Subsidy Advice Unit Report on the proposed subsidy to Related Argent Property Limited Partnership

Referred by London Borough of Barnet (LBB)

29 February 2024

Subsidy Advice Unit

Part of the Competition and Markets Authority

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1. Introduction

1.1 This report is an evaluation prepared by the Subsidy Advice Unit (SAU), part of the Competition and Markets Authority, under section 59 of the Subsidy Control Act 2022 (the Act).

1.2 The SAU has evaluated the London Borough of Barnet (LBB)'s assessment (the Assessment) of a subsidy proposed to be given to Related Argent Property Limited Partnership (RA) for its compliance with the requirements of Chapters 1 and 2 of Part 2 of the Act.[1]

1.3 This report is based on the information provided to the SAU by LBB in its Assessment and evidence submitted relevant to that Assessment.

1.4 This report is provided as non-binding advice to LBB. The purpose of the SAU's report is not to make a recommendation on whether the subsidy should be given, or directly assess whether it complies with the subsidy control requirements. LBB is ultimately responsible for granting the subsidy, based on its own assessment, having the benefit of the SAU's evaluation.

1.5 A summary of our observations is set out at section 2 of this report.

The referred subsidy[2]

1.6 LBB proposes to provide RA with £100m of short-term loan funding to support the development of the first phase of the new Station Quarter business district at Brent Cross Town ('Plot 1'), which forms part of the Brent Cross & Cricklewood Regeneration project.

1.7 The subsidy aims to facilitate the construction of a new office/flexible workspace building at Plot 1. Sheffield Hallam University (SHU) has committed to take part of the building for its new London campus.

1.8 LBB has assessed the subsidy value to be £17.46 million. The subsidy is calculated as the discounted value[3] of the difference in the total interest and fees that would be payable on a market loan alternative, as compared to the financing structure proposed by LBB (where the interest rates are lower than market rates).

[1] Chapter 1 of Part 2 of the Act requires a public authority to consider the subsidy control principles and energy and environment principles before deciding to give a subsidy. The public authority must not award the subsidy unless it is of the view that it is consistent with those principles. Chapter 2 of Part 2 of the Act prohibits the giving of certain kinds of subsidies and, in relation to certain other categories of subsidy creates a number of requirements with which public authorities must comply.

[2] Referral of the proposed subsidy to Related Argent Property Limited Partnership by the London Borough of Barnet - GOV.UK (www.gov.uk)

[3] LBB uses a discount rate of 5.3% over three years (being the expected timeframe in which the loan will be repaid) to calculate the cash equivalent value of the subsidy. This discount rate is consistent with that recommended in the Statutory Guidance (Annex 4, paragraph 18.14).

1.9 The subsidy is intended to be awarded in March 2024.

SAU referral process

1.10 On 15 January 2024, LBB requested a report from the SAU in relation to the subsidy.

1.11 LBB explained[4] that the subsidy is a Subsidy of Particular Interest because its value exceeds £10 million.

1.12 The SAU notified LBB on 19 January 2024 that it would prepare and publish a report within 30 working days (ie on or before 29 February 2024).[5] The SAU published details of the referral on 22 January 2024.[6]

[4] In the information provided under section 52(2) of the Act
[5] Sections 53(1) and 53(2) of the Act.
[6] Referral of the proposed subsidy to Related Argent Property Limited Partnership by the London Borough of Barnet - GOV.UK (www.gov.uk)

2. Summary of the SAU's observations

2.1 The Assessment uses the four-step structure described in the Statutory Guidance for the United Kingdom Subsidy Control Regime (the Statutory Guidance) and as reflected in the SAU's Guidance on the operation of the subsidy control functions of the Subsidy Advice Unit (the SAU Guidance).

2.2 LBB demonstrated that they have undertaken a thorough and considered approach to assessing the compliance of the subsidy with the subsidy control principles. In summary the following are our observations on the Assessment. We found that, in particular, the Assessment reflects the following positive features:

(a) In relation to Principle A, it clearly explains the policy and equity objectives of the subsidy;

(b) In relation to Principle E, it has given detailed and thorough consideration to both alternatives to and alternative forms of subsidy and supported its conclusions with appropriate reasoning and evidence.

