

Committee(s): Finance Committee – For decision Policy and Resources – For decision Court of Common Council – for decision	Date(s): 19 February 2019 21 February 2019 7 March 2019
Subject: Capital and Supplementary Revenue Project Funding – Fundamental Review and Interim Revised Prioritisation Process	Public
Report of: The Chamberlain	For Decision
Report author: Caroline Al-Beyerty, Deputy Chamberlain	

Summary

Whilst the City Corporation is able to fund the projects (major and second-tier) that are currently in flight during 2019/20, resources are significantly constrained beyond next year. Furthermore, there are a large number of projects coming through the pipeline requesting funding, but not yet at the stage when funding decisions would be made. Members may consider some of these pipeline projects to be more essential than those already in the capital programme, which are a mixture of essential, advisable and desirable. If all the projects currently in flight and planned in the medium term are funded, capital and revenue reserves would be exhausted by 2022/23. We would be unable to fund the capital programme beyond March 2023 without extending external borrowing plans or disposing of investment assets (both of which will deteriorate the revenue position still further).

The need to maintain tight control of the major project budgets and operate within a definitive cash limit on each project is imperative if the City Corporation is to be able to afford the ambition of its capital programme; both major and second-tier. Operating strict cash limits on the major projects will require strict discipline throughout the life-cycle of each project.

The depletion of capital reserves for projects which are not categorised as essential raises the following questions:

1. whether the right projects are being progressed- i.e. those projects which strategically have the most impact or are the most essential; and
2. what constitutes 'essential'.

In June 2012, Policy and Resources Committee faced with a similar gap between ambition and funding, agreed that only essential projects should be progressed, and which fit within the following categories:

- a) Health and safety compliance
- b) Statutory compliance
- c) Fully/ substantively reimbursable

- d) Spend to save or income generating with a short pay-back period (five years or less)
- e) Major renewal of income generating assets

However, there may be a need to define what essential is for the second-tier projects in deciding which to progress first as the existing criteria have not been applied in a sufficiently robust manner to contain capital and SRP plans within affordable or sustainable limits – this is no longer fit for purpose in the context of the Prudential Code. Logically, this prioritisation process needs to align with the priorities identified from the fundamental review of revenue budgets. However, the consequent criteria will take time to formulate and as the need for prioritisation is immediate; it is proposed that the following approach be adopted, in the interim, to the second-tier capital projects:

- a. A hold on gateway 5 approvals in the project procedure and all new projects pending the review. Resource Allocation Sub-Committee could defer projects that are not critical for 1 year; and only
- b. Approve essential schemes that:
 - i. Address a risk on the corporate risk register, and
 - ii. Have a sound business case that clearly demonstrates the negative impact of deferring the scheme, i.e. penalty costs or loss of income, where these are material (if any schemes are deferred, cancelled or scope reduced there will inevitably be some abortive costs).

To avoid any unnecessary delays in funding being allocated to essential projects, it is recommended that a special meeting of Resource Allocation Sub Committee takes place in March using the above criteria, amended as necessary, to scrutinise the bids and prioritise resources.

To facilitate this process, officers will prepare a proposed prioritisation of schemes for Member consideration.

Recommendation(s)

Members are asked to:

- Approve the incorporation of pipeline/all new capital and SRP projects within the fundamental review for spend for 2020/21 and beyond (paragraph 26).
- Approve the prioritisation of existing capital schemes in 2019/20 that have not yet entered Gateway 5 of the Projects Procedure (paragraph 15), using the criteria outlined at paragraph 24.
- Approve the prioritisation of new capital projects in 2019/20 in accordance with the criteria in paragraph 24.
- Delegate authority to the Chamberlain to determine financing of the capital budgets (paragraph 26).

Policy and Resources Committee members are asked to approve that:

- a special meeting of Resource Allocation Sub Committee takes place in March using the criteria outlined at paragraph 24, amended as necessary, to scrutinise the bids and prioritise resources.

Main Report

Background

1. The City Corporation has a significant programme of major projects together with property investments and works to improve the operational property estate and the public realm. Spending on these types of activity is classified as capital expenditure.
2. The “Supplementary Revenue Projects” (SRP) classification was created to cover project expenditure controlled in the same way as capital projects that does not meet the accounting definition of capital expenditure, e.g. does not produce an asset, such as preliminary project costs for feasibility and option appraisal. The relevant expenditure and income on such projects is posted to revenue accounts, rather than capitalised at year end.
3. The City Fund, City’s Cash and Bridge House Estates capital and supplementary revenue project budgets are being submitted to the Court of Common Council in March and are included in the Summary Budget Book. They include only those budgets which are approved to spend in accordance with the corporate project procedures.
4. The current capital and SRP programme has not required the City Corporation to enter into external borrowing to fund projects, being able to fund projects from internal resources or external funding. With the inclusion of the Major Projects, the City Corporation will need to take on external borrowing on both City Fund and City’s Cash. There are also a significant number of pipeline projects for which funding has yet to be determined. Such projects would previously have been funded from reserve balances of the relevant City Corporation Fund.
5. In light of the scale of potential capital requirements, which exceed available resources, in terms of both funding and officer capacity, it will be essential to prioritise effectively which capital projects should progress. Funding will need to be allocated in a measured way, by applying a process of prioritisation that ensures the right schemes are progressed in order to meet corporate objectives.
6. In June 2012, when the City Corporation faced a considerable reduction in funding levels, the Policy and Resources Committee agreed that only projects that are considered essential and which fit within the following categories should be allocated funding:
 - a. Health and Safety compliance.
 - b. Statutory compliance.
 - c. Fully/substantively reimbursable.

- d. Spend-to-save or income-generating, generally with a short payback period (e.g. 5 years or less).
 - e. Major renewals of income generating assets.
7. In addition, under exceptional circumstances, other projects considered to be a priority by the Resource Allocation Sub-Committee were allowed to proceed.
 8. In recent years the criteria have been relaxed somewhat, with projects considered 'advisable' or even merely 'desirable' going ahead. However, in view of the scale of requests for funding and resourcing constraints for essential schemes, it is now timely to reflect on these criteria once more.

Current Position

9. The latest forecasts of capital and supplementary revenue expenditure are set out below and have been analysed as follows:
 - Major Projects – Museum Relocation, Combined Court facilities, Markets Consolidation Programme and, (beyond the current planning period) the Centre for Music
 - Capital and SRP Programmes – schemes both pre and post gateway 5 (authority to start work) for which funding sources have already been confirmed
 - Pipeline/Funding unconfirmed (“Pipeline schemes”) - comprising both those schemes which have yet to enter the gateway process and also pre-gateway 5 projects for which funding has not been confirmed. They are dependent on the allocation of central resources held under the control of the Resource Allocation and Policy and Resources Committees

Table 1: Capital and Supplementary Revenue forecast expