occupier can be signed up in advance of development then maybe the economics of a project just about stack up. But if there are large reclamation costs that cannot be avoided, or for example costs associated with flood defences, a speculative development in much of older industrial Britain is simply not viable.

This is classic 'market failure'. Left to its own devices, the market does not provide the industrial and commercial floorspace that's needed and because this floorspace doesn't get built the growth of the local economy is constrained and the low market value of properties is perpetuated.

Table 1: Rateable value per sq. metre, 2019-20: selected local authorities

OFFICE (Eng. & Wales average = 100)		INDUSTRIAL (Eng. & Wales average = 100)		RETAIL (Eng. & Wales average =100)	
Westminster	294	Kensington & Chelsea	385	Westminster	474
Camden	236	Westminster	300	Kensington & Chelsea	325
Kensington & Chelsea	229	Camden	269	Hammersmith & Fulham	270
Southwark	190	Tower Hamlets	267	Camden	258
Hammersmith & Fulham	157	Hammersmith & Fulham	215	Tower Hamlets	196
Tower Hamlets	147	Southwark	213	Guildford	161
Cambridge	125	Cambridge	179	Oxford	154
Reading	112	Guildford	177	Cambridge	148
Guildford	102	Brighton	169	Southwark	142
Bristol	83	Reading	169	Brighton	126
Brighton	79	Oxford	133	Reading	123
Manchester	76	Southampton	133	Leeds	112
Oxford	71	Bristol	110	Sheffield	107
Birmingham	68	Cardiff	100	Manchester	104
Leeds	68	Wakefield	97	Newcastle upon Tyne	102
Southampton	67	Leeds	95	Cardiff	102
Cardiff	60	Birmingham	92	Southampton	92
Newcastle upon Tyne	53	Newcastle under Lyme	92	Liverpool	92
Liverpool	52	Manchester	90	Nottingham	92
Nottingham	51	Bolsover	85	Birmingham	89
Sheffield	51	Doncaster	85	Bristol	89
Rhondda Cynon Taf	45	Newcastle upon Tyne	82	Bolsover	83
Sunderland	44	Nottingham	79	Gedling	80
Wigan	44	Sunderland	79	Sunderland	77
St Helens	44	Wigan	79	Bridgend	75
Bridgend	44	Gedling	79	Wakefield	73
Barnsley	43	St Helens	79	Wigan	70
Northumberland	43	Barnsley	77	Northumberland	69
Newcastle under Lyme	43	Sheffield	74	St Helens	69
Bolsover	42	Liverpool	74	Doncaster	68
Doncaster	40	Northumberland	69	Newcastle under Lyme	65
Gedling	40	Rhondda Cynon Taf	69	Redcar & Cleveland	63
Wakefield	40	Redcar & Cleveland	67	Barnsley	62
Neath Port Talbot	36	Bridgend	67	Rhondda Cynon Taf	59
Barrow in Furness	34	Neath Port Talbot	62	Neath Port Talbot	57
Redcar & Cleveland	22	Barrow in Furness	62	Barrow in Furness	51

London boroughs in blue
Prosperous southern England in green
Main regional cities in yellow
Older industrial areas in pink

Source: Valuation Office Agency

The consequences of market failure

Sites with negative land value

Many of the largest brownfield sites that once blighted older industrial Britain have now been cleaned up through the work of government agencies. Over a hundred former colliery sites, for example, were remediated and regenerated through the National Coalfields Programme. Where undermining for stone, chalk or salt threatened subsidence, these were dealt with by the Land Stabilisation Programme. Where a major industrial site has closed leaving significant contamination issues, such as the steelworks in Redcar, the government has sometimes established a Special Purpose Vehicle to lead the clean-up. In the case of the UK's earliest nuclear power stations, the Nuclear Decommissioning Authority takes the lead.

However, in just about all older industrial areas there are still derelict or contaminated sites for which a solution remains to be found. The problem is negative land values – the cost of cleaning up and site preparation exceeds the value of the completed development-ready site. In these circumstances the private sector fails to bring the site to market.

There is no typical site. Some former colliery and steel sites are large, covering many hectares but sites can also have a much smaller footprint, such as cotton and wool mills, gasometers or other ex-industrial sites that have fallen into disuse or disrepair. In areas where rents are high, these sites 'wash their face' commercially. For example, canal-side mills and warehouses in central Manchester have been converted into urban living space. In areas where rents are low, they become the domain of cheap workspace and storage, often at prices which are not sufficient to maintain the fabric of the building.

New quality workspace

In several market segments in older industrial Britain the private sector shows a reluctance to invest in new quality workspace. Private sector developers are sometimes willing to invest in large 'sheds', generally on the outskirts of towns and often with a specific occupier signed up from the outset, but the private sector rarely if ever invests in speculatively built space for SMEs, in incubator units for start-ups, or in high-quality office space in town centres. In their eyes, the returns from investment are not sufficiently secure or high enough and they do not take the risk.

