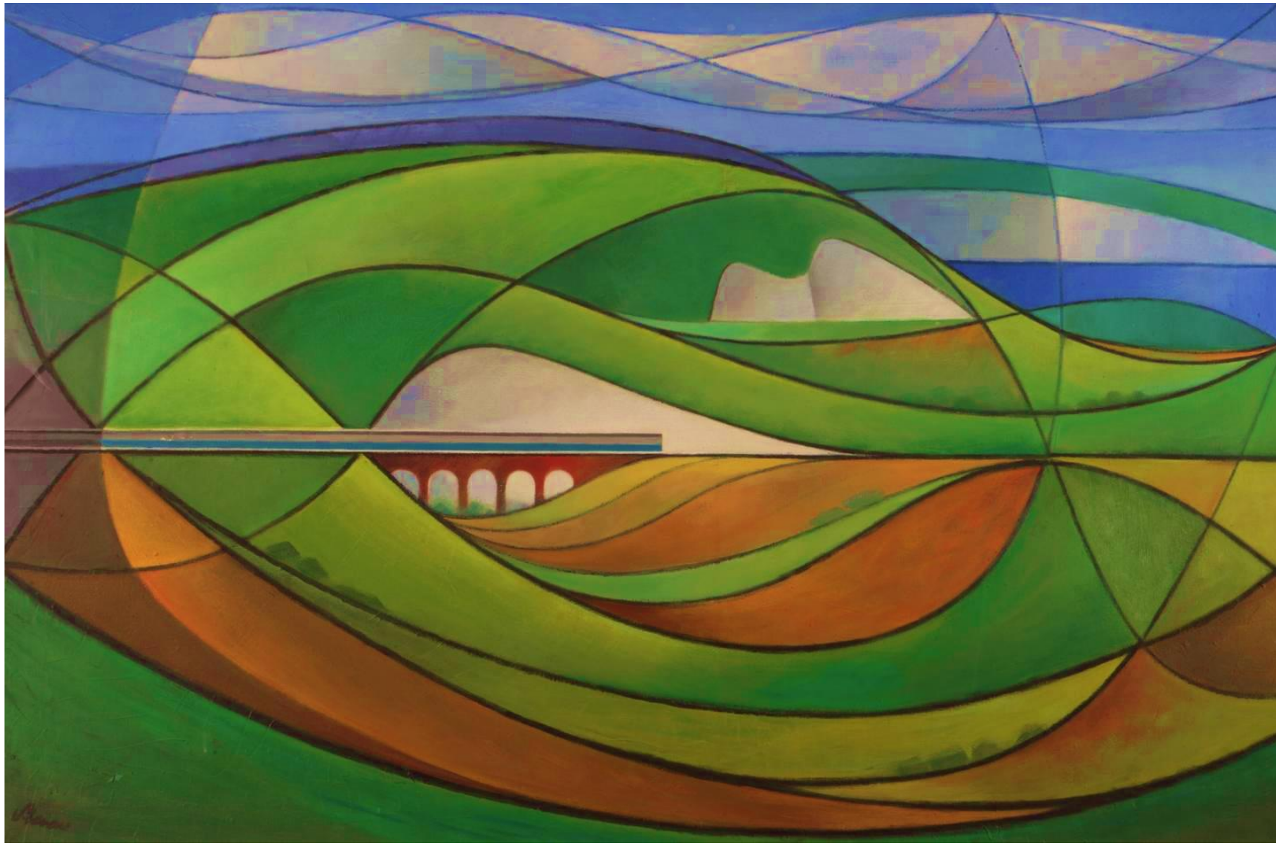
June 2022

# A Strategic Investment Plan for the South East - Funding and Financing Technical Annex (Appendix C)



Transport for the South East
Our ref: 24133701

steer

Report
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# A Strategic Investment Plan for the South East - Funding and Financing Technical Annex (Appendix C)

Prepared by:

Steer
28-32 Upper Ground
London SE1 9PD

+44 20 7910 5000
www.steergroup.com

Prepared for:

Transport for the South East
County Hall
St. Anne's Crescent
Lewes, BN7 1UE
Client ref: N/A
Our ref: 24133701



steer

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# Cover Photo

"Spirit of the Southern" (Harry Stevens, 1969)

*Science Museum Group Collection*
**https://collection.sciencemuseumgroup.org.uk/objects/co226606/spirit-of-the-southern-painting**

# 1 Introduction

## Overview

This annex provides further content to support the discussion in the funding and financing chapter of the Transport for the South East (TfSE) Strategic Investment Plan (SIP). In particular, it provides:

1) further contextual narrative to introduce and support the discussion of potential funding and financing approaches;
2) further detail on the illustrative analysis of scenarios for future central government funding for the programme; and
3) an overview of some of the potential new, alternative and innovative funding mechanisms that could in time support financial contributions to the programme.

