a return to development freakonomics

Following an earlier article on planning and development economics, Michael Beaman suggests that there are still more common misconceptions on the subject of development viability

Development viability continues to be a key issue for planning policy-makers and practitioners, with the latter piling on the pressure for it to be a critical factor in planning matters. Both flounder in their efforts to make sense of the issues involved. In the June 2012 issue of *Town & Country Planning*, following the style of Steven Levitt and Stephen Dubner's popular *Freakonomics* books, I showed why independent viability appraisals struggle to achieve a reasonably accurate view of whether a scheme stacks up or not, and I tried to unpick some aspects of the economics of the development business that are frequently misunderstood.[1] Here, in a second article, I take aim at a few more.

The 'winners curse' – a bigger threat to viability than planners!

How often do developers complain that planning contributions do not allow them to make a return on their investment in a site? As they see it, compromise is needed or, better still, different policies. But I contend that the main threat to viability isn't planning contributions[2] but a feature of the land market, and that willingness to compromise can be counter-productive.

In many cases the real problem developers face is a simple market bias that leads them to pay too much for the land they buy. This is an economic affliction known as the 'winner's curse', which is succinctly described on Wikipedia as 'a phenomenon akin to a Pyrrhic victory that occurs in common value auctions with incomplete information [where] the winner will tend to overpay'. Auctions and open-market sales techniques are designed and staged to exploit this. A very recent example was the tender to run the West Coast Main Line rail services which was won, before the award was subsequently halted, by First Great Western at a price considered by many, not least its rival Virgin Trains, to be unsustainable.

How does this come about? From the independent appraiser's point of view, the price at which land is sold on the open market will usually exceed any calculation of what it might be worth for development, based on standard assumptions about values and costs. That can happen because the eventual purchaser paid a price that reflected a special interest and which could not be anticipated – for example, ownership of adjacent land, offering the prospect of realising so-called 'marriage value'. Or it might be because the purchaser knew more about the detailed circumstances or had a genuinely unique plan to exploit the development potential. But the most common reason for a high price is that the buyer succeeded by inflating the bid price with unjustifiably optimistic assumptions about those values and costs as well as about the planning permission that might be forthcoming.

So the real problem is not caused by the planning policies but by the marketing of sites being rigged in the seller's favour and resulting in buyers overpaying. The main exceptions are where planning policies really are silly or where land values are low. There are a limited number of ways in which the developer can recover from the consequences of this over-payment, and often planners are the first port of call.

The value of design

It is surprising how many practising planners believe that it is axiomatic that investment in good design will improve the economics of a scheme, and how few have given any detailed thought to how the transmission mechanism involved actually works. In practice, a developer's appraisals will not include a line for soul balm, so in order for

investment in design to improve perceived viability, there must be a confident expectation that at some point down the line it will lead to higher sales values and/or lower costs.

Cost reduction through good design is an unalloyed benefit if it can be achieved without compromising the value of a scheme. My experience of commercial development was that obsessive attention to the engineering and layout could sometimes pay dividends,[2] but housing schemes were more challenging because, with a standardised mass-market product, many of the potential ways of adding sale value or making savings had already been spotted.

A great thing about investment in design to achieve cost savings is that the trade-offs can be quantified in advance. In contrast, forecasting improvements to sales receipts needs a crystal ball. Investment in higher standards only adds financial value to buildings if they offer something which a buyer will pay more for, on a scale that provides an adequate reward for both the extra costs and risks involved. These risks are real, and crystal balls tend to be cloudy. In a large and diversified market, you can get away with a niche design, but in smaller markets the result might be slower sales. BedZED, the Beddington Zero Energy Development in Hackbridge, Sutton, is a good example. It attracted buyers in London but, built on that scale and priced to provide a proper return on its (high) costs, it would probably have struggled to attract enough buyers elsewhere.

In terms of estate layout, some research has suggested that while quality design results in premium values, these mainly accrue when a house is sold on; i.e. the developers bear the cost but do not get the benefit. It is easy to see how this can happen when the investment is in landscaping that is not mature at the time of first sale.[3]

In the commercial world, investors in particular are increasingly prepared to pay a premium for sustainable buildings and will sometimes actively avoid buildings if, for instance, they do not meet BREEAM standards and might thus be more difficult to let in the future. Novel spatial layouts can be more problematic. For example, the Ark building at Hammersmith was designed by Ralph Erskine and lauded for providing good working conditions in an attractive and sustainable building, but in practice the layout was found to be awkward to use, and as a result the building lay empty for many years until it was remodelled, allegedly at a cost of £20 million.

There is an increasing amount of research on this topic, although much of it does not directly relate to UK experience.[4] Oddly, there is more useful research on commercial development than housebuilding, given the relative preponderance of the latter, even in these benighted times. Studies from CABE and The Prince's Foundation[5] had a go, but tried too hard to prove the positive case and would have benefited from a bit more academic rigour. RICS (the Royal Institution of Chartered Surveyors) seems to have opted for the carrot rather than the stick and invested in more dispassionate research into the merits of the case for investment in sustainability standards, in the hope that this might do more than propaganda to influence the property business.

The profit on a scheme is the developer's key measure of success

This is a misleading idea which can distort the way in which policies are formulated and planning permissions are negotiated.

First, in this context the term 'profit' is often used loosely and inaccurately as a label for the margin or return on a scheme, which is the difference between receipts and costs expressed either in absolute terms or as a percentage. This is not the same as the profit in the hands of the development company, which factors in all the general costs of running a business, such as overheads, depreciation, actual finance costs, and taxes, none of which appear in a conventional development viability appraisal.[6]

'The margin is one of a number of measures of operational efficiency and not a reliable guide to the viability of a scheme'

More importantly, the real aim of most businesses is not the margin that its individual projects or products achieve but the annual return it makes on its shareholders' money. When you push Grannie down the stairs and invest the modest legacy you inherit, you judge the savings accounts on the market by the annual interest rate on offer and not by the actual amount of money that you might get back. For instance, if you had £1,000 to save at present you might be delighted to get a return or margin of £50 after a year, because that would be equivalent to 5% per annum. If on the other hand it took five years to earn that £50, your annual interest would be less than 1% per annum, which you might reasonably regard as a pittance.

It is the same for the shareholders in property development companies. Their main concern is the annual return on their money rather than the margin on a particular project. The margin is only relevant in so far as it provides a level of comfort that receipts will exceed costs by a comfortable degree given the risks involved. It is one of a number of measures of operational efficiency and not a reliable guide to the viability of a scheme, which also critically depends on how long it takes you to make that margin and the risks involved.

This affects the scope for planning contributions. Einstein said that 'Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't, pays it.' In my earlier article I suggested that many developers would settle for an annual rate of return on the total amount of capital invested in their projects of around 15%, with the caveat that there is a wide range of actual targets. At this rate and if all other factors are equal, a planning contribution of £1 million now would have the same effect on the overall annual return on the developer's capital as a contribution of £1.8 million made in five years' time. So if the local authority was prepared to split the benefit of delaying the contribution each side might benefit by around £0.4 million, thus improving the pot available for infrastructure and the viability of the development. The trade-off isn't quite that straightforward and I am not sure that many developers would feel comfortable following this arithmetic to its logical conclusion, but it does illustrate the scope.

Given the effective cost of requiring planning contributions upfront when the developers require such a high return on their capital, why do so many planning authorities still insist on it in so many cases? It is not as if the money earns much in the bank these days! I believe it is because they do not think clearly enough about the nature of the risks involved. In many cases there is only a very small risk that a large and vital piece of infrastructure will not be delivered. Generally, non-delivery is usually a consequence of the non-delivery of the scheme that required it. In other cases the sums involved might be so small that it would hardly be worth a developer reneging on them. Wouldn't it be worthwhile trading these risks for significantly higher contributions?

But does any of this matter?

Obviously this is all good to know, but does it have any wider implications? I think that it does.

I start from the position that the viability of development should not be compromised without good reason – and also as a poacher turned gamekeeper. In the planning system, the default approach to assessing viability is increasingly to hire expensive consultants to run antediluvian appraisal models whose complexity is only matched by their inaccuracy. Call it quantitative tarot. It is a time-consuming, ineffective and unintelligent system.

Instead, we need more commercially literate planners who are willing and able to place more reliance on a bit of common sense. An example of what I mean can be found in the Community Infrastructure Levy (CIL) guidance. This doesn't compel planning authorities to spend a fortune on arcane calculations. If there are no applications on the desk or cranes visible from the window, there is a viability problem. If you can't see the window behind the stack of applications, there isn't. In many cases, it is likely that Inspectors will prefer clear evidence of what is going on in the real world to highly theoretical and contested viability modelling exercises. And it is much cheaper evidence to assemble!

In terms of policy design and scheme negotiations, more attention could usefully be paid to the timing and risk issues that developers face; to the trade-off between the timing of payments and obligations. In some cases demands for planning contributions to be paid upfront (and often in advance of real need) should be measured in the context of the real risk of non-delivery, and sacrificed in the interests of increasing the actual receipts and easing the developer's cash flow.

Finally, if developers tend to make optimistic assumptions when buying land, then the logical approach to dealing with many viability issues affecting individual sites is to ensure that sensibly gauged contributions policies are not flexible but explicitly and widely known to be non-negotiable, because the benefits of any flexibility will in many cases simply flow back to the seller of the land. The CIL is admirable in this respect, but there are still many planning contributions requirements that are effectively negotiable. In the long term, it is not the developers but the landowners who will benefit, and the number of instances in which the scale of contributions will be found to be genuinely critical to the viability of a scheme at the margin will turn out to be minimal.

● ***Michael Beaman*** *recently retired as an urban regeneration and growth areas consultant and now focuses on teaching. He is the author of the forthcoming RTPI Online CPD course on viability. His website is at www.regenerate.co.uk. The views expressed are personal.*

Notes

1 M. Beaman: 'Development freakonomics'. *Town & Country Planning*, 2012, Vol. 81, Jun., 277-80

2 I distinguish between planning contributions and wider design and layout policies here. The latter can have a far greater impacts on returns, and are rarely if ever considered in the context of their impact on viability

3 However, I have sour memories of allowing architects to innovate and being rewarded with leaky roofs and environmental systems with a mind of their own; often because they lacked the technical know-how to integrate specialist sub-contract packages successfully

4 A starting point for anyone interested might be the reports listed in a note on this topic which you can find under 'links' on my website, at www.regenerate.co.uk

5 The *Valuing Sustainable Urbanism* study, undertaken by Savills for The Prince's Foundation for the Built Environment (Jun. 2007; www.princes-foundation.org/what-we-do/projects/engage/policy) is often taken as proving the commercial value of design, mostly by people who have read the propaganda in the summary but not the full report, which presents a much more balanced and nuanced view

6 Most appraisals include a nominal interest calculation which is based on the unlikely possibility of the bank stumping up the full cost of the scheme and thus over-estimates the real cost involved