



Article by Denise Stephenson, Partner

## **EXAMPLES OF WHERE A SECTION 106/DEVELOPMENT AGREEMENT MIGHT BE CAUGHT BY THE PROCUREMENT RULES**

### **Introduction**

Until fairly recently, European courts have not really been concerned with the question of whether works (as set out in a Section 106 planning obligation, development agreement or regeneration scheme) carried out on behalf of the public authority by a developer – where it procures a benefit to the public authority – constitutes a “public works contract”. That is, until the ECJ’s judgment in the case of *Jean Auroux v Commune de Roanne (C – 220/05)*.

Keith Simkins has given you the detail of this case and its effects – suffice to say many regeneration schemes around the country and no doubt around Europe were delayed or stalled completely as a result of that judgment as public authorities examined whether they needed (and actively undertook) to procure or tender for contracts and services. However, we have been given some reprieve and a level of clarification in the case of *Helmet Muller v Bundesanstalt [2010]*, the judgment of which was issued on 25 March 2010.

Before we go into this in detail, or the drafting examples, let us set out the mechanism of a Section 106 planning obligation.

Section 106 planning obligations:-

- (i) The power for a local planning authority to enter into a planning obligation is set out in Section 106 of the Town and Country Planning Act 1990 (as amended). The main provisions are as follows:-
  - (a) used primarily to make acceptable development which would otherwise be unacceptable in planning terms<sup>1</sup>;
  - (b) underlying principle which underpins use of planning obligations is that planning permission should not be bought or sold;
  - (c) bilateral agreement/unilateral undertaking entered into by deed;
  - (d) enforceable by injunction against the original covenanting party and anyone else acquiring an interest from it;
  - (e) may be conditional or unconditional; and may:-
    - (i) restrict development or use of land in a specified way;
    - (ii) require specified operations or activities in, on, under or over land;

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<sup>1</sup> Paragraph B3 of Circular 05/05.

- (iii) require land to be used in a specified way; and
  - (iv) require a sum or sums to be paid to the authority.
- (ii) Planning obligations must comply with the tests of Circular 05/052.
- (iii) Case law dictated the scope of tests and the extent to which the use of planning obligations must comply with them.

### **What is a development agreement?**

Briefly, this is an agreement to develop a piece of land for commercial/personal use. The development agreement will set out the time limits for certain steps to be undertaken, e.g. land transfers or submission of an application for planning permission, etc.

### **What is a public works contract?**

Article 2(1) of the Public Contracts Regulations 2006 defines a public works contract as “a contract in writing for consideration (in cash or in kind): (a) for the carrying out of a work or works on behalf of a contracting authority; or (b) under which a contracting authority engages a person to procure by any means the carrying out for the contracting authority of the work corresponding to particular specified requirements”.

### **European cases**

Cases such as *Auroux* bought development agreements and other specified works which a developer may undertake pursuant to the undertaking by an LPA of their planning functions, into the procurement spotlight. The principle highlighted in *Auroux* was:-

- (i) where there are works or a piece of work specified by a contracting authority; and
- (ii) there is an enforceable obligation on the developer or contractor to carry out works, e.g. a development agreement/Section 106 planning obligation; and
- (iii) there is some pecuniary interest for carrying out this work (not necessarily a cash payment – some argue the grant of planning permission could suffice)

this is likely to constitute a public works contract there is no capital at this.

Note that where a contract does not contain a legally binding obligation for a contractor/developer to undertake works (even where land was transferred to that body for that purpose), there is a right to buy back if works are not undertaken and the general intentions for the scheme are mooted (although not specified in a legal document) this will not be considered as a public works contract (in the European Commission decision on *Flensburg [2008]*).

The case of *Muller* (referred to above) greatly curtailed and assisted in clarifying the scope of what would be considered to be a public works contract. For such a contract to fall within the procurement laws it must include works or a piece of work carried out on behalf of the public authority to their specification resulting in immediate economic benefit to the authority. The three main tests coming out of the judgment are:-

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<sup>2</sup> It is now unlawful for permission to be granted subject to a Section 106 planning obligation if it does not comply with the three tests set out in Regulation 122 of the CIL Regulations 2010.

- (i) are there material and physical works being undertaken or carried out for the contracting authority; and
- (ii) is there an immediate economic benefit to the contracting authority as a result?
- (iii) Have the works have been undertaken have been done in the exercise by the local planning authority of its urban planning powers?
- (iv) If the first two limbs satisfied as above then this element may not save the contracting authority from having to comply with the procurement rules (see the case of *Auroux*).

We now need to look at whether the specific requirements of a Section 106 obligation are capable of falling within the definition of a “public works contract”. Please note that each case will need to be determined on its own facts and therefore the advice given in the sample scenario below is strictly on the basis of the information as it pertains to that case. The general principles, however, can be applied safely to each individual case. There may well be other considerations.

### **Scenario**

The following is a sample scenario only, it is not based on any facts and the advice given is based on the current law, following the ECJ’s decision on *Muller*. Obviously, as further cases come out of the ECJ, the advice given may need to be reviewed.

Cox Town lies in the north of Appletree in the south west of the country. It is an area of low employment and is fairly run down and as such Appletree Council (the “Council”) have been planning for years to regenerate the area. The Council have commissioned a company to produce a regeneration scheme and in line with the Council’s Area Action Plan, the scheme identifies the need for a new shopping centre, leisure facilities, not less than 2,500 residential units, retail units, new access roads and the provision of open space. A number of developers and landowners are working with the Council to realise this vision.

The Council is approached by Bramley PLC (“Bramley”), a well known housing developer in the area. They have produced good, well designed, sustainable schemes. They also own 70% of the land on which the residential units and some other uses are proposed to be located. (The Council owns the remaining 30%.)

Bramley indicate that they intend to submit a planning application for the regeneration of this part of Cox Town for the provision of 2,500 residential units, shops and restaurants, new access roads and the provision of open space.

Policy 20 of the Council’s Development Plan requires that, for any development proposing more than 15 residential units within the borough, the Council will seek 40% provision of Affordable Housing across the whole development. At present there is not an Affordable Housing Provider (“AHP”) in place, however, the Council’s arms-length management organisation, Appletree Housing Corporation (“Appletree”) has offered to manage the units subject to the transfer of the freehold or long leasehold of the Affordable Housing Units to the Council once they have been constructed and are ready for occupation. They have also provisionally offered to invest £2.5 million into the scheme.

The Council's Housing Needs Survey for 2009 indicates high levels of need for Affordable Housing and the Council has failed to meet its previously developed land targets but is near its up-to-date five year supply of deliverable sites. For this reason, the scheme is vitally important to the Council.

The scheme is not well located for schools, the nearest primary school is seven miles away and the nearest secondary school is 10 miles away. There are also no community or leisure facilities nearby but the Developer is speaking to the Council on this point.

The Council are keen to progress with Bramley's proposal. Bramley submits a planning application which is granted subject to a Section 106 agreement. Some of the heads of terms are as follows:

### **Affordable Housing**

Due to there being no AHP in place, and therefore no funding from the Housing Corporation, there is a viability issue. The Developer has therefore requested that it provides lower levels of Affordable Housing, 30%, within the earlier stages of the development's completion with an overage clause to secure future payments or future provision of Affordable Housing Units on the site if the market picks up. The Developer has also promised to pay the Council an additional 25% of the value of each Affordable Housing Unit provided. This is in exchange for the £2.5 million investment to be provided by Appletree. As such the Council have agreed for an initial provision of 30% Affordable Housing on the site.

The terms of the Section 106 agreement as it relates to Affordable Housing is as follows:-

- (i) the Affordable Housing Units are to be constructed and completed in accordance with the Council's Affordable Housing Specification (the Specification has been prepared by the Council and is attached to the agreement) and be made ready for Occupation to the Council's reasonable satisfaction and prior to the use or Occupation of more than 50% of the Market Housing Units; and
- (ii) not more than 50% of the Market Housing Units are to be occupied until the Affordable Housing Units have been completed as above and the transfer for £1.00 or long leasehold of not less than 125 years, at a peppercorn rent has been made to the Council.

(i) and (ii) are to be completed prior to the occupation of any more than 50% of the Market Housing Units.

The overage clauses included which will ensure the Developer provides a lower level of Affordable Housing Units now but this is to be assessed in two years time and if the appraisals demonstrate an increased provision of Affordable Housing is possible, Bramley will provide this on site with a payment to the Council of 25% of the increase in the value of each Affordable Housing Unit in exchange for the £2.5 Million investment from Appletree.

Other Affordable Housing clauses are included as usual.

### *Questions*

Do any of these clauses or scenarios cause problems in so far as procurement is concerned?

In order to answer this question we need to have a look once more at the tests set out in Muller and deal with each question as it relates to this scenario.

- (i) Are the works physically and materially carried out on behalf of the Council?

There is a contract (the Section 106 obligation) which imposes an obligation on the Developer to build the units in accordance with a detailed specification. The existence of the contract itself does not pose a problem; however, the works to be undertaken will be materially and physically carried out for the benefit of the Council as it is to be transferred to an ALMO. Also the works are to be carried out in accordance with the Council's detailed specification and using the tests set out in *Auroux* this most certainly tips this element of the agreement into public works contract territory. Approval of plans submitted by a third party is not sufficient to constitute a works contract. However, developing a detailed scheme or specification which has design specifications, requirements as regards to location, etc, potentially is a works contract if it is done on the Council's behalf.

- (ii) Is there an immediate economic benefit to the Council?

Yes. The Developer has strangely offered to pay the Council 25% of the market value of each additional Affordable Housing Unit provided on the site in exchange (they say) for the £2.5 million to be provided by the ALMO. This is a definite economic benefit to the Council.

Secondly, the transfer to the Council of the Affordable Housing Units is an immediate economic benefit as the Council will be able to use the receipts of that transaction to obtain loans against it. The Council will also take the benefit of the increase in the market value of the properties once they are sold as the transfer is to be made to the Council for £1.00 or, if leased, a peppercorn rent. In my view, this renders the Section 106 agreement a public works contract.

#### *Advice*

Does the fact that the Council is exercising its town planning powers provide an exemption?

No, the case of *Auroux* provided that the contract will fall foul of the procurement rules and this is the case regardless of the fact the contracting authority is exercising its urban planning powers. Muller does not appear to change this position.

The payment to the Council by the Developer (25% of the market value of the additional Affordable Housing Units) falls foul of Circular 05/2005 (remember three of the five tests of the Circular have been given statutory status now following on from the implementation of the Community Infrastructure Levy Regulations ("CIL Regulations")). Legal advisers should be stepping in at this point.

- (i) do not have agreements for the transfer of sites or units to the Council following works done to the Council's specification as this will result in an immediate economic benefit to the Council. Transfers or letting of property or land does not render the transaction a public works contract. What may do is if works are undertaken on the Council's behalf in accordance with a detailed specification provided by the Council. Such a transaction if set out in an agreement will be a public works contract. Its effect, though it may not be stated, will be to also provide the authority with an immediate economic benefit;

- (ii) do not supply a specification. It is acceptable for the Developer or another third party to supply a specification and for the Council to approve this, but not for works to be carried out in accordance with a detailed specification set out by the Council. That will amount to a public works contract;
- (iii) where you have the provision of Affordable Housing it is better to have an AHP on board. The AHP can then manage the site and if the transfer is made to it, then it will potentially be left with the issue of procurement (see my points on this shortly).

Would the answer be different if an AHP was on board/party to the legal document?

- (i) Save for the payment of money to the Council, if an AHP was to take the transfer/lease of the units from the Developer, this would change the situation in that this element of the Section 106 agreement would not be taken to be a public works contract. This is the normal scenario that you find in Section 106 agreements. Keith may have some comments about whether the fact that the Developer then builds out the scheme to the AHP's specification would render that element of the Section 106 agreement a public works contract. No doubt he will clarify this in his paper. If it does, it is for the AHP to seek to meet the procurement requirements and tender for the work to be done.

### **Schools**

As stated before there are no nearby schools in the area. Child yields are expected to be fairly high in light of the substantial provision of flats and houses of three bedrooms and above to be built on the site. The Council would like a school built on land owned by the Developer. The Council have therefore agreed with the Developer that the following will be requested through the Section 106 agreement:-

- (i) the Developer shall construct and complete the School to the Council's specification on the Green Land shown on the Plan X; and
- (ii) will fit out, service and equip the School in accordance with the Schools Specification (again such specification has been provided by the Council and is attached to the Section 106 agreement) such that its facilities are ready for use by those using the School;
- (iii) the Developer covenants not to Occupy any more than 50% of the Market Housing Units until the School has been built to the Council's reasonable satisfaction and transferred for £1.00 or leased at a peppercorn rent to the Council.

### *Questions*

Is this a public works contract?

Are these works materially or physically carried out for the Council?

The works are physically and materially carried out by the Developer on the Council's behalf. There may have been other competitors interested in developing the scheme for the Council. This situation is similar to that of *Auroux*.

Is there an immediate economic benefit.

Yes. The transfer of the land to the Council will mean again the Council will be able to use the receipts of the transfer to obtain loans against the land and will undoubtedly make a profit on the sale or lease.

Does the fact that it is exercising a town planning function provide an exemption?

No. This is obviously providing much needed schooling in the area and this Council, in exercising its planning functions, is requiring the School in mitigation of the adverse affects (pressures) the development will place on the educational services in the area. However, as the Council will derive economic benefit and since works being undertaken in accordance with its detailed specifications this will mean the contract will be a public works contract.

#### *Advice*

Councils are therefore advised in this situation to ask for a contribution and to undertake the works themselves. This is the safest way of ensuring that the contract does not fall foul of the procurement regulation. The Developers will no doubt argue that it is cheaper for them to build out the school than it would be for them to pay for the Council to do it. However, this is not a mitigating factor in determining whether or not the Council should be requiring a full contribution rather than for the school to be built out. This is the safest way to avoid the procurement regulations and it is what we would advise in this case.