# 2 Context – the funding challenge

## An ambitious, diverse, long-term and capital-intensive strategic investment programme

### Overview

2.1 Overall, the programme will have a very significant investment requirement (we estimate around £45 billion in capital spend alone, including inflation) and will need to be delivered over a number of decades.

2.2 Within the programme are individual interventions with net funding requirements that range from modest to extremely large.

2.3 The ‘types’ of intervention are also very diverse. The SIP represents TfSE’s broad geographic coverage and the variety of investment that is needed to deliver sustainable economic growth. It is accordingly wide-ranging in terms of modes, locations, and delivery models. Additionally, many interventions are strategic in nature and cross political boundaries or modes.

2.4 Therefore, while a programme-level approach is likely to be appropriate for some aspects of delivering the SIP, the reality is that different types of scheme will lend themselves to different funding approaches at different times.

2.5 And this means that while the SIP can provide a framework for a route to affordable delivery, in practice it will be an ‘umbrella’ for a number of different individual and bespoke strategies for different types of project.

2.6 Furthermore, it is acknowledged that while the interventions identified in the SIP account for the largest transport projects within the South East, they potentially represent only part of the picture. Meeting the South East’s growth ambitions will also depend on delivering critical local and smaller-scale infrastructure and services, not to mention investment in other key areas such as skills and place-making.

2.7 These complementary investments will significantly enhance the 'reach' and overall benefit of strategic connectivity schemes and will be able to unlock greater economic value for the South East as a result of being integrated with the strategic schemes. They will, however, likely require further material investment.

## The funding environment for strategic transport infrastructure

2.8 Traditionally, strategic connectivity schemes have been funded from a combination of user or farebox revenues and central government grant directed towards delivery bodies and transport authorities.

2.9 But today these organisations face a number of competing priorities, with financial positions that are in many cases highly constrained.

2.10 The overall availability of funding for transport infrastructure is being stretched due to post-Covid fiscal uncertainty, not to mention changes to travel patterns and an unclear future for conventional revenue sources such as motoring taxes.

2.11 From a Government perspective, transport is competing with other sectors, and TfSE – like others – is competing with other regions. While the case for continued investment in transport and in the South East is very strong, regions such as the South East are likely to face challenges presented by the levelling-up agenda and an uncertain future for devolution in our area. These factors are expected to influence the quantum of future government funding that TfSE-type interventions might be able to benefit from.

2.12 Further challenges (but also opportunities) can be expected to accompany technological change in the transport sector, particularly the electrification of the road vehicle fleet and the implications for road taxation and the way users pay to access the highways network.

2.13 These are national-level questions of policy and taxation, but the national level response is likely to affect the funding and financing options available for TfSE-type programmes across the country well within the timeframe covered by the SIP.

## Towards a beneficiary-led approach

2.14 The SIP reflects the changed world in which we live and work. The schemes we have identified seek not only to address transport connectivity and capacity issues, but to promote and maintain economic development, increase the supply of homes, support the transition to net zero and improve quality of life and social inclusion.

2.15 This approach is consistent with post-pandemic policy priorities that are shifting towards a broader consideration of labour markets, including more attention on housing, inclusion, 'levelling up' and decarbonisation, rather than a singular focus on addressing overcrowding and capacity on transport networks.

2.16 From a financial perspective, the national Exchequer will benefit from the broader fiscal impacts this will deliver – which is one of the reasons why it will remain wholly appropriate for taxpayer funding to support the SIP.

2.17 More broadly, however, the programme will bring significant tangible benefits for a wider range of beneficiary across the South East, London and beyond – in terms of productivity, employment, income levels, environmental impacts, quality of place, and land and property values.

2.18 The SIP's wide reach suggests that there is a strong case for seeking a fair and proportionate contribution from this full spectrum of beneficiary groups - something that will be more important than ever given the fiscal costs of the pandemic, nationally and to the South East.

2.19 Recognising the broad beneficiary base of comparable programmes, as well as the challenges involved in sustaining traditional approaches to funding, significant focus has been given in recent years to identifying potential new and innovative tools – especially those (such as Land Value Capture mechanisms) that seek to monetise a share of the specific value that projects deliver for beneficiaries.

2.20 Such mechanisms could play a material role in supplementing or (eventually) replacing traditional central government grant and local farebox sources – and there are examples of precedent schemes (e.g. Crossrail in London) where new mechanisms have been designed and implemented to support delivery.

2.21 These new approaches may be appropriate for certain types of scheme within the SIP (e.g. where the impact on local land values can be identified, quantified and monetised). However, where innovate approaches might - on paper - be appropriate, they are likely to require either broader (e.g. nation-wide) reform which itself requires political will at a central government level, or a degree of devolution of funding powers beyond that which the South East currently enjoys.

2.22 Critically, evidence from elsewhere suggests that even where the required powers are made available locally (e.g. through devolution deals), there will remain a challenge of securing political and community acceptance for any new revenue-raising tools.

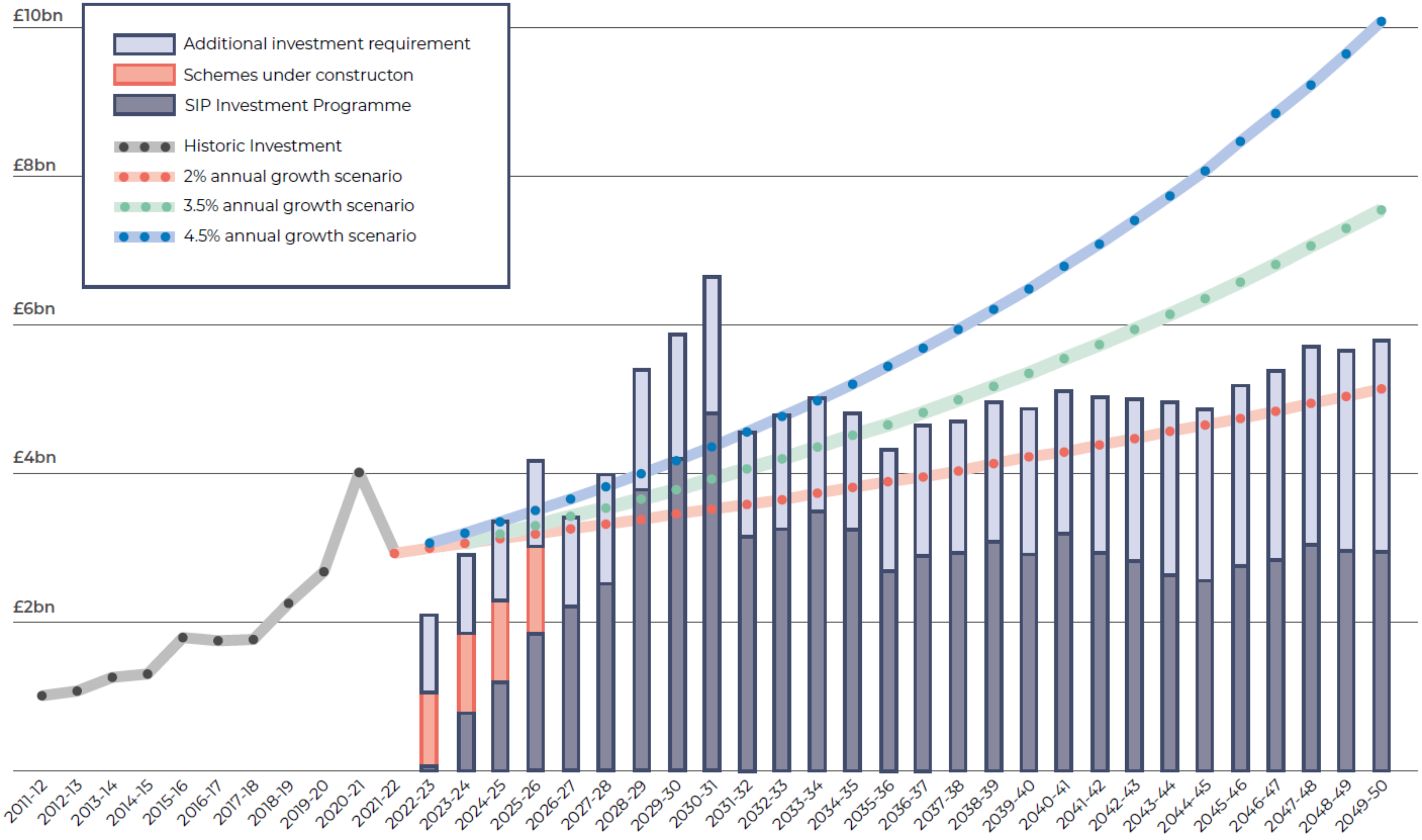
2.23 All this means that it is wholly appropriate to consider new approaches and they are likely to play a role at some stage in the multi-decade programme. However, we will need to work hard with local and national stakeholders if new approaches are going to be able to make a meaningful contribution (especially in the short-term) to the SIP.

# 3 The SIP's funding requirement in context

## Overview

3.1 **Figure 1** overleaf compares the proposed future investment in transport in the South East with a range of illustrative future growth scenarios of government spend. Inputs and assumptions are then detailed for the development of this illustrative analysis

**Figure 1: Indicative investment requirement and historic and projected spend profiles**



## Historical government spend

- Historical transport spend figures for the South East have been sourced from the Government's 'Country and Regional Analysis, 2021'.[1]
- To account for differences between the South East region used in national statistics (which includes Oxfordshire, Buckinghamshire and Milton Keynes) and the TfSE geography (which does not), 87% of the National Statistics overall number has been used, based on the population of the TfSE geography compared to the overall South East as set out in ONS data.[2]
- The Government's data includes both capital and revenue expenditure, and so an adjustment has been made for the amount that relates to capital spend based on HMT Public Expenditure Statistical Analyses (PESA) data.[3]

## Future government spend:

- The growth in historical spend from 2011-12 to 2020-21 was considered. Due to one-off 'spikes' in spend in 2015-16 (when DfT changed its methodology for accounting for Network Rail expenditure) and in 2020-21 (due to emergency support to the sector during the pandemic) these years were excluded. The resulting average annual growth in spend across England was 3.5%.
- Three illustrative future scenarios were then plotted: (1) 2% annual growth (assumed to be a rough proxy for inflationary growth and lower than the English historical average growth rate), (2) 3.5% (equivalent to the English historical average growth rate), and (3) 4.5% (the English historical average growth rate plus 1%).

## The investment programme:

- The future spend on the core capital programme is consistent with the investment programme set out in the SIP and is presented in nominal terms (i.e. includes inflation).
- An assumption has been made for additional local transport expenditure and schemes not included in the SIP. It has been assumed that over the course of the SIP period, this will require an additional two thirds of capital spend in real terms. This amount has been distributed evenly over the programme period in real terms, with inflationary growth then added using a long-term Tender Price Index (TPI) assumption.
- A further assumption has been made for spend in the first four years of the programme on schemes already under construction. It has been assumed that

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1 https://www.gov.uk/government/statistics/country-and-regional-analysis-2021

2 https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatesforukenglandandwalesscotlandandnorthernireland

3 https://www.gov.uk/government/collections/public-expenditure-statistical-analyses-pes

this amount is equivalent to the spend in these years on ancillary investment out with the SIP.

3.2 Based on these inputs and assumptions, the illustrative analysis suggests that, under all three indicative scenarios, the majority of the overall assumed level of spend on the programme could theoretically be supported within an illustrative envelope of potential future central funding.

3.3 Similar analysis has also been undertaken to look just at spend in rail and highways schemes – with the outputs provided in Figure 2 and Figure 3.

