Edinburgh and South East Scotland City Region Deal Joint Committee

10am, Friday 24 June 2022

Edinburgh Innovation Hub (East Lothian Council / Queen Margaret University) VAT Reinvestment

Item number 6.2

Executive Summary

The Joint Venture Structure (concluded in April 2022) between East Lothian Council and Queen Margaret University secured financial and commercial advantages for the delivery of the Edinburgh Innovation Hub. One of the key advantages is that the Joint Venture Structure enables the Joint Venture to exercise an Option to Tax on the construction and the development element of the Hub project. This enables the Joint Venture to reclaim the Value Added Tax in accordance with HMRC regulations, estimated at Full Business Case in 2021 as £6.002m.

The Joint Venture seeks approval from the Edinburgh and South East Scotland City Region Deal Joint Committee to reinvest the reclaimable VAT into the development and construction elements of the Hub project.

Whilst paragraphs 3.6 to 3.9 of this Report detail the positive impact the reinvestment will have on the Edinburgh Innovation Hub project costs, these can be summarised as follows

1. Enhance the project outcomes through targeted additionality in the design and specification to further the value proposition to end users.
2. Extend projects performance on sustainability and Net Zero Carbon.
3. Contain impact of construction cost inflation

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Report

Edinburgh Innovation Hub (East Lothian Council / Queen Margaret University) VAT Reinvestment

1. Recommendations

1.1 To note that the Joint Venture Structure (“JV”) between East Lothian Council (ELC) and Queen Margaret University (QMU) enables the JV to exercise an Option to Tax on the construction and the development element of the Edinburgh Innovation Hub (“Hub”) project which enables the JV to reclaim the Value Added Tax (“VAT”) in accordance with HMRC regulations.

1.1 To note that the JV is currently exercising the Option to Tax in accordance with the HMRC regulations which will offer the ability for the JV to reclaim the VAT monies on the Hub project costs.

1.2 To note the proposed schedule of investment and returns at paragraphs 3.6 to 3.9 which include enhancing the Hub project outcomes through targeted additionality in the design and specification to enhance the value proposition that improves the experience for the end user.

1.3 To approve the reinvestment of the reclaimed VAT monies into the Hub Project costs, previously identified as £6.002 million in 2021.

2. Background

2.1 On 4 June 2021, the Edinburgh and South East Scotland City Region Deal Joint Committee approved the Full Business Case (“FBC”) submitted by ELC and QMU. The FBC sought approval to secure funding for, and enact, the development and delivery by ELC and QMU of the Hub. The Hub is adjacent to the QMU campus at Craighall on land owned by ELC.

2.2 The FBC demonstrated that the Hub will be a bespoke and highly targeted infrastructure and property offer, together with the specialist services required to capture, support and grow companies working in fast-moving innovation-led sectors. It will comprise a serviced multi-occupied laboratory and office building. The design concept for the Hub is for a facility that anticipates success and the need for subsequent ‘grow-on’ expansion. A number of ‘innovation hub’ facilities in the UK have not exploited their full potential because success and the concomitant need for contiguous expansion was not anticipated. To deliver expansion capability, a two-phase approach to the development of the Hub building has been adopted. The development of the Hub will unlock a significant opportunity for the JV to develop ELC’s landholdings adjacent to the campus into the Edinburgh Innovation Park

("EIP"). The EIP would be a science and technology park, aligned with the University and the Hub that will support the growth of high value added and innovative businesses including those in food & drink related sectors that would directly mature in and benefit from the activities of the Hub. The wider development also includes infrastructure improvements, being the delivery of a grade separated junction, 1500 new homes (including affordable homes) a new primary school and community centre. A Segregated Active Travel Corridor will also improve connectivity and accessibility throughout the development,

2.3 The FBC noted at paragraph 3.3.1 that

"it is the intention of the parties to establish a formal joint venture company…. to take forward the development, management and operation of the hub and any future EIP. The principal reasons for adopting this approach are:

