Manchester City Council
Report for Information

Report To: Resources and Governance Scrutiny Committee – 11 January 2022

Subject: Funding of the Capital Programme

Report of: Deputy Chief Executive and City Treasurer

Summary

This paper provides a summary of the Council's proposed capital investment priorities, which will be included in the Capital Strategy report to Executive in February.

Recommendations

The Committee is asked to note and comment on the report.

Wards Affected: Various

Environmental Impact Assessment - the impact of the decisions proposed in this report on achieving the zero-carbon target for the city
Under the governance process for capital expenditure decision making, zero and low carbon measures are a key component. Each project must set achievable carbon reducing targets before being approved. For some projects, the aim of the investment will be to reduce the City's carbon impact, for example the Civic Quarter Heat Network.

Manchester Strategy outcomes	**Summary of the contribution to the strategy**
A thriving and sustainable city: supporting a diverse and distinctive economy that creates jobs and opportunities	The capital programme contributes to various areas of the economy, including investment in public and private sector housing, education and children's social care, transport infrastructure, major regeneration activities, environmental, cultural and leisure services.
A highly skilled city: world class and home-grown talent sustaining the city's economic success	The capital programme includes substantial investment in education and also provides opportunities for the construction industry to bid for schemes that could provide employment opportunities at least for the duration of contracts.
A progressive and equitable city: making a positive contribution by unlocking the potential of our communities	The capital programme includes investment in adult and children's social care, education, housing and the environment, cultural and leisure services, all of which contribute towards

	the strategy.
A liveable and low carbon city: a destination of choice to live, visit, work	Investment in all areas of the capital programme contributes towards the strategy, notably investment in sustainable and affordable housing, building schools for the future, transport, environmental and major regeneration programmes.
A connected city: world class infrastructure and connectivity to drive growth	Through investment in areas such as ICT and the City's infrastructure of road networks and other travel routes

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy, please contact one of the contact officers above.

Report to the Executive 17 February 2021 (Capital Strategy and Budget 2020/21 to 2024/25)
Report to the Executive 17 November 2021 (Capital Programme Monitoring 2021/22)

1.0 Introduction

1.1 This report seeks to provide the Committee with an update on the Council's capital financing position, based on the existing approved capital programme, the future constraints, and the prioritisation approach to capital investment.

2.0 Background

2.1 The Council sets a capital budget each financial year. However, unlike revenue expenditure, capital expenditure by its nature is not cyclical as it relates to the creation of assets, so the capital programme is managed on a rolling basis with approved projects added when required. The budget report reflects the programme at a specific point in time and represents all the projects which have received funding approval.

2.2 On an annual basis the Council publishes a Capital Strategy as part of the budget process, which sets out the governance arrangements, details the existing approved programme, and indicates potential future investment requirements. The approved programme has to be affordable within the revenue budget in terms of capital financing costs.

3.0 Development of the Capital Strategy

3.1 The Capital Strategy sets out the longer-term context for future investment and is developed to ensure that the Council can take capital expenditure and investment decisions in line with Council priorities and properly take account of stewardship, value for money, prudence, risk, sustainability, and affordability.

3.2 The current capital programme includes planned investment of c£1.1bn by 2024/25. The details can be found in the November Executive report. This represents current approved spend and does not yet include future grant programmes and any additional planned investment. An updated capital programme will be included in the suite of February Budget reports.

	2021/22 forecast	**2022/23 forecast**	**2023/24 forecast**	**2024/25 forecast**	**Total**
	£m				
Highways	48.0	34.8	2.3	0.0	**85.1**
Neighbourhoods	38.6	55.1	17.1	0.0	**110.8**
The Factory and St John's Public Realm	50.6	38.5	0.0	0.0	**89.1**
Growth and Development	83.2	69.7	36.2	5.0	**194.1**
Town Hall Refurbishment	60.4	83.5	65.6	40.7	**250.2**
Housing – General Fund	18.6	15.4	12.7	2.7	**49.4**

Housing – Housing Revenue Account	28.3	56.5	22.4	5.5	**112.7**
Children's Services (Schools)	33.7	35.3	24.3	0.0	**93.3**
ICT	6.4	8.5	7.3	0.0	**22.2**
Adults, Children's, and Corporate Services	14.5	14.2	2.8	0.0	**31.5**
Total (*exc. Contingent budgets)*	**382.3**	**411.5**	**190.7**	**53.9**	**1,038.4**
Contingency Budgets	45.0	6.0	2.5	0.0	**53.5**
Total	**427.3**	**417.5**	**193.2**	**53.9**	**1,091.9**

3.3 The table below sets out the proposed funding for the current programme, which includes over £650m of borrowing.

	Draft funding 2021/22	**Draft funding 2022/23**	**Draft funding 2023/24**	**Draft funding 2024/25**	**Draft funding all years**
	£m				
Grants	97.2	76.0	42.6	0.0	**215.8**
Contributions	27.5	26.5	0.0	0.0	**54.0**
Capital Receipts	17.7	12.0	14.1	2.7	**46.5**
Revenue Contribution to Capital	29.4	52.0	20.7	5.5	**107.6**
Capital Fund	7.8	1.7	1.3	0.0	**10.8**
Borrowing	247.7	249.3	114.5	45.7	**657.2**
Total	**427.3**	**417.5**	**193.2**	**53.9**	**1,091.9**

3.4 The Capital Strategy for 2022/23 and beyond will consider future investment in the context of the financial constraints that the Council faces and market forecasts for interest rates. This report does not focus on the future priorities for capital investment but sets out how the capital financing arrangements work and the affordability and implications of any increased borrowing activity.