**Figure 2: Indicative investment requirement and historic and projected spend profiles – rail programme**

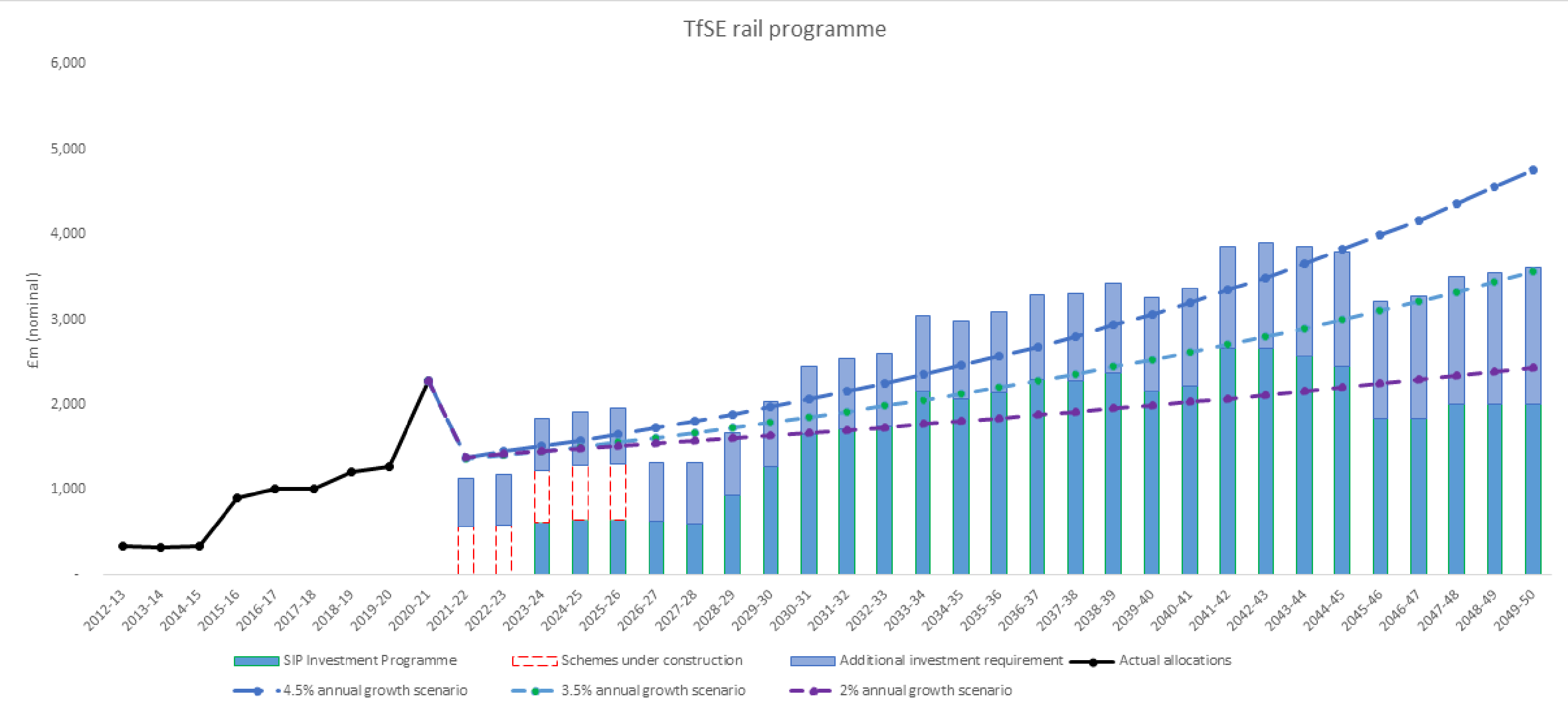
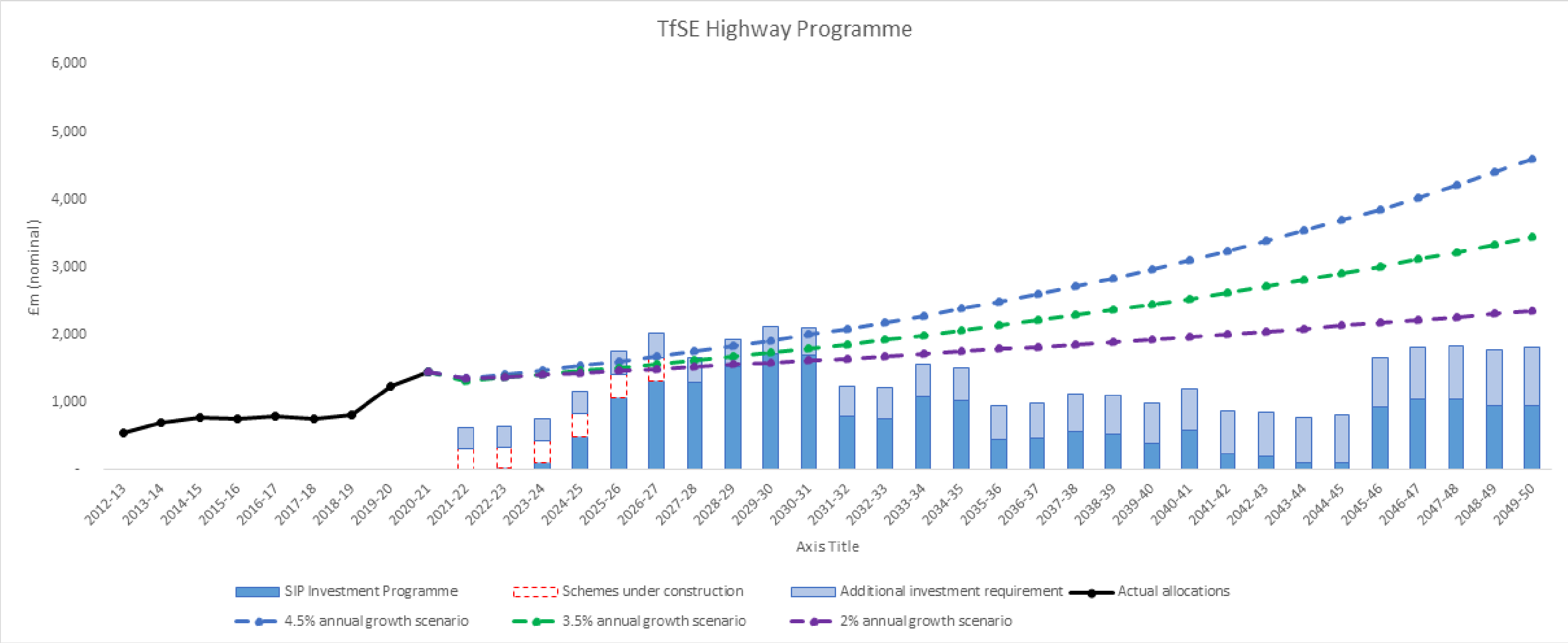