At one time, local authorities were in a financial position to develop and build industrial units and workspaces for SMEs, and central government itself played a key role through agencies such as English Estates and the New Town development corporations. At other times there have been public-private partnerships to develop workspace such as Priority Sites and Network Space. However much of the earlier accommodation has become dated, even run down, and does not provide for the needs of newer industries.

Protecting historic assets

Many older industrial towns have historically and architecturally important buildings that are central to the identity of the place but whose former use has run its course. These include distinctive older industrial buildings, such as warehouses and mills, but also cinemas, pubs, church halls, shops and even quite a number of town halls left over from the days before local government re-organisation. In some cases, the buildings are listed or in a conservation area.

In areas with a stronger economy the market generally works to re-purpose these buildings, for example as workspace, living space or as a cultural hub. However, in areas of market failure these grand old ladies face a sad decline, with commercial rates of return unable to justify major investment to change their use or even to keep them in a fit state of repair. They can become a blight rather than an asset.

Similarly, there can be local housing that has historical and cultural value but whose future is in doubt. Examples include the 'model villages' often associated with mining communities. Where rents are low and ownership has become fragmented, these can fall into disrepair.

Re-purposing buildings

Lifestyles are changing: where we shop, where we go for leisure and where we work. Also, 'rationalisation' has meant that many of the services that we might once have accessed in town centres have either been transferred elsewhere or gone online. Many older industrial towns find they have too much of the wrong sort of accommodation, such as retail or older-style office space. Empty frontages cast a shadow over the town and make it less attractive to consumers and investors.

Changing the use of surplus buildings or adaptive re-use can be a costly exercise and, where the economy is weak or there are low and falling property values in struggling high streets, too risky for the commercial developer. Again, the market is failing.

The regeneration of town centres is an acute concern as the UK emerges from the pandemic, which has accelerated the shift to internet shopping. The collapse of flagship retailers such as Debenhams and the Arcadia Group (Top Shop, Burtons, Dorothy Perkins etc.) means their disappearance from high streets already afflicted by vacant properties. Some of the bigger shopping centre management companies have themselves been struggling, as witnessed by the demise of the Intu Group in 2020. In many places, it is hard to see that the market alone will deliver the re-use or re-purposing of buildings

Additional obstacles

Time

Solutions to market failure are not something that can generally be delivered overnight. For a start, where there are fundamental challenges in a local economy it is unlikely that a one-off, short-term intervention will turn around years of structural weakness. Given time, however, it is possible to make real progress.

Take the example of the former coalfields. The National Coalfields Programme was first established in 1996 to reclaim the many colliery sites across England that the private sector shied away from because of remediation costs. At its peak, it was the largest land reclamation programme in Europe, growing to cover 107 sites. The programme had a multi-year budget, initially under the wing of government agency English Partnerships, with its own management team. The target completion date was 2012 but jobs and homes are even now still being created on some of the sites. Overall, for a net cost to the Exchequer of around £400m some £2bn of private sector investment has been levered onto the sites.

Another example of potentially long timescales is the redevelopment of Barnsley town centre. Plans were first announced in 2003 but put on hold after the 2008 financial crisis and then revised to upgrade existing buildings rather than replace them. As local authority finances were squeezed and funding sources dried up, the council persisted: a new transport interchange was built, as were new council offices, a hotel, offices and a hub for community groups. More recently a new library has opened, the existing market buildings have been remodelled and a new entertainment complex is under construction. The entire project will have taken nearly two decades.

Ownership

One of the barriers to development can be a network of ownership that has to be resolved before plans can move forward. Often sites, whether it be town centres or former industrial sites, can have a patchwork of ownership. Some land may be in local authority hands, some may be held by large landholders, some may be owned by private individuals and other parts may belong to the NHS or utility companies. There may also be issues surrounding leasehold and tenancies. The time it takes to get all the partners to the table is often vastly underestimated and the non-cooperation of a single partner can jeopardise a whole scheme.

An example is the former steelworks in Redcar. It has taken several years to bring the site back into single ownership following fragmentation and break-up. The site is immense, covering over 430 hectares, making it Britain's largest ex-industrial zone. After steel production ended in 2015 the government created the South Tees Development Corporation to oversee its regeneration. Land assembly took four years and £233m is being spent just to get to the stage where development can begin. In contrast, when the Ebbw Vale steelworks closed in South Wales the early 2000s the site was still in single ownership and moved quickly to the public sector for redevelopment.

State Aid rules

Where there is public sector intervention in failing property markets the issue of State Aid rules – or 'subsidy control' in the UK government's new terminology – raises its head. There are legal limits to how much financial support can be offered and for what purpose. For example, if public land is sold below market price this counts as a subsidy and falls within the scope of the rules.

Until the end of 2020 the UK lived within EU State Aid rules. The UK government is presently consulting on a new UK regime for subsidy control, which is unlikely to be in place for some while because it will almost certainly require legislation. During the interregnum between the old and new rules, public bodies across the UK face considerable uncertainty about exactly what they can and cannot do to subsidise developments. The default position is that they will continue to behave as if the EU rules are in place, which is perhaps the only sure way to ensure that their decisions are not challenged.

The diminished supply of gap funding

Gap funding for projects that are not deliverable by market forces alone has long been part of the economic development toolbox. It has enabled financial support to be given where there is market failure, where remediation costs are otherwise prohibitive, and to enable speculative development in places where the private sector is reluctant to invest. However, in recent years, the availability of gap funding has decreased.

In England, there have been several schemes over the years – the Urban Development Grant, the City Grant and the Partnership Investment Programme for example. The Regional Development Agencies were also at one time a major source of gap funding. More recently, gap funding from central government has increasingly become contingent on successful bids for funding from the Local Growth Fund or, just at present, the Towns Fund and Future High Streets Fund.

In Wales, from 1976 until 2006 the Welsh Development Agency provided gap funding. The Agency absorbed the Derelict Land Unit created in the wake of the Aberfan disaster and its responsibilities were eventually brought in-house by the Welsh Government. A Contaminated Land Capital Fund was established but terminated in 2011. Since then, there has only been ad hoc funding.

In Scotland, the Land Commission reported that almost a third of the population lives within 500 metres of a derelict site. The amount of land on the Vacant and Derelict Land Register has remained static for years and there is limited funding available. A newly announced Vacant and Derelict Land Investment Programme is worth £50m over five years but makes only £5m a year available in each of the first two financial years, open to bids from all Scotland's 32 local authorities. A Regeneration Capital Grant Fund, with a budget of £20m a year, tackles market failure as one of its aims. The EU-funded SPRUCE scheme has dealt specifically with brownfield and contaminated land but closes in 2021.

Brexit poses new challenges. The EU Structural Funds have historically been a major source of finance for land and property development but no new EU-funded spending commitments are now possible. The UK government's proposed replacement – the Shared Prosperity Fund – will not be operational until April 2022 and the extent to which it will be available to provide gap funding remains to be determined.

Prior to Brexit, the European Investment Bank (EIB) invested about £5bn a year in the UK economy. The EIB supported projects by providing loans and by guaranteeing that it would cover certain risks so that other financial institutions would be more likely to invest. The UK's new National Infrastructure Bank will take over some of these functions but, with a budget of just £1.5bn a year, on a reduced scale.

What's needed?

A PLENTIFUL SUPPLY OF GAP FUNDING

At the core, a plentiful supply of gap funding is needed to unlock land and property development in the parts of the country, such as much of older industrial Britain, where the private sector is reluctant to invest by itself. There is nothing new in this observation, and gap funding is far from a new invention, but it remains the key tool to unlocking development in these places.

Realistically, there is never going to be a single UK-wide funding stream that will provide all resources that are needed. As in the past, the devolved administrations can be expected to develop their own initiatives and in England there is the potential for more than one budget line to provide gap funding.

The UK is however at a pivotal moment, with the new emphasis on levelling up and the introduction of UK-wide spending programmes such as the Levelling Up Fund and the Shared Prosperity Fund. It is important that the design and operation of the new funds makes full provision for gap funding where it is needed.

GRANTS NOT LOANS

In places or sectors of the market where there is market failure, the primary need is for grants rather than loans.

In areas where property values are high an initial loan to put in infrastructure, for example, may open a site up for development and the value of the completed development is likely to be more than enough to enable the loan to be repaid. In these cases, it is worthwhile for developers to take out a loan on commercial terms. The loan deals with a cashflow problem.

Where there is market failure, the same level of investment may open up a site but the value of the completed development fails to provide enough to repay the loan. In these circumstances a low-cost loan from the public sector will reduce a developer's total costs by a few percentage points and occasionally tip the balance, but in most cases a small reduction in costs fails to solve the fundamental problem. In the least prosperous parts of the country, where the extent of market failure is greatest, only a grant rather than a loan will make something happen.

SHARING THE BURDEN OF DE-RISKING

Some local authorities use their reserves to invest in projects to kickstart the local economy, where the private sector is less keen to step in. Doing this comes at significant risk to the authority. If the project fails, for whatever reason, the financial burden ultimately falls on the local ratepayer.

These are risks that only the local authorities in the less prosperous parts of the country are under pressure to take. Elsewhere, where the property market is working smoothly, councils don't need to intervene directly to make developments happen because the private sector doesn't need the same financial help.

There needs to be a mechanism to 'de-risk' local authorities where investment decisions are taken in the best interests of the economy. A matching contribution from the UK government or the devolved administrations, or from their development agencies, would spread the risk and ultimately be in the interest of all players.

Industrial Communities **Alliance**

The Industrial Communities Alliance is the all-party association of local authorities in the industrial areas of England, Scotland and Wales

The present document has been developed in consultation with economic development practitioners from Alliance member authorities, drawing on their hands-on experience and expertise in understanding how property markets function in older industrial areas.

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