Manchester City Council
Report for Information

Report to:	Resources and Governance Scrutiny Committee – 6 December 2022
Subject:	Capital Programme – Impact of Recent Market Changes and Budget Process
Report of:	Deputy Chief Executive and City Treasurer

Summary

This report provides members with an update on the impact of recent changes in financial and construction markets on the capital programme and provides an update on the proposed capital budget process for 2023/24.

Recommendations

The Committee is recommended to note the contents of the report.

Wards Affected: All

Environmental Impact Assessment - the impact of the issues addressed 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. All capital projects are reviewed throughout the approval process with regard to the contribution they can make to Manchester being a Zero-Carbon City. Projects will not receive approval to incur costs unless the contribution to this target is appropriate.

Equality, Diversity and Inclusion - the impact of the issues addressed in this report in meeting our Public Sector Equality Duty and broader equality commitments

Manchester Strategy outcomes	Summary of how this report aligns to the OMS/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 this community strategy, notably the 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	The capital programme includes investment in highways infrastructure, and broadband expansion.

Full details are in the body of the report, along with any implications for:

- Equal Opportunities Policy
- Risk Management
- Legal Considerations

Financial Consequences – Revenue
None.

Financial Consequences – Capital
None.

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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 16th February 2022 – Capital Strategy and Budget 2022/23 to 2024/25
- Report to the Executive 16 November 2022 – Capital Programme Monitoring 2022/23

1.0 Introduction

1.1 The purpose of the report is to provide members of the Committee with an update on the capital programme in the context of recent market changes, specifically inflation and interest rate increases, and also to provide an update on the capital budget process for 2023/24.

2.0 Background

2.1 The Executive approved the Capital Budget for the period 2022/23 to 2024/25 in June 2022 as part of the Capital Outturn Report. Since then, subsequent capital budget update reports have been to the Executive and the current forecast for the approved programme over this and the next 3 years is £1,037.8m.

2.2 Since the start of 2022 the rate of inflation has increased significantly, with the construction industry particularly affected. The Council has seen costs rise across the programme, with some projects seeking budget increases given the severity of the cost increases. The Bank of England has sought to use monetary policy to curb inflation and has therefore increased interest rates away from the historic lows. This, coupled with market expectations regarding the impact of inflation in the medium term, has seen the cost of additional borrowing for the Council increase.

3.0 Current Approved Capital Programme and Capacity

3.1 The current forecast for the approved capital programme as at the end of September 2022 is shown in the table below.

Manchester City Council Programme	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**All Years Variance to Current Budget**
		£'m			
Highways	39.9	28.2	5.2	0.0	0.0
Neighbourhoods	86.1	16.1	4.4	2.9	(0.1)
The Factory and St John's Public Realm	79.4	0.0	0.0	0.0	0.0
Growth and Development	95.3	93.5	29.9	3.6	(0.9)
Town Hall Refurbishment	74.9	86.1	40.7	0.0	0.0
Housing – General Fund	16.3	36.8	17.6	7.8	0.0
Housing – Housing Revenue Account	40.8	58.8	30.7	6.4	0.1

Children's Services	44.9	5.4	0.5	0.0	(0.1)
ICT	4.8	2.0	0.1	0.0	0.0
Corporate Services	15.2	1.4	0.5	0.0	0.0
Total *(exc. Contingent budgets)*	**497.6**	**328.3**	**129.6**	**20.7**	**(1.0)**
Contingent Budgets	15.4	18.0	28.2	0.0	0.0
Total	**513.0**	**346.3**	**157.8**	**20.7**	**(1.0)**

3.2 The programme represents significant investment in the city and its infrastructure and contains projects at all stages of development and build. This means that the recent volatility in inflation and financial markets has implications in terms of the costs of construction as well as the cost of financing.

3.3 Construction inflation is currently estimated at 16.7% in the year to September 2022 based on the latest Business, Energy and Industrial Strategy (BEIS) statistics and has been relatively high for some time. A number of requests to increase budgets on major projects have been approved by Executive and Council in recent months for cost increases caused by inflation. Whilst the forecast over the medium term is for inflation to subside, the price increases are not expected to reverse and therefore costs across the programme will stay at these higher levels. The risk of further inflation pressures across the programme therefore remains.

