Reducing the threat, building resilience
empowering communities

Future funding strategy: ‘payment for outcomes’

Flood and Coastal Erosion Risk Management

December 2010

defra

Summary

- Defra is consulting on a new funding system for capital investment projects from April 2012
- The new system builds upon the current set of outcome measures but introduces the concept of Government paying set amounts per outcome delivered – '*payment for outcomes*'
- Doing so would potentially mean:
  - greater certainty of funding for each project, based on the outcomes and benefits expected
  - a more transparent and fairer allocation system between sources of risk, and parts of the country
  - more local choice for local authorities and RFCCs over what and when projects can proceed
  - better value for money for the taxpayer, by encouraging cost reduction as well as more external contributions to come forward
- Would value peoples' input as part of the consultation

Drivers for change

- There will always be a limit to how much the national taxpayer can be expected to pay towards flood defence
  - As each £1 spent on flood/coastal risk management is a £1 added to the burden of general taxation (income tax, VAT, etc) , and a £1 that can't be spent on other priorities such as schools, hospitals, defence, policing etc
- There are always likely to be more projects worth doing than can be afforded by Government alone
  - Even if Government funding were to double by 2035 many projects with benefits far in excess of the costs would remain unaffordable
- Communities have little say and financial stake in what is done
  - Most choices are currently taken nationally in order to deliver Ministers' outcome targets and achieve value for money
  - Where defences are funded there is little incentive for people to contribute or to find ways to reduce the costs involved
  - This means less funding is left for schemes elsewhere in the country

Objectives of the new funding system

- Encourage total investment to increase beyond levels that Government can afford alone
  - To meet the twin challenges of climate change and the natural deterioration in existing defence assets
- Enable more local choice within the system, and encourage more cost-effective options to come forward
  - By giving every area an explicit choice over whether they value better protection being provided, and in what form
- Maintain the widespread take-up of flood insurance
  - As investment sustains affordable insurance. Government support would focus on those most at risk and least able to pay, who are less likely to be adequately insured

The proposal - ‘payment for outcomes’

- **Defra sets a new outcome measure framework** and says how much it is prepared to pay per outcome achieved by EA, local authorities and IDBs
  - **Ministerial targets no longer set**, as delivery of outcomes largely dependent on decisions by local authorities and Regional Flood and Coastal Committees
  - **Outcomes treated equally for all sources of flood risk and all operating authorities**, c.f. surface water projects not being funded at present, and IDBs capped at 45% grant rates
  - **Reward levels set for years in advance**, to provide certainty over funding levels for each project, and avoid contributions being delayed in the hope that terms improve
  - **New properties do no count for the purposes of funding**, to avoid any incentive to allow new development on the flood plain in order to justify future protection at the taxpayers’ expense
- **Payment levels are scaled** to prioritise the most important outcomes
  - Households at **significant risk**, especially in **deprived areas**; as households in these areas are least likely to be insured, nor easily recover following flooding without state support
  - Plus promoting **property-level protection** in areas at very significant risk
  - Plus delivering the **environmental outcomes** needed to meet EU legislation, such as the Water Framework Directive, Birds Directive and Habitats Directive
- **Payment rates relate directly to the value of benefits achieved** when outcomes are delivered, plus how many years the benefits will last for

Outcomes and reward levels

- **Outcomes and reward levels focus will be risk-based** - focused on avoiding future damages - regardless of the source of risk or who plans to manage it
  - All projects will still need to be appraised and scrutinised under current procedures before approval
- Flood Defence Grant-In-Aid – i.e. general taxation - **expected to pay primarily for the national, public, share of project benefits**
  - As opposed to the local, private, share of the benefits – as Pitt recommended these should be funded by the beneficiaries concerned
  - Benefits for all sectors, both public and private, will be fully valued as part of each project, but FDGIA will only pay a ‘fair share’ of each projects’ benefits (which will still be 100% of costs in many cases)
  - Businesses, agriculture and private infrastructure etc will be given less funding support than householders on the basis that these sectors should be encouraged to respond to price signals and adapt as appropriate to the risks they face, including by contributing towards local projects
  - Smaller businesses (village shops, high streets, etc) and local infrastructure (schools, other public buildings, etc) likely to be protected by projects justified on the basis of the households in the area
- **Coastal erosion, and property-level protection, included as separate outcomes** for the first-time, and rewarded on an equal ‘damages avoided’ basis
- **Environmental outcomes also included** as they are needed to meet EU legal requirements. These will be fully paid for, as projects unlikely to proceed otherwise

