Manchester City Council
Report for Information

Report to:	Resources and Governance Scrutiny Committee – 7 December 2023
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 2024/25.

The report also highlights the increased Government and public scrutiny of council capital programmes and borrowing approaches, following the issuing of several Section 114 notices as a result of poor capital investment decisions.

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 15th February 2023 – Capital Strategy and Budget 2023/24 to 2025/26
- Report to the Executive 15th February 2023 – Treasury Management Strategy Statement 2023/24
- Report to the Executive 15th November 2023 – Capital Programme Monitoring 2023/24

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 to provide an update on the capital budget process for 2024/25.

2.0 Background

2.1 The Executive approved the Capital Budget for the period 2023/24 to 2026/27 in June 2023 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 £920.4m.

2.2 Since the start of 2022 the rate of inflation has increased significantly, with the construction industry particularly affected. The Council has continued to see 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.

2.3 Although the rate of inflation has begun to decelerate, the increase in construction costs persists, and relatively high interest rates remain and are currently forecast to only fall marginally over the next 12 months. This means that the Council's capital financing capacity is constrained.

3.0 Current Balance Sheet Position and Government Scrutiny

3.1 At the end of March 2023, the Council held external debt of c. £1.2bn and had a capital financing requirement (CFR) of c. £2.0bn. The CFR is the total value of projects funded by borrowing for which the Council has not yet made provision to repay the debt.

3.2 The difference between the CFR and external debt is known as internal borrowing and represents the value of reserves and working capital on the Council's balance sheet which have been used in lieu of debt, rather than holding cash and a higher level of external debt. At the point that a reserve is required for its intended purpose and spent, it is necessary to borrow externally, with any associated interest costs then being incurred.

3.3 For 2021/22, the latest financial year for which full statistics are available, the Council had the 4th highest CFR amongst English local authorities excluding combined authorities and police and fire authorities, and the 17th highest level of external debt. The Council is the 3rd largest metropolitan district in England, which suggests that the debt position is proportionate. The level of the Council's CFR and level of debt is affordable and the capital financing budget is sufficient to allow the delivery of the current approved capital programme, with no increased call on the revenue budget.

3.4 There is a renewed focus across the local authority sector on financial sustainability given the challenging financial outlook for several councils. As noted in the recent capital monitoring report to Executive, both the Office for Local Government (OFLOG) and the Department of Levelling Up, Homes and Communities (DLUHC) are developing statistics which can be used to examine the performance of local authorities, including capital expenditure, debt, and financing costs.

3.5 The Capital Strategy must therefore be mindful of the impact on the Council's balance sheet of investment and borrowing decisions and ensure that such decisions are compliant with the CIPFA Prudential Code and are prudent, affordable, sustainable and proportionate.

3.6 The capital strategy is part of a suite of documents that is presented to Full Council for approval in March each year which includes the Treasury Management and Borrowing Strategy and Prudential Indicators which ensure compliance with the Prudential Code. Section 4 provides an assessment of the Council's position and assurance that the current programme is compliant with the Prudential Code.

4.0 Current Approved Capital Programme and Capacity

4.1 The current forecast for the approved capital programme as at the end of September 2023 is shown in the table below.

Manchester City Council Programme	2023/24	2024/25	2025/26	2026/27	Total All Years	All Years Variance to Current Budget
£'m						
Highways	39.3	20.5	4.8	4.4	69.0	-1.7
Neighbourhoods	42.8	11.7	2.8	0.0	57.4	-0.7
The Factory International and St John's Public Realm	54.4	0.0	0.0	0.0	54.4	0.0
Growth and Development	91.3	76.9	14.3	0.0	182.5	-0.7
Town Hall Refurbishment	64.3	86.2	20.4	0.0	170.8	0.0
Housing – General Fund	28.4	45.8	11.4	0.0	85.7	0.0
Housing – Housing Revenue Account	42.6	85.7	32.5	4.4	165.2	0.7
Children's Services	28.4	29.7	1.0	0.0	59.1	0.0

ICT	4.2	1.3	0.0	0.0	5.5	0.0
Corporate Services	4.3	0.5	0.5	0.0	5.3	0.0
Total *(exc. Contingent budgets)*	**400.1**	**358.2**	**87.7**	**8.9**	**854.9**	**-2.4**
Contingent Budgets	0.9	40.9	23.7	0.0	65.5	0.0
Total	**401.0**	**399.1**	**111.4**	**8.9**	**920.4**	**-2.4**

4.2 The programme represents continuing significant investment in the city and its infrastructure and contains projects at all stages of development and build. As noted above, the recent volatility in inflation and financial markets has had implications in terms of the costs of construction as well as the cost of financing.