2.3 The Assessment could however be strengthened by:

(a) in relation to Principle A, more clearly explaining and evidencing what information relating to the subsidy is unavailable to capital market participants (or why they might be unable to correctly interpret this when assessing risk) and thus why the market-driven level of financing for this project is below the socially optimal level;

(b) considering whether the market failure associated with the subsidy could be better expressed in terms of spillovers and positive externalities; and

(c) in relation to Principle C, identifying and exploring the counterfactual scenario in more detail.

2.4 Our report is advisory only and does not directly assess whether the subsidy to RA complies with the subsidy control requirements. The report does not constitute a recommendation on whether the subsidy should be implemented by LBB. We have not considered it necessary to provide any advice about how the proposed scheme may be modified to ensure compliance with the subsidy control requirements.[7]

[7] Section 59(3)(b) of the Act.

3. The SAU's Evaluation

3.1 This section sets out our evaluation of Assessment, following the four-step framework structure used by LBB.

Step 1: Identifying the policy objective, ensuring it addresses a market failure or equity concern, and determining whether a subsidy is the right tool to use

3.2 The first step involves an evaluation of the Assessment against:

(a) Principle A: Subsidies should pursue a specific policy objective in order to (a) remedy an identified market failure or (b) address an equity rationale (such as local or regional disadvantage, social difficulties or distributional concerns); and

(b) Principle E: Subsidies should be an appropriate policy instrument for achieving their specific policy objective and that objective cannot be achieved through other, less distortive, means.[8]

Policy objectives

3.3 The Assessment sets out that the policy objective of the subsidy is to facilitate the development of the first phase of Plot 1 which, it argues, is necessary to facilitate the delivery of a viable and well-functioning new mixed use metropolitan town centre at Brent Cross Town.

3.4 The Assessment sets out a series of further economic, social and placemaking[9] objectives which are specific to the development of Plot 1, including delivering new, high quality office space to accommodate quality employment and education opportunities, and improving the surrounding area. These are explored further in paragraphs 3.7 to 3.9 below.

3.5 In our view, the Assessment clearly explains the policy objective and how it fits into wider objectives for the development of the area.

Equity objective

3.6 The Statutory Guidance sets out that equity objectives seek to reduce unequal or unfair outcomes between different groups in society or geographic areas.[10]

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[8] Further information about the Principles A and E can be found in the Statutory Guidance (paragraphs 3.32 to 3.56) and the SAU Guidance (paragraphs 4.7 to 4.11).
[9] The process of creating quality places that people want to live, work, play and learn in.
[10] Statutory Guidance, paragraphs 3.49-3.53.

3.7 The Assessment sets out that the development of Plot 1 and its wider effects will address an equity objective by: (i) reducing crime and enhancing personal safety in the area; (ii) improving skills and the availability and quality of employment opportunities; and (iii) increasing economic activity, productivity and quality of employment. The Assessment explains that Plot 1 is situated within a socio-economically deprived area, as measured in the 2019 Indices of Multiple Deprivation, as well as being characterised by higher levels of crime than the LBB or London averages.

3.8 The Assessment further explains that the subsidy will support up to 1,600 jobs and, as part of its contribution to the delivery of the wider Brent Cross Town Masterplan,[11] catalyse the creation of up to 25,000 jobs. It sets out that the combination of skills development and the provision of additional employment opportunities enabled by the subsidy will assist with increasing overall levels of economic activity in the borough and that the increased footfall will deter crime.

3.9 In our view, the Assessment clearly sets out the equity objectives which the subsidy seeks to address. However, the Assessment could be improved by setting out in more detail how the Plot 1 development will catalyse the delivery of the wider Brent Cross Town Masterplan.

Market failure

3.10 The Statutory Guidance sets out that market failure occurs where market forces alone do not produce an efficient outcome.[12]

3.11 The Assessment states that the subsidy seeks to address an imperfect / asymmetric information market failure impeding the provision of capital finance to RA on terms which would make the development of Plot 1 commercially viable. It explains that this failure is part of wider challenges in the market for financing commercial real estate developments post pandemic, where the demand for some commercial property has fallen and construction costs have risen. It sets out that the approach of commercial lenders has changed and that they now tend to accept a lower level of risk.