Value of outcomes to the taxpayer

Main assumptions

£30,000

Average household damages caused by a flood based on 2007 flooding

£6,000 per year

Loss from coastal erosion based on avg. rental income

£5 *per £1 spent*

Min. Benefit Cost Ratio (BCR) required for taxpayer

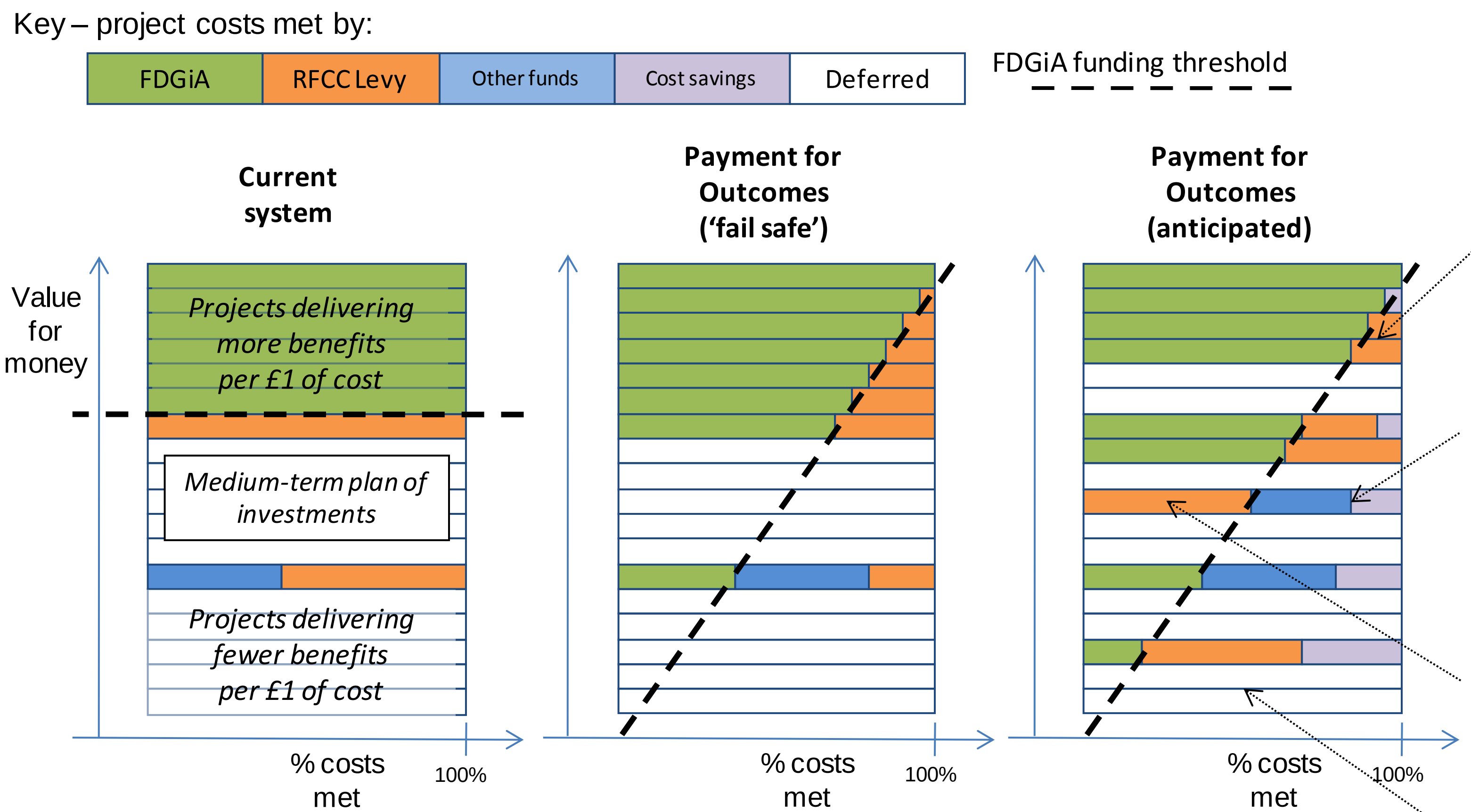
All values indicative only - subject to consultation