### **Community/Leisure Centre Facilities**

The Council had identified the land they owned on this part of Cox Town (the remaining 30%) as being a suitable site for a Community/Leisure Centre Facility to be used by members of the public. This is also set out in the regeneration scheme and the Area Action Plan. The Council, once the Community/Leisure Centre Facility is finished, intends to transfer the site to a well known leisure operator at market value, but will seek to ensure that members of the public are given access to the leisure centre at a discounted rate. The Council thereby agrees the following with Bramley which is set out in the Section 106 agreement:-

The Developer covenants with the Council to undertake the following:-

The Developer shall:-

- (i) construct and complete the Community/Leisure Centre Facility on the Blue Land (identified as that which is owned by the Council); and
- (ii) fit out and equip the Community/Leisure Centre Facility in accordance with the CFLC specification (as defined, this to be drawn up at a later stage) such that all its facilities are ready for use by the public

prior to occupation of 60% of the Market Housing Units;

- (iii) not to allow occupation of any more than 60% of the Market Housing Units unless and until the Community/Leisure Centre Facility has been completed and is ready for use to the satisfaction of the Council.

### *Questions*

As this is on Council land, is this a public works contract?

Using the tests in Muller:-

- (i) Are the works to be undertaken materially or physically carried out for the benefit of the Council?

Yes and it is also to be done in accordance with the Council's specification. These two factors ensure that, subject to the questions below, this can be considered to be a public works contract.

- (ii) Is there an immediate economic benefit to the Council?

Definitely yes, as the Council is to sell or lease the Community/Leisure Centre Facility to the leisure operator at market value.

- (iii) Is the exercise of the Council's town planning powers an exemption?

This should not render the contract free from the procurement rules. There may be policies relating to the provision of leisure facilities, however, those are not being strictly used for regulating planning powers although the provision of the Community/Leisure Centre Facility may be in accordance with the Council's Development Plan. The same issues as set out in paragraph 2.2.1 above will apply here.

### *Advice*

The LPA should require that the Developer makes a contribution for the provision of the Community/Leisure Centre Facility and the Council carries out the work. Whomever the Council instructs to undertake the works must be appointed subject to the procurement regime separately.

### **Local Labour**

Cox Town has a low rate of employment. The regeneration scheme will obviously bring in much needed employment into the area and the Council wants to capitalise on this through local labour provisions in the Section 106 agreement. The Council thereby agrees with the Developer that the agreement will contain the following:-

The Developer will use reasonable endeavours to ensure:-

- (i) at least 70% of full time equivalent jobs on the Development Site are filled by residents of the Local Area (defined in the agreement as Cox Town and the area within a five mile radius of Cox Town) and that 30% are filled by residents of Appletree;
- (ii) that it will advertise jobs through local employment agencies such as Appletree Jobs, Appletree Employers and Appletree Positions and to notify such vacancies to those listed and advertise the vacancies on the Developer's website; and

- (iii) to continue to provide a list of those employed to the Council with details of the names, addresses and dates of birth of those employed together with details of their job title.

#### *Question*

Is this a public works contract? Yes.

Does it breach any EU requirements?

This is a breach of freedom of movement and is a potential discrimination against those from other areas/countries.

#### *Advice*

Ensure such clauses are drafted generally, i.e. recruit from an area where the GDP is below £100,000 per annum – this could include any number of countries or towns in the UK.

Avoid reference to a particular recruitment company as this is restraint of trade.

#### **Conclusion**

The question of whether a Section 106 planning obligation (or elements of it) involves a public works contract will depend on the particular requirements of that contract. Applying general principles:-

- (iv) works which are specified in a document to be undertaken by a developer;
  - (v) for the benefit of a contracting authority;
  - (vi) to a specification produced by the authority;
  - (vii) which results in immediate economic benefit to the authority;
  - (viii) regardless of whether the Council is exercising its urban or town planning powers
- will be a public works contract.

My advice to you is to seek the advice of a planning or procurement lawyer if you have clauses such as these which you are concerned about.

Planning solicitors are currently concerned with the effect that the CIL Regulations<sup>3</sup> will have on Section 106 obligations. The Government's intention is for a severe curtailment of the use of Section 106 planning obligations and for any works relating to infrastructure to be paved through by way of a tariff/standard charge regime.

Local planning authorities have discretion as to whether or not to apply CIL and will need to take certain steps, i.e. adopting a charging schedule which is subject to an examination in public, prior to adopting CIL. However, a lot of this depends on what happens with the General Election as the Conservative Party have spoken in the past about scrapping CIL.

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<sup>3</sup> Came into force on 6 April 2010.

In the event that the CIL Regulations are retained and are adopted by local planning authorities this will obviously result in a substantial reduction in the use of Section 106 agreement and therefore the issues that we have discussed as regards procurement may well be academic.

As with most recent changes to the planning system, this is another case where we will have to wait to see what comes out in the wash!

**This note is intended to provide a brief overview of the legal principles under discussion.  
It is not intended to be a comprehensive guide or to constitute legal advice.**