**Figure 2: Indicative investment requirement and historic and projected spend profiles – highways programme**



# 4 Alternative funding mechanisms

## Overview

4.1 Over time, there will be a growing case for moving away from conventional sources of funding (in particular government grant) and instead seeking to capture a fair and proportionate contribution from the full spectrum of beneficiary groups that are expected to derive value from the SIP investment programme.

4.2 Some tools already exist to support this endeavour, but they are limited in their effectiveness, meaning that new and innovative mechanisms that seek to monetise a greater share of the specific value that projects deliver for beneficiaries is likely to be needed.

4.3 Below we set out some of these potential new mechanisms.

## (i) The diversion of incremental revenues from existing taxes or charges

**Community Infrastructure Levy (CIL)**

4.4 CIL is a spatial charge levied on new development floorspace by a planning authority under powers available via the Planning Act 2008.

4.5 CILs are in place in many local authorities already and are well understood by the development community.

4.6 In theory, the purpose of CIL is to mitigate additional costs borne by the authority as a result of development, rather than capturing value created by investment in infrastructure itself. Were CIL revenues allowed to be diverted to strategic infrastructure schemes, the funding requirements for local infrastructure programmes would need to be met from other sources.

4.7 CIL’s ability to raise significant revenue at scale is limited because, as a flat rate charge, and because it needs to be designed to not impact the viability of new development across the whole authority, rates are generally relatively low.

4.8 Furthermore, there are limits to the ‘bankability’ of CIL. The charge is levied at a point of significant risk for developers, before development profit has been realised. Its collection can be volatile as it is dependent on development volumes and is therefore highly sensitive to market conditions.

4.9 The Government is currently consulting on potential changes to CIL (replacing local authority CIL and s106 with a flat-rate, value-based charge, set nationally, at either a single rate or at area-specific rates). Under the proposals, revenues would continue to be collected and spent locally.

**Business rates retention**

4.10 There are precedents across the UK (including a number of ‘trials’) for arrangements whereby local authorities are able to ring-fence and retain incremental growth in business rates receipts, associated with new developments in a specified area for a period of time, above a baseline, away from the regular rates distribution regime.

4.11 There are also similar, but more localised and longer-term, arrangements for rates retention through Enterprise Zones.

4.12 This mechanism is a relatively good form of value capture – the connection between value uplift and revenue is strong and transparent, as the revenue diverted is likely to be a function of new development opportunities in specific locations.

4.13 There is relatively little by way of additional implementation or ongoing operating costs and there is no impact on rate-paying businesses as the funds are moved between public authorities ‘behind the scenes’.

4.14 The quantum and timing of revenue is, however, dependent on commercial development and rateable value growth at revaluation points within the agreed geography, and therefore potentially risky and lumpy.

**Council Tax ‘top slice’**

4.15 Under this approach, some or all of the incremental growth in Council Tax receipts (generated as a result of the delivery of new homes) would be diverted by a local authority to support the funding of the programme.

4.16 Theoretically, diverting Council Tax revenues would be easy to implement, as Council Tax is an established mechanism with well understood collection arrangements and powers. It would involve no extra charge for residents and the value capture would happen ‘behind the scenes’.

4.17 However, Council Tax is a core revenue source of local authorities which is required to support the delivery of essential services for residents. The decision to divert any of this core funding away from services and towards infrastructure programmes would be subject to local decisions and community acceptability.

4.18 As a value capture tool, subject to the sizing of the contribution, this mechanism could be considered somewhat responsive to the impacts of new investments in that only the portion of Council Tax revenues related to new homes would be in scope, and so if the programme catalyses residential development, revenues will increase.

4.19 However, the Council Tax system in general is highly irresponsive to changes in property *values* and hence ineffective in capturing uplift for existing stock. The bandings have not been reassessed since the introduction of the tax in 1991 and so do not reflect current valuations or relative changes in property prices by location since 1991. In addition, the structure of bands means that Council Tax bills can only increase when a property moves into a new band, and even then, the uplift would be limited to the multiplier of the next band relative to the lower band.