3.4 In parallel, and linked in part to inflationary pressures, financial markets have also seen significant volatility in interest rates. The cost of debt available to the Council from the Public Works Loan Board)has on average more than doubled since December 2021, which means that ongoing revenue costs associated with additional borrowing have increased.

3.5 The financing of the programme above, including borrowing, is shown in the table below. It highlights the significant level of additional borrowing required to fund the approved programme.

	Draft Funding 2022/23 £m	Draft Funding 2023/24 £m	Draft Funding 2024/25 £m	Draft Funding 2025/26 £m	Draft Funding All Years £m
Grants	106.6	83.1	41.8	3.6	235.1
Contributions	29.0	19.8	0.0	0.0	48.8
Capital Receipts	37.0	27.0	12.6	7.8	84.4
Revenue Contributions to Capital	47.2	45.9	22.7	6.4	122.2
Capital Fund	5.3	3.2	1.3	0.0	9.8
Borrowing	287.9	167.3	79.4	2.9	537.5
Total	**513.0**	**346.3**	**157.8**	**20.7**	**1,037.8**

3.6 It is important to note that the current approved programme remains affordable within the existing budgets available for capital financing. The Council has prudently budgeted for capital financing costs across a number of years and built up a capital financing reserve from funding including underspends in the historic annual capital financing budget to smooth the effects of potential increases in interest rates. Specifically for Our Town Hall which accounts for a large portion of the borrowing requirement, a carefully planned strategy including the approach to the Minimum Revenue Provision (MRP) was devised to ensure that the additional revenue costs for the decant and the additional borrowing costs did not put any additional pressure on the revenue budget. However, the combined impact of construction cost increases and interest rate rises means that future borrowing capacity is diminished.

3.7 Given the ongoing market volatility in both costs and interest rates, and the implications further increases would have on the approved programme, calculating future financing capacity is extremely challenging. However, it is clear that additional borrowing capacity is limited unless additional revenue budget is committed to fund capital financing costs, which would contribute towards the budget gap that the Council faces. There is also a need to ensure that the overall level of debt the Council has remains prudent and affordable in the longer term. With the changes in market conditions, a more cautious approach is now required for additional capital investment.

4.0 Proposed Financing Approach

4.1 In order to maximise the use of resources, it is proposed that the following principles are followed to ensure that the limited capital resources are clearly prioritised to achieve best value for money. If projects demonstrate that they support the achievement of corporate priorities, including both low carbon and social value, then they will be supported to proceed if:

- the project is fully funded by external grants and contributions;
- the project generates additional capital receipts to the Council, so the impact on resources is minimal; or
- the project will generate a robust net income stream or revenue savings that is sufficient to meet the associated capital financing costs and therefore be funded on an invest to save basis.

4.2 Additional borrowing will only be considered for funding a project as a last resort, if there are no other funding sources available and the project is of critical importance to the Council. Any impact on the Council's revenue budget will be clearly set out and form part of the decision making.

4.3 Work will also continue to identify and review how other income sources could be used within the programme, such as Section 106 receipts and maximising the use of external grant funding. This will include continuing to review all government funding streams available and seeking to bring fragmented funding streams together to complement investment proposals.

4.4 The current programme will be reviewed to ensure that there are robust plans in place for all of the current funding in place. Any future projects which remain at an early stage of project development will be reviewed to ensure they remain a strategic priority and affordable.

4.5 The Strategic Asset Management Plan (SAMP) will create a long-term plan for the evaluation and review of the Council's assets, including the commercial estate and community assets, and will be the subject of a report to a future meeting of the Committee.

4.6 The SAMP work may create income to support the capital programme through the disposal of assets which are deemed to be surplus to the Council's requirements. These receipts can then be used to fund future capital investment. Given how property markets can be volatile, these receipts should not be committed for investment until they are realised and should be spent in arrears.