From:	To:	Govt. pays per year	Present Value discounted@3.5%
1 in 100 Moderate risk *£300 annual damages*	1 in 200 Low flood risk *£150 annual damages*	£30 £150 divided by 5	£710 pv per household over 50 years
1 in 20 Significant risk *£1500 annual damages*	1 in 100 Low risk *£150 annual damages*	£270 £1350 divided by 5	£6,415 pv per household over 50 years
Loss from erosion in year 20 *£3050 avoided in yr20*	Loss from erosion in year 70 *Damages delayed 50yrs*	£610 £3050 divided by 5	£14,490 pv per hh over 50 years
Very significant risk *£2,000 annual damages*	Property-level protection *£750 annual damages*	£250 £1250 divided by 5	£2,100 pv per household over ten years
Outcomes in	*deprived areas*	*values x*	*2.25*

Importance of the RFCC & Local Levy

- **All projects would be offered some FDGIA funding** – meaning less money needed from the 'local levy' for projects RFCCs might otherwise need to fully fund
- Instead, the **RFCC levy becomes the 'safety valve' for the entire system**:
  - <u>If FDGIA is undersubscribed</u> (i.e. not enough fully-fundable projects), RFCCs encouraged to use the levy to pay for the *local contribution* element necessary to take more projects forward - up to the point where FDGIA is exhausted
  - <u>If FDGIA is over-subscribed</u> (i.e. more fully-fundable projects than can be afforded), RFCC's encouraged to use the levy to pay the *FDGIA element* needed to avoid the projects having to be deferred – up to the value of the local levy the RFCC votes for
- In doing so, **RFCCs decide which projects proceed in to the 'Regional Programme'**, and which projects are deferred, based on their willingness to raise local levy
- **EA retain control over a 'National Priority Programme'** – a critical mass of the most beneficial projects to the nation
  - To avoid these projects being delayed, and so EA can continue to deliver an efficient investment programme that exploits economies of scale and a stable long-term pipeline
  - Local authorities are encouraged to leverage the benefits of these projects to help pay for lower benefit schemes within the Local FRM Strategy. This is so that overall, costs and benefits of the entire local strategy can be shared fairly between groups and areas

What this might look like…



RFCCs determine the programme to a larger extent by them choosing where to invest local levy

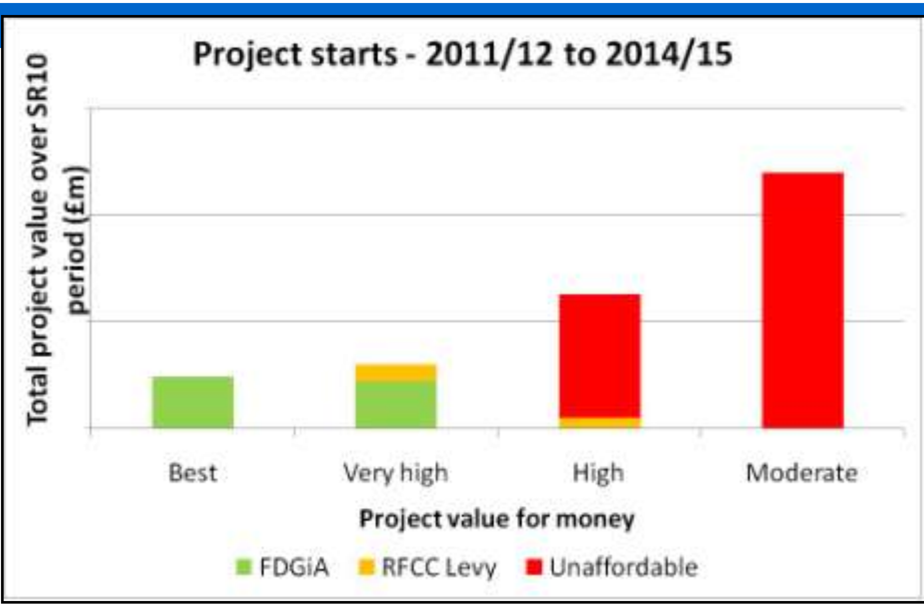
As there is greater certainty of at least some funding on offer, cost savings and other funding sources are encouraged to come forward

If FDGiA is used up RFCCs can decide to fund the FDGiA element of projects so they can still go ahead

Overall, fewer projects may have to be deferred

Impact of ‘payment for outcomes’