- *It offers a single point of interface (landlord) for tenants of the hub and future EIP while providing confidence that both QMU and ELC stand behind and are committed to the obligations and service being offered to tenants;*
- *An arms-length vehicle enables more nimble day-to-day management and governance structures to be put in place to respond to the rapidly evolving needs of the SME and innovation sector while retaining appropriate strategic control and influence for the partners;*
- *Over time, the JV vehicle may offer a desirable route to leverage in third party commercial investment on a structured basis;*
- *It provides appropriate financial and commercial incentives for both parties to invest in the success of the hub and EIP via their respective academic and land assets;*
- *It offers flexibility in recruitment of appropriate management and leadership resource to grow the offer and its standing in its key target markets over time; and*
- *A review of case study evidence suggests this is the most common formula for similar successful projects elsewhere in the UK and further afield with established advantages.*

2.4 The FBC also noted at para 4.3.1 that all VAT is recoverable (subject to confirmation from tax advisors).

2.5 The tax advice was that, on adopting a specific JV structure, (detailed in Appendix 1), the JV could exercise an Option to Tax on the construction and the development element of the Hub project which enabled the JV to reclaim the VAT. On that basis and for other financial and commercial advantages (as captured in the FBC), the JV structure and supporting legal documents were concluded in April 2022.

3. Main report

3.1 The delivery of the Hub remains on programme, becoming operational in summer 2025. Recent milestones achieved include (1) the appointment of the design team and (2) advancing critical documents to support the commercial success of the Hub. These include the Operational Business Plan, the Marketing Strategy and EIP development options.

3.2 The timing of the appointment of the design team is critical in terms of the interface with the VAT position. There is a time sensitivity as the design brief has been provided to the design team who will commence the design process, scheduled for completion in November 2022. Approval of the reinvestment of the reclaimed VAT would allow the additionality (as detailed in paragraphs 3.6 to 3.9 below) to be designed in at the outset. Furthermore, it will avoid abortive design work or late stage design changes that would risk programme delay and cost increases.

3.3 To enable the recovery of the VAT the JV have submitted to HMRC:-

- An application to register Edinburgh Innovation Park Hub Operating Company for VAT;
- An application to register Edinburgh Innovation Park Hub Development Company for VAT; and
- Supporting tax forms being:
    - The 1614A form
    - The VAT5L form.

3.4 Once HMRC have allocated the VAT number to the two companies within the JV structure (Hub Devco and HubOpco) than the JV is in a position to start to reclaim the VAT.

3.5 The JV recognise that any additionality must offer an enhancement of the Hub that benefits the end user. Paragraphs 3.6 to 3.9 below provide more detail on proposals that would all contribute to an enhancement of the Hub for the benefit of the end user.

3.6 **Design & Specification enhancement**

Improved functionality, infrastructure and flexibility focussed on end user experience.

- Provision of office furniture in some office and write up areas.
- Extended fitting out in the Hub Café.
- Vibration – improved (lower) level of vibration performance than previously briefed .
- IT Managed service quality and functionality enhancements including possibility of an improved resilient connection.
- Extended access control to individual suites. The current design brief limits access control to floors and wings with individual suites requiring a key. If access control were extended to all suites then this would provide a functional enhancement for tenant companies.
- Improved ventilation in the freezer farm to mechanical instead of a naturally ventilated solution.
- Provide some demised gas bottle stores with gas lines and manifolds to increase functionality for incoming tenant companies.
- It is proposed that 17.5% of the VAT amount (4% of the project costs) is set aside against this element of the project.

3.7 **Sustainability Enhancement**

Improving the sustainability performance/carbon emission impact of the project.

- Consider the whole life carbon costs of the project, including potential to deliver against net zero carbon targets in line with the Climate Change (Emissions Reduction Targets) (Scotland) Act 2019 and the Scottish City Deal carbon guidance.
- Consider elements of the Mechanical and Electrical plant and equipment installation for higher standards of energy performance and efficiency.
- Opportunity to make the metering strategy more comprehensive and higher specification in order to achieve long-term operational and financial advantages. The provision of offices and laboratories, (CL1 and CL2) mean that usage of electricity will vary very considerably between occupiers. An apportionment approach would be inequitable and therefore the metering strategy will be to ensure that all electricity used by tenant companies is recharged on an accurate and equitable basis.
- Make more robust assumptions regarding the extent to which electric car charging points are installed and are ready for use immediately following Practical Completion.
- It is proposed that 20% of the VAT amount (4% of the project costs) is set aside against this element of the project.

3.8 **Inflation risk**

- The construction industry in Scotland and the UK is currently experiencing unprecedented adverse market conditions, which is leading to significant rises in tender prices for a wide range of materials. Complications resulting from the withdrawal of the UK from the European Union have exacerbated this situation and continue to impact the UK construction sector.
- Key factors contributing to the pricing increases include contractors no longer being able to absorb strong upward pressure from input costs, rising demand, logistics problems and materials and labour shortages. In particular, materials price rises are likely to be an ongoing concern due to worldwide supply issues.
- This is being reflected in recent tender returns, which have indicated an increase beyond expectation for tender prices.
- Tendering contractors are making specific reference to time periods for the supply of labour and materials, a recent change in diesel rules, the current conflict in Ukraine and potential shortages of materials from China and elsewhere.
- Specific areas of major increases include groundworks, steel (structural and steel product), metal cladding, timber, insulation and fire protection.
- When the cost for the Hub project was reviewed in January, there was an estimated £1.5 million increase to the Hub project costs, which was primarily down to increased inflationary pressures. the contingency amount of £2.8m provided a level of protection from this however this would reduce the contingency to £1.3m which would be circa 6% and therefore will be a significant challenge at this early stage of the project. Since January,

inflationary pressures have continued to escalate and it is likely that the cost of the project has risen further due to market conditions.

- We have evidence that inflation can be shown to be affecting projects between 10% and 15% beyond BCIS predictions. We therefore recommend that to provide further protection to delivering the quality product set out in the brief we should set aside 62.5% of the VAT amount (12.5% of the project costs) to deal with this significant project risk.

3.9 To summarise, paragraphs 3.4 to 3.8 above set out a menu of possible enhancements that overall will contribute to the Hub having a greater impact, thereby being a more attractive proposition to the end-users and positively impacting the viability of the Hub. Furthermore the menu of possible enhancement will allow consideration of options to contribute to the achievement of the Climate Change (Emissions Reduction Targets) (Scotland) Act 2019 net-zero carbon target whilst offering a level of protection against construction inflation.'

4. Financial impact

4.1 Through the approval of the FBC, East Lothian Council and Queen Margaret University secured funding of £30 million being £28.5 million from UK Government, £1.4 million from the Scottish Government

4.2 East Lothian Council has provided a capital contribution of £10 million (being £6 million for the construction of the Hub and £4 million for the acquisition of the land on which the Hub and wider EIP will be located).

4.3 Approval of the reinvestment of reclaimed VAT monies will enhance the value proposition for the end user as detailed in Paragraphs 3.4 to 3.9 above

5. Alignment with Sustainable, Inclusive Growth Ambitions

5.1 The proposals align with sustainable inclusive growth ambitions by supporting the propositions set out in Paragraph 3.8

6. Background reading/external references

6.1 Edinburgh and South-East Scotland City Region Deal Document, August 2018.

6.2 Queen Margaret University Innovation Hub for Food, Drink and Health Sciences Business Case - Edinburgh and South East Scotland City Region Deal Joint Committee 4 June 2021

7. Appendices

7.1 Joint Venture diagram

The Edinburgh Innovation Park Joint Venture