3.12 The Assessment explains that LBB sought advice from independent advisors who examined the potential for market alternatives to subsidy. As part of this LBB were advised that it may be possible to access a higher proportion of senior debt[13] which would reduce the funding gap, but this would likely come at a higher cost.

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[11] Transforming Brent Cross Cricklewood | Masterplan (transformingbx.co.uk)
[12] Statutory Guidance, paragraphs 3.35-3.48.
[13] Senior Debt is money owed by a company that has first claims on the company's cash flows. It is more secure than any other debt, such as subordinated debt (also known as junior debt), because senior debt is usually collateralised by assets. It means the lender is granted a first lien claim on the company's property, plant, or equipment in the event that the company fails to fulfil its repayment obligations.

The conclusion of that advice was that market finance rates (if they were attainable) would be at such a cost that the project would not be able to proceed.

3.13 In our view the Assessment explains the viability gap associated with the development and how the subsidy will contribute to overcoming it. However, it could be improved by more clearly explaining and evidencing, having regard to the Statutory Guidance,[14] what information relating to the subsidy is unavailable to market participants (or why they might be unable to correctly interpret this when assessing risk) and thus why the market-driven level of financing for this project is below the socially optimal level and constitutes a market failure.

3.14 LBB could also consider whether the market failure associated with the subsidy could be better expressed in terms of spillovers and positive externalities from crowding in investment in the broader area/development.

Consideration of alternative policy options and why the subsidy is the most appropriate and least distortive instrument

3.15 In order to comply with Principle E, public authorities should consider why the decision to give a subsidy is the most appropriate instrument for addressing the identified policy objective, and why other means are not appropriate for achieving the identified policy objective.[15]

3.16 The Assessment explains that the proposed subsidy is an appropriate means of addressing the policy objective because it will provide the necessary development finance to enable the Plot 1 development to proceed.

3.17 The Assessment goes on to examine the alternatives to subsidy and alternative forms of subsidy explored by LBB. It explains that, in relation to the alternatives to subsidy, LBB has promoted the use of the land through its planning development framework and has secured vacant possession of the land, thereby providing readily assembled land for plot development. LBB has also, as the relevant authority, granted all the necessary approvals to remove development risks. The Assessment, however, concludes that these interventions, alone, have been insufficient to incentivise development of Plot 1 to achieve the desired policy outcome.

3.18 The Assessment then considers alternative forms of subsidy including (a) providing grant funding equivalent to the proposed loan; (b) the provision of a guarantee to a third-party funder; (c) providing a rental guarantee; and (d) investing in Plot 1 as a long-term owner of the building.

[14] Statutory Guidance, paragraphs 3.44-3.46.
[15] Statutory Guidance, paragraphs 3.54-3.56.

3.19 In relation to (a) grant funding, the Assessment explains that this was rejected as the fundamental barrier to Plot 1 proceeding is not overall viability, but rather availability and cost of development finance. In any event, the Assessment explains that if a grant were to be considered it would likely need to meet the initial funding gap (ie up to £100m) which would be unaffordable for LBB.

3.20 In relation to (b) the provision of a guarantee, the Assessment concludes that this would not reduce the levels of interest or other fees associated with obtaining development finance for the project. It would pose a similar level of financial risk to LBB but without the potential benefits of profit sharing upon loan repayment.[16] In any event, the cost of finance would likely be comparable to the prevailing commercial rates, which would render the project unviable, so this does not represent a viable alternative to the proposed LBB loan.

3.21 It then examines options (c) and (d) namely with LBB as an owner of the site or alternatively, a long-term tenant. It dismisses these options as being incompatible with the strategic objectives of the Borough.

3.22 In our view the Assessment has given detailed and thorough consideration to both alternatives to and alternative forms of subsidy and supported its conclusions with appropriate reasoning and evidence.

Step 2: Ensuring that the subsidy is designed to create the right incentives for the beneficiary and bring about a change

3.23 The second step involves an evaluation of the assessment against:

(a) Principle C: First, subsidies should be designed to bring about a change of economic behaviour of the beneficiary. Second, that change, in relation to a subsidy, should be conducive to achieving its specific policy objective, and something that would not happen without the subsidy; and

(b) Principle D: Subsidies should not normally compensate for the costs the beneficiary would have funded in the absence of any subsidy.[17]

Counterfactual assessment

3.24 In assessing the counterfactual, the Statutory Guidance explains that public authorities should assess any change against a baseline of what would happen in the absence of the subsidy (the ‘do nothing’ scenario’).[18] This baseline would not

[16] As part of the terms of the agreement, RA and LBB have agreed that profits generated by the project following repayment of the loan may be shared.
[17] Further information about the Principles C and D can be found in the Statutory Guidance (paragraphs 3.57 to 3.71) and the SAU Guidance (paragraphs 4.12 to 4.14).
[18] Statutory Guidance, paragraphs 3.60-3.62.

necessarily be the current 'as is' situation (the 'status quo') but what would likely happen in the future – over both the long and short term – if no subsidy were awarded.

3.25 The Assessment identifies a counterfactual scenario in which RA would not proceed with the development of Plot 1, absent the subsidy. The Assessment then sets out a range of alternative scenarios for the site if the proposed project were not to proceed.

3.26 These alternatives are described as: (i) reduction in the scale of development of Plot 1 to the area which has already been pre-let to SHU; (ii) use of Plot 1 for residential-led development; and (iii) a do-nothing scenario with market-led development. The Assessment dismisses these alternative scenarios, in favour of its identified counterfactual.

3.27 In our view the Assessment could be improved by a fuller consideration of the likely counterfactual scenario including what would happen to the site in the case of RA not proceeding with the development. In doing so, it may be helpful for LBB to draw upon some of the reasoning and evidence set out in the Assessment's discussion of the 'alternative scenarios', reflecting these points within its discussion and consideration of the counterfactual. By doing so, the counterfactual would more clearly describe how the market would evolve if there were no intervention, both over the short and longer term.

Changes in economic behaviour of the beneficiary

3.28 The Statutory Guidance sets out that subsidies must bring about something that would not have occurred without the subsidy.[19] In demonstrating this, public authorities should consider the likely change or additional net benefit.

3.29 The Assessment explains that the baseline from which to measure the change in economic behaviour is a scenario in which 'RA would seek to generate profit from the development of land and buildings.' It continues by explaining that 'RA will also seek to generate revenue from providing services such as development management and estate management.'

3.30 The Assessment indicates that the subsidy will change the economic behaviour of RA by incentivising it to go ahead with the project. This outcome is consistent with the counterfactual scenario identified in the Assessment (in which RA would not proceed with the project absent the subsidy).

[19] Statutory Guidance, paragraph 3.64.

3.31 The Assessment explains that, based on the current letting status of Plot 1 (being 50% pre-let), the expected level of profitability that RA may generate under market conditions would be below its required expected rate of return of 15%.

3.32 The Assessment refers to supplementary evidence (the development appraisal) which finds that the expected return for the project to be well below RA's 15% rate of return requirement. It explains that as part of the project proposal, RA has agreed to modify its required profit return to 3.25% ('significantly below market norms'). On this basis, the Assessment explains that the subsidy is necessary to generate the incentive for RA to invest in the project.

3.33 We note that there are inconsistencies in the language used to describe the baseline from which the change in economic behaviour is measured (as set out at paragraph 3.29) and the language used to describe the counterfactual (as set out at paragraph 3.25).

3.34 The Assessment describes the counterfactual as RA not proceeding with the project, while the change in economic behaviour describes the baseline as one in which RA would seek to generate a profit. As explained in the Statutory Guidance,[20] the counterfactual is intended to provide the baseline scenario from which the change in economic behaviour of granting the subsidy can be measured, and therefore it is important that there is consistency across the two.

3.35 In our view the Assessment describes why the subsidy is necessary to effect the required change in economic behaviour. We consider that strong evidence is provided to support the viability gap and to evidence the calculation of the expected 3.25% return of the project.

3.36 The Assessment would have been strengthened with evidence to support the position that RA would require a return of 15% under market conditions, and from a clearer explanation as to why RA has chosen to reduce its required return in this case. It would also be improved by greater consistency in language and narrative across the discussion of both the counterfactual and the change in economic behaviour. However, in the round, we are of the view that the Assessment sufficiently describes the change in economic behaviour.