4.3 In the year to September 2023 the Department for Business and Trade estimates that construction costs fell by 1.8%. However, this is in the context of construction prices in the previous 12 months increasing by 16.7%, meaning that costs remain at highly elevated levels. Indeed, in the three years since September 2020 it is estimated that construction costs have increased by nearly 39%.

4.4 Subsequently, over the last two of years, a number of requests to increase budgets on major projects have been approved by Executive and Council 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.

4.5 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 tripled since December 2021, which means that ongoing revenue costs associated with additional borrowing have increased.

4.6 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 2023/24 £m	**Draft Funding 2024/25 £m**	**Draft Funding 2025/26 £m**	**Draft Funding 2026/27 £m**	**Draft Funding All Years £m**
Grants	113.7	84.8	31.8	0.0	230.4
Contributions	17.0	19.6	1.5	4.4	42.6
Capital Receipts	41.4	39.4	18.7	0.0	99.4
Revenue Contributions to Capital	24.0	75.1	29.4	4.4	132.8
Capital Fund	4.6	1.0	1.3	0.0	6.9
Borrowing	200.4	179.2	28.8	0.0	408.3

Total	**401.0**	**399.1**	**111.4**	**8.9**	**920.4**

4.7 As outlined above, it is important to note that the current approved programme remains affordable within the existing budgets available for capital financing across the period of the medium-term financial plan. 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.

4.8 However, the combined impact of sustained construction cost increases and interest rates persisting at relatively high levels means that the affordability of the programme will continue to be monitored closely, and that future borrowing capacity is diminished.

4.9 Given the number of variables, including ongoing market volatility in both costs and interest rates and the timing of spend, calculating future financing capacity is extremely challenging. However, any additional borrowing capacity is now limited unless additional revenue budget is committed to fund capital financing costs, which would contribute towards an increased 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. It therefore remains prudent to adopt a more cautious approach to additional capital investment.

5.0 Proposed Financing Approach

5.1 Capital expenditure plays an important role in supporting the Council to achieve its strategic objectives, and therefore even in the context of a challenging financial environment there remains a drive to continue to invest in assets.

5.2 To maximise the use of resources, it is proposed that the following principles continue to be 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.

5.3 In addition the Council also has a capital disposals strategy. Understanding how existing assets are used, and opportunities to realise income from them, is critical to future capital investment capacity. To this end, the Strategic Asset

Management Plan (SAMP) has created a framework for the evaluation and review of the Council's assets, including the commercial estate and community assets.

5.4 The SAMP work seeks to 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.

5.5 Additional unsupported borrowing will only be considered as a funding approach for a project as a last resort if there are no other funding sources available and the project is of critical importance to the Council. This will have to be funded from an increase to the capital financing revenue budget. Any impact on the Council's revenue budget will be clearly set out and form part of the decision making.

5.6 These principles will form a framework to support decision making and will be monitored alongside wider market conditions to ensure that the overall programme remains affordable and sustainable. If, for example, interest rates fell further than currently anticipated this might create additional investment capacity which could then be used to expand the capital programme further.

5.7 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.

5.8 Under the Council's capital approval process, all potential investments are required to demonstrate that they are a strategic priority at an early stage of development, and the capital finance team work closely with project teams from project inception to seek to identify suitable and sustainable funding options.

6.0 Proposed Budget Approach

6.1 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

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

6.3 The capital budget process has been 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 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.

6.4 For the 2024/25 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.

6.5 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 anticipated that an ongoing multi-year investment and asset management programme is established as part of the Capital Strategy reported to Executive in February.

6.6 It is expected that other schemes will come forward, provided they meet the funding criteria detailed at paragraph 5.2 above.

7.0 Recommendations

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