**Stamp Duty Land Tax (SDLT) increment**

4.20 This mechanism would involve Government diverting to the programme some or all of the incremental SDLT revenues, above a baseline, associated with higher sale values (and potentially volumes) resulting from investment, for residential and/or commercial property stock within a defined geography.

4.21 This would in theory be an effective means of capturing some of the programme specific land value uplift, as SDLT is a tax that responds to changes in property and land values and is assessed based on actual market values at the time of transaction. There is therefore a strong connection between value growth and revenue (although the portion of uplift that can be captured is limited to the applicable marginal SDLT rate). An approach would need to be agreed with Government to identifying the tax revenues that are genuinely incremental (i.e. would not have arisen without the programme).

4.22 This mechanism would not require any change to the structure, rate or incidence of SDLT – and therefore there is no impact on taxpayers themselves. There are established collection arrangements for SDLT and the movement of funds would happen 'behind the scenes' between public authorities. The scale of potential revenue could potentially be significant.

4.23 SDLT is a highly volatile source of revenue, being very sensitive to market forces, transaction volumes and values, which makes it hard to predict and to use to raise finance. The extent to which the revenues could be borrowed against may be a function of the arrangements agreed with Government around the diversion of funds to local areas, and who takes the risk on receipts.

4.24 SDLT is, though, a national tax, and to date HM Treasury has been very resistant to hypothecating SDLT. What may be more appropriate, is to use the assessment of the incremental impact of the SIP on SDLT to help inform a future discussion around broader government contributions to the programme, without explicit hypothecation.

## (ii) Increased rates, or other enhancements, to existing taxes and charges

**Supplementary CIL or Strategic Infrastructure Tariff**

4.25 Under this mechanism, a localised CIL supplement is applied with revenues diverted to support the programme.

4.26 A similar mechanism (Mayoral CIL) is in place in London and – through the Strategic Infrastructure Tariff – is available to combined authorities. To be used in the South East the legislative and governance basis for implementing a localised charge outside of a combined authority would need to be established.

4.27 As described above, CILs are now widely used and well understood. A supplementary CIL would still likely be a flat rate per square metre and therefore regressive (i.e. more profitable development pays a smaller percentage of value).

4.28 However, the localised nature could mean that the supplement could be carefully designed to be as effective as possible in capturing a share of the benefits associated with higher development values, permissible development densities or development that only becomes viable with the scheme.

4.29 Although a demonstration of viability would likely be required, the supplementary rate would need to be carefully calibrated. There is a risk of decreasing the appetite for investment if the supplement results in a total CIL level that is considered by developers to be excessive, relative to their risk, the uplifts in values linked to the projects and the relative profitability and risk of alternative development locations.

4.30 CIL revenues are not yet fully tested through the economic cycle and are likely to be volatile and cyclical. Subject to the navigation of implementation challenges, however, a well-designed localised CIL supplement could represent an effective tool for targeting project-specific development volume and value uplift within a defined radius of a scheme or a programme.

**Business Rates Supplement (BRS)**

4.31 A BRS is a supplement on the business rate multiplier in a local authority area. The link to overall property values is strong, but cannot effectively discern the specific uplift attributable to a particular project. This makes it somewhat blunt and limits its effectiveness as a pure land value capture mechanism. Once established, however the revenue can be relatively stable, and can be borrowed against (as per London precedent).

4.32 The BRS Act stipulates that a BRS can be levied up to 2p/£ for hereditaments with a rateable value over £55,000, subject to a ballot of affected businesses. Smaller businesses would be exempt owing to the minimum rateable value (RV) threshold.

4.33 A BRS is currently in place in London to support financing for Crossrail. The Mayor has increased the minimum RV threshold to £70,000.

4.34 Although the legislation applies to unitary and county councils, currently the only other areas that have been given the ability raise a BRS are mayoral combined authorities (and even in these cases additional legislation would be required) – which presents a challenge for the South East.

4.35 The legislation currently stipulates that a ballot of affected businesses is required (which may be considered a barrier to implementation and would require a concerted effort to persuade local businesses as to the value of the investment that a BRS would support). We note that the National Infrastructure Commission has recently recommended that this requirement be removed.

**Council Tax precept**

4.36 A Council Tax precept is essentially a supplement on existing Council Tax which would be paid by residents in specific local authority areas, with the revenues diverted to the programme. There is precedent including the Olympic Games levy in Greater London and the Greater Manchester transport levy.

4.37 Assuming it was based on existing systems and collection regimes, a Council Tax precept could be administratively simple to introduce. It would represent a stable and predictable revenue source and the localised (i.e. authority-specific) nature of a precept could create the perception of a strong connection between the charge and the programme (provided that the programme were to generate benefits across as much of the authority area as possible).

4.38 The key challenge may come in the form of securing the community's acceptance of a new Council Tax precept. This is especially relevant given that there is a limit set by the Government (currently 2% plus 1% for adult social care) to the percentage by which local authorities are able to increase Council Tax without triggering a referendum.

## (iii) New local charging mechanisms

**Betterment levy**

4.39 A ‘betterment levy’ or ‘transport premium charge’ would be a new charge levied on owners of properties (residential and/or non-residential) which experience value uplift as a result of investment in the SIP.

4.40 The potential for residential and non-residential property value uplift has been demonstrated to be significant in previous work on other comparable infrastructure programmes. Subject to proper design and careful calibration to expected value uplifts, tailored betterment levies have the potential to provide a clear, flexible and transparent linkage to capturing a share of the windfall value uplifts that arise as a result of taxpayer investment.

4.41 This could provide a route to raising a significant amount of revenue from one of the largest expected beneficiary groups of the SIP.

4.42 However, while transaction taxes (e.g. SDLT, CGT) are common throughout the world, there are few examples of a property tax that is directly related to the uplift in value attributable to a particular project or investment programme.

4.43 A geographically targeted mechanism would likely require primary legislation. And there may well be community acceptance challenges associated with the introduction of a new 'tax' – especially if applied in a specific location only and outside of broader (e.g. national) reform.

**Road user charging**

4.44 As more vehicles are electrified, Fuel Duty revenues are expected to fall, and alternate methods of raising revenue will need to be found to support investment in the highways network.

4.45 Expanding existing local congestion and air quality charges, tolls and/or distance-based ('pay-per-mile') road user charging schemes presents the opportunity to move towards an approach whereby the usage of a vehicle (rather than its ownership) provides the basis of a contribution.

4.46 This would not only provide the Government with revenues for infrastructure spending (including in the South East), but also address other objectives such as optimising the capacity of the finite road asset, managing congestion, and improving air quality.

4.47 While broad national reform is being considered, it may be likelier that more cities and regions use the powers available to them to implement road user charging systems. Cities such as Cardiff, Reading and Bristol are considering congestion charging, following the lead of London and Durham. There are indications that cities like Birmingham and Manchester will follow London's lead in establishing Clean Air Zone (CAZ) and Low Emission Zone (LEZ) schemes, though these are subject to consultation in respect of the long-term impact of COVID-19 and the advancement of the ban on ICE vehicles.

**Workplace Parking Levy (WPL)**

4.48 A WPL is a charge on employee car parking in designated areas. The Transport Act 2000 gave local authorities the power to introduce a WPL, but any new scheme must be confirmed by the Secretary of State. There is a WPL scheme currently in place in Nottingham and has been considered in Oxford and Birmingham.

4.49 Alongside creating a revenue stream to support mass transit projects, a WPL can incentivise modal shift, effectively increasing the demand for public transport and therefore ridership and farebox of mass transit systems. It can also incentivise land use change away from off-street parking and into additional development which is likely to have further beneficial economic and financial benefits to local authorities, offsetting any loss of car parking revenue.

4.50 A reduction in the number of parking spaces provided by employers (as has been seen elsewhere) would, however, result in diminishing returns from the levy over time, particularly as places become better-connected by public transport and development accelerates.

## (iv) Broader sources of government funding

4.51 The SIP describes the ‘conventional’ sources of Government funding that have traditionally been used to support transport investment – both core funding for transport agencies such as Network Rail and National Highways, and transport-specific grant programmes.

4.52 The wider value that the SIP is expected to generate within the South East also creates an opportunity to look at funding sources that go beyond the prism of specific schemes or transport modes.

4.53 For example, there is a growing trend for broader ‘growth deals’ between local areas and government whereby a package of investments is agreed that might stretch beyond transport to, for example, housing delivery, regeneration or decarbonisation, and in return unlock either matched funding and/or access to wider revenue-raising powers at a local level.

4.54 This trend, which recognises the wide reach which transport investment can have, may have a key role to play in supporting a more strategic approach to delivering the SIP, and one which TfSE can play a key role in developing alongside local stakeholders and partners within Government.

## Control Information

| Prepared by | Prepared for |
|---|---|
| Steer<br>28-32 Upper Ground<br>London SE1 9PD<br>+44 20 7910 5000<br>www.steergroup.com | Transport for the South East<br>County Hall<br>St. Anne's Crescent<br>Lewes, BN7 1UE |

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