Additionality assessment

3.37 'Additionality' means that subsidies should not be used to finance a project or activity that the beneficiary would have undertaken in a similar form, manner, and timeframe without the subsidy.[21]

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[20] Statutory Guidance, paragraph 3.57 to 3.62.
[21] Statutory Guidance, paragraphs 3.63-3.67.

3.38 The Assessment explains that the subsidy will result in RA bringing forward the development, and that the required profit level from the development will be set at 3.25% rather than the circa 15% as would be the case in market conditions (ie absent the subsidy).

3.39 The Assessment also explains that the subsidy does not result in the funding of business-as-usual costs. It notes that:

(a) the Plot 1 project is a discrete ring-fenced project, and the general costs relating to RA will not be funded through the development of Plot 1; and

(b) while some costs have been incurred by RA in advance of the loan, they have been funded by RA's equity investment and represent design, planning and marketing costs necessary to progress the development. They would not be regarded as business-as-usual expenditure as they consist of fees to third parties such as architects, planning consultants and other professional advisors engaged to progress the development to this point.

3.40 In our view the Assessment clearly describes the additionality arising from the subsidy and that the subsidy does not constitute the funding of business-as-usual costs.

Step 3: Considering the distortive impacts that the subsidy may have and keeping them as low as possible

3.41 The third step involves an evaluation of the assessment against:

(a) Principle B: Subsidies should be proportionate to their specific policy objective and limited to what is necessary to achieve it; and

(b) Principle F: Subsidies should be designed to achieve their specific policy objective while minimising any negative effects on competition or investment within the United Kingdom.[22]

Proportionality

3.42 The Assessment identifies a number of key factors in seeking to demonstrate that the subsidy is proportionate and limited to the minimum necessary.

3.43 As discussed in paragraphs 3.16 to 3.22 a range of alternative forms of subsidy were considered including the use of grants and guarantees, however it concludes that these would not be effective and/or would be less proportionate.

[22] Further information about the Principles B and F can be found in the Statutory Guidance (paragraphs 3.72 to 3.108) and the SAU Guidance (paragraphs 4.15 to 4.19).

3.44 The Assessment also explains that the subsidy value of £17.46 million was identified through a calculation of the difference between the costs of the required financing in the market and that from the proposed LBB loan. It notes that the subsidy of £17.46 million compares to £184.7 million development costs and a net development value of £195.88 million.

3.45 The Assessment goes on to provide considerable detail on costs and cost assurance as well as sensitivity analysis on development values, and notes that the target base profit level is below the usual industry benchmarks.

3.46 It further explains that, as part of the overall development investment, RA has made an equity investment of £18.4m and that this equity stake would be at risk if there were cost overruns and/or the net development value is lower than expected. LBB's capital would become at risk if the net development value falls to around £172.0 million. This equity stake thus provides some mitigation against LBB incurring a capital loss. In addition, the parent company has provided some guarantees on the LBB loan (though not on the principal).

3.47 The Assessment also explains, at a high-level, how the proportionality of the subsidy is supported by effective monitoring of costs and values, the existence of a profit-sharing mechanism, which gives LBB 60% of any additional profits once RA has obtained a 12% return on its equity stake, and by limiting the timespan over which the subsidy is provided to a maximum of five years.

3.48 The Assessment also provides supporting evidence to demonstrate that a competitive tendering process was used to appoint RA as the development partner and therefore the beneficiary of the subsidy.

3.49 In our view the Assessment could be improved by more consistently considering how the relevant subsidy design characteristics outlined in the Statutory Guidance will help ensure proportionality, as well as by explaining how the profit-sharing level was determined and how this level is consistent with Principle B.

Design of subsidy to minimise negative effects on competition and investment

3.50 The Assessment sets out how elements of subsidy design could minimise distortion to competition, consistent with those set out under the subsidy characteristics detailed in the Statutory Guidance.[23]

3.51 These include: (i) the use of a loan rather than a grant; (ii) a rigorous competitive selection process for the beneficiary; (iii) the nature of the costs covered (capital for investment) and the limited timespan of the subsidy; (iv) the inclusion of a

[23] See Statutory Guidance (paragraphs 3.80 to 3.108) for further detail.

profit-sharing mechanism; as well as (v) features including loan guarantees from the beneficiary's parent and cost monitoring.

3.52 Our view is that the Assessment provides sufficient explanation and evidence of how the subsidy has been designed to minimise negative effects on competition and investment.

Assessment of effects on competition or investment

3.53 The Assessment identifies the relevant market to be that of the supply of office space in the LBB, and more widely the market for the development of commercial property within the UK. It concludes that the subsidy will not distort the market for office space in the LBB noting that there is relatively little office space there (and that this has been declining) and that there are no other comparable office development and investment opportunities in the area.

3.54 The Assessment provides some explanation and evidence as to why the subsidy will not cause significant distortion to competition in the market for the development of commercial property within the UK. It explains that profit margins on the development of 3.25% is below a 'normal' level of profit in the sector and therefore the project is not expected to result in excessive profits for the developer.

3.55 The Assessment notes this development is also small in the context of the UK market for the development of commercial property, and that the subsidy supports initial investment capital costs rather than ongoing costs.

3.56 The Assessment further notes the potential impact on related markets, with land values, employment and wages all expected to increase. We note that the anchor tenant, SHU, may also be an entrant into the further and higher education market in the area.

3.57 The Assessment explains its approach to assessing the potential for negative effects and the reasons these effects are likely to be limited.

3.58 However, the Assessment could be strengthened, in relation to the effect on the local office supply market, by considering broadening the geographic market definition to reflect likely commuting patterns in and around the Borough of Barnet.

3.59 LBB should also consider whether, in relation to the effect on the commercial development market, a narrower geographic area of Greater London and the South East, rather than the whole of the UK, would have been appropriate, in light of the supporting evidence it provided.

3.60 Finally, the Assessment could be strengthened by an appropriate level of explanation of the position of RA in the relevant market (or markets), who its competitors might be, and how any distortion arising from this subsidy could impact them.

Step 4: Carrying out the balancing exercise

3.61 The fourth step involves an evaluation of the assessment against subsidy control Principle G: subsidies' beneficial effects (in terms of achieving their specific policy objective) should outweigh any negative effects, including in particular negative effects on: (a) competition or investment within the United Kingdom; (b) international trade or investment.[24]

3.62 The Assessment sets out the benefits which will be achieved by the subsidy across three areas including economic, social and placemaking benefits as well as setting how the subsidy will address the equity objectives identified in Step 1.

3.63 The Assessment sets out that the subsidy will generate significant benefits such as direct and indirect job creation, improved educational and skills development opportunities and broader increases in wellbeing and increased vibrancy of the area post development.

3.64 In our view the benefits are well reasoned and supported with evidence. However, we note that a number of these benefits are dependent on the fact that the anchor tenant for Plot 1 will be SHU or a similar educational provider.

3.65 The Assessment then goes on to set out how the subsidy will address the socio-economic issues identified in Step 1. This includes how the increased local employment, earning potential, skills and training and improvements to perceived public safety would positively address key components of the Indices of Multiple Deprivation.

3.66 The Assessment also sets out the potential negative effects. These include that the subsidy will benefit RA in relation to the UK property development market and that it may also enable them to secure private finance from a UK bank that might otherwise have been offered to another market participant. However, neither of these risks is fully explained.

3.67 The Assessment goes on to describe the scale of the UK property construction and relevant finance markets and argue that these potential effects are very small in comparison.

3.68 The Assessment explores the potential for negative effects on international trade and investment. LBB considers there to be two possible effects- first, on the European and worldwide property development markets, and second, the impact

[24] See Statutory Guidance (paragraphs 3.109 to 3.117) and SAU Guidance (paragraphs 4.20 to 4.22) for further detail.

of the development on choices of the potential occupiers of the development. It concludes that given the scale of the development of Plot 1 the potential for any negative impact is negligible.

3.69 In our view the Assessment considers the potential for effects on international trade and investment and explains its reasoning well as to why these are unlikely.

3.70 The Assessment could be strengthened by explicitly weighing the identified competition effects identified in the previous step against the anticipated benefits to achieve the balancing exercise at Step 4.

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