5.0 Proposed Budget Approach

5.1 The Council's capital investment priorities are contained within the current Capital Strategy and reflect the Our Manchester Strategy. In summary they are:

- Investment into neighbourhoods and communities;

- Investment in growth and regeneration;
- Delivery of the Zero Carbon action plan;
- Delivery of the Housing Strategy;
- Maintenance of corporate assets; and
- Investment in new and upgraded transport infrastructure

5.2 Capital investment proposals must support one or more of these priorities and must be affordable and sustainable within the capital and revenue budget.

5.3 The capital budget process is being refined and aligned more closely with the annual Council budget. The capital programme which is being developed will ensure an appropriate balance between:

- Asset based investment decisions, including corporate assets, driven by the Strategic Asset Management Plan. This will include the annual Asset Management Programme (AMP);
- Delivery of infrastructure requirements, such as Highways, active travel and digital connectivity, historically the Council has used a significant amount of borrowing to support the Highways Capital programme;
- Delivery of strategic priorities, including zero carbon, affordable housing, and ensuring there is some capacity to invest in neighbourhoods; and
- Grant and external contribution funded programme, if they support strategic priorities. Major parts of the capital programme including school maintenance and places and the highways programme are supported by government grants.

5.4 For the 2023/24 budget, given the market and capacity uncertainty, it is anticipated that additional capital investment proposals will be tightly focussed on a number of key priorities.

5.5 The Council has a large number of existing corporate assets on its balance sheet which require annual capital expenditure to keep the asset to a good standard. Last year a one-year programme was agreed for both Highways and the Corporate Estate and it is proposed that proposals for a further year for both areas are included within the Capital Strategy reported to Executive in February. The intention will then be to establish an ongoing, multi-year investment and asset management programme for these assets.

5.6 It is expected that other schemes will come forward, provided they meet the funding criteria detailed at paragraph 4.1 above.

6.0 Proposed changes to the approval process

6.1 Previous report to the Committee have detailed the capital approval process. It is important that the approval process remains fit for purpose and reflects best practice. Following the most recent review, which incorporated key stakeholder feedback, there are a number of proposed changes which will be brought forward as part of the Capital Strategy for 2023/24.

6.2 A key objective of the changes is to provide a strong strategic top down as well as bottom-up approach to the development of the future programme. This will ensure that all scheme proposals will be considered together at the same time so that only those that are key priorities are taken forward, with the pipeline reviewed twice a year as part of the budget setting process. This will ensure that the maximum benefit is gained from council resources. The prioritisation process will build in a stronger approach to planning for place and have a greater focus on neighbourhoods.

6.3 *Due Diligence template* – to support more robust decision making at the early stages a due diligence template will be completed detailing the associated assumptions around benefits, costs and links to strategic priorities. This will support greater scrutiny of projects at the inception stage and allow a more holistic approach to developing the business case by allowing other services to comment at that stage.

6.4 *Improved Place Focus* - to increase the neighbourhood focus, recognising the impact of capital investment on place, Neighbourhood management teams will be invited to scrutinise projects at the inception stage, to ensure they align with neighbourhood plans.

6.5 *Key Decisions* – currently the key decisions for capital expenditure are taken at the point that expenditure is about to be incurred. This limits effective scrutiny which should be at the point the project is approved and added to the capital budget. It is therefore proposed to alter the Council's constitution to make the key decision at the point the budget increase is approved. This would enable scrutiny at an earlier stage of a project and support better decision making.

6.6 *Project Governance* – the approval review process will increase the multi-disciplinary peer review to provide more robust challenge to investment proposals, and to ensure that the benefits ascribed to the projects are realistic and achievable. A member and senior officer led Capital Board will also be established to regularly review the project pipeline, alongside the capital financing forecast.

6.7 *Budget Approvals* – the capital budget process is to be refined with the priorities set each year as part of the annual budget cycle. To support this, it is intended to reduce the frequency of capital budget requests to Executive and Council from monthly to quarterly.

6.8 These proposals will continue to be developed and will form part of the Capital Strategy to go to Executive in February.

7.0 Recommendations

7.1 Members are asked to note the contents of the report.