- Existing ‘all or nothing’ system
  - All available funds would be drawn in to delivering only the most beneficial projects
  - Contributions unlikely towards lower benefit schemes as the costs are high and unsubsidised, benefits more marginal, and people will naturally want to hold out in the expectation of full funding
  - Potential for many projects to be deferred without any promise of taxpayer support, even though the benefits in some cases will be only marginally less than for the fully funded schemes
- Payment for Outcomes
  - Concept of a ‘National Priority Programme’ preserved to avoid the most important projects being delayed and allow EA to continue to exploit certainty over funding and economies of scale
  - Lower benefit projects more likely to proceed, as costs are encouraged to fall and taxpayer support is available if enough other money can be found
  - Fewer projects deferred, and projects are only deferred if local areas decide not to pay the remaining share of costs, and the RFCC decides not to support the project either



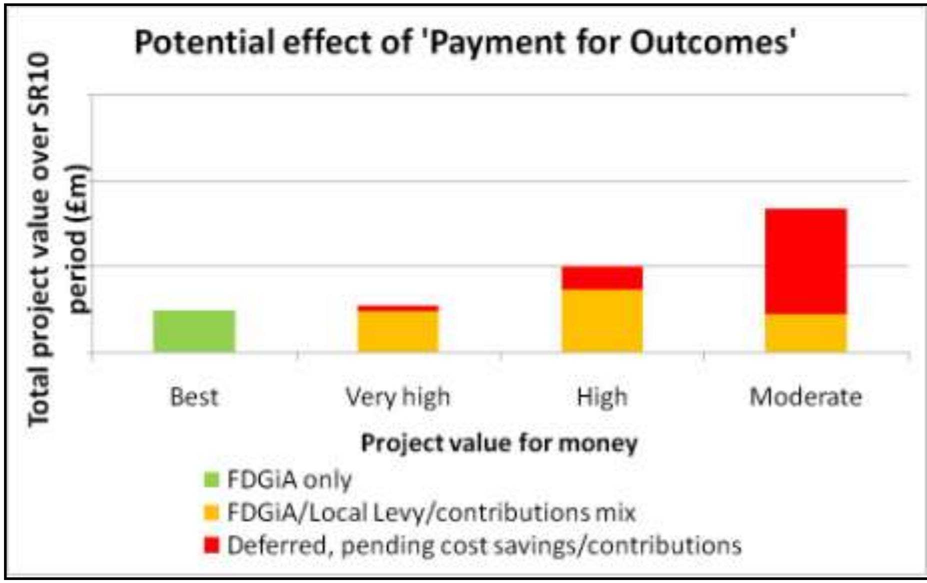


Illustration: Major city-centre

- Major fluvial flood risk management project, £120m whole-life costs
  - 3,800 households being protected from significant risk, mainly in deprived areas
  - >90% of benefits relate to business districts and commercial development of the riverside
  - Expected to deliver £370 million in benefits over the 100 year life of the scheme
  - The relatively low benefit cost ratio (3.1) means unlikely to ever justify full funding
- Under the new system, EA would offer ~£60m from FDGIA towards the whole-life costs, based on the outcomes delivered over the 100 year life of the scheme
- If they wish the scheme to go ahead, the city council could decide to:
  - Seek to reduce the whole-life costs to below £60m, to allow it to be fully funded
  - Commit to raise £60m (present value) over the lifetime of the scheme, through a locally-decided mix of borrowing, business rates, developer contributions, etc
  - Or a combination of cost reduction and alternative funding
- The taxpayer is guaranteed VFM for its share, a 6 to 1 return in this case
- The city is protected for the next 100 years, also at an effective 6 to 1 return
- By reducing the costs of the project to the taxpayer by £60m many other projects can also go ahead in parallel and would no longer need to be deferred

Next steps

- Consultation documents available at:
  - http://www.defra.gov.uk/corporate/consult/flood-coastal-erosion/index.htm
- Consultation closes on February 16th, 2011
- Final National Strategy expected in the spring
  - This will confirm the way forward on funding at a high level, based on the consultation responses
  - Then later in the spring/summer a Defra policy statement anticipated , to set the final framework in terms of outcomes and payment rates etc
  - Finally, EA will publish guidance in summer 2011 on how the new system will operate
- New system becomes operational from April 2012, as part of EA's 2012/13 medium-term plan