3.5 In terms of funding, the Council seeks to maximise the use of external grants and contributions to fund capital expenditure. The funding strategy recognises that capital receipts can only be used once, and therefore cannot provide a sustainable funding source. Projects which can generate an income stream to support capital financing costs and could therefore be considered fully or part self-funded are preferable, with prudential borrowing used as a last resort.

4.0 The Approach to Borrowing

Capital Financing Requirement

4.1 The Council's overall underlying need to borrow is called the Capital Financing Requirement (CFR). The CFR represents the level of borrowing that is required to fund the Council's current capital asset base (not just the current capital programme). This will include all historic and current schemes where the borrowing or debt has not yet been repaid.

4.2 In the Capital Strategy the Council is required to forecast the CFR and ensure that the associated borrowing costs are affordable. At the end of March 21, the total capital financing requirement for the Council is £1.65bn of which £0.9bn is covered by existing long-term debt and liabilities and the balance of £0.75bn is met from utilising the Council's cash backed reserves (known as internal borrowing).

Capital Financing Costs

4.3 When a capital project is funded from borrowing the associated revenue costs include the interest cost on the debt and the Minimum Revenue Provision (MRP). MRP is an annual revenue cost and is created to reflect the repayment of the debt. It is incurred annually over the life of the asset created, and in total will equal the borrowing used to fund the scheme. MRP must be paid on all capital projects with the only exception being loans provided to organisations where there are financial guarantees from a third party.

4.4 Borrowing is either from the Council's own resources (see below – where the Council uses its own cash balances) or borrowing external debt. In both cases MRP is payable.

Internal Borrowing

4.5 The Council's useable reserves are 'cash backed' i.e., there is physical cash in the bank or invested to support them. The current useable reserves (as per the 2021/22 Budget Report including earmarked reserves, General Fund reserve, Schools reserves and HRA reserves) are £515m. These are scheduled to reduce substantially by 2024/25.

4.6 The Council can choose whether to borrow externally, and incur external interest costs, or use its existing cash reserves and forgo any interest on those balances in what is known as internal borrowing. As the interest that can be gained from holding cash balances is lower than the interest rate paid on debt, the Council is one of many local authorities that has sought to maximise internal borrowing by using these funds to support the capital programme. When those reserves are required, the cash will need to be replenished from external borrowing. The Council is therefore delaying the need to borrow externally until the reserves are needed.

4.7 It is worth noting that this approach has, based on the current internal borrowing position noted above, avoided c. £15m of interest costs in this financial year based on current long-term interest rates.

5.0 How Capital Financing Costs are Funded

5.1 The Council has a c.£39.5m annual revenue budget for net capital financing costs. This incorporates interest costs related to external borrowing, MRP and interest income received on investments. The budget has been at a constant level for a number of years as any underspend has been used to create the capital financing reserve.

5.2 The capital financing reserve is a specific reserve created to support future capital financing costs. This was to recognise the need to repay the internal borrowing in the future, including for the significant borrowing requirement for the Our Town Hall refurbishment, and to smooth the impact of the increased borrowing costs on the revenue budget. In short, a reserve has been created to meet the increased capital financing costs in future years so there will be no additional pressures on the revenue budget, for the completion of the current programme.

6.0 Capacity for Additional Borrowing

6.1 The existing capital financing revenue budget and reserve are sufficient to cover the planned additional borrowing to fund the current approved capital programme and the planned use of reserves which will unwind some of the Council's internal borrowing. The Capital Financing Reserve as at March 2022 is expected to stand at c. £34.7m, and is available to support the additional revenue costs incurred from the additional prudential borrowing required and provides some flexibility to support additional borrowing for new capital priorities.

6.2 Due to the inherent uncertainty on future borrowing costs and the level of reserves held, it is not possible to say how much more prudential borrowing to fund the capital programme could be supported. As a rough estimate the reserve could support c. £100m of borrowing over the next 3-to-5-year Capital Strategy.

6.3 Whilst this is a significant sum, there are a number of competing priorities, and the reserve would also need to mitigate any overspend risks within the existing capital programme as well as new schemes.

6.4 This reinforces the importance of continuing to access grant funding, to seek external contributions to capital works, to support schemes that generate a revenue income stream that can repay borrowing costs, and to review the Council's existing asset base for potential disposals which could raise a capital receipt.

6.5 There may be scope to fund further borrowing from the revenue budget. However, it should be noted that a common feature of local authorities that have had to issue S114 notices is that they have been heavily borrowed and face high capital financing charges. It is also a balance between supporting capital funding priorities and the delivery of day-to-day Council services.

7.0 Conclusion

7.1 Careful financial management over a number of years of the Council's capital financing position has allowed significant capital investment and has mitigated the risks of the level of internal borrowing that the Council has.

7.2 The capital financing reserves are expected to deplete over the next ten years, as the capital programme is delivered, which will act as a constraint on any significant additional capital investment. There is a risk that additional revenue funding will be required, either to fund the investment directly or to increase the revenue budget for financing costs.

7.3 The Council will also need to ensure that its capital financing requirement and borrowing costs are proportionate and affordable in the longer term, so its overall financial position is not weakened. The new Prudential Code will place increased emphasis on regularly monitoring and reporting on the affordability of borrowing costs.

7.4 It is important to note that the forecasts in this report are based on market forecasts for interest rates and the capital and revenue monitoring positions, and therefore are subject to change. Officers will continue to monitor the capital financing forecasts and borrowing capacity.

8.0 Recommendations

8.1 The recommendations appear at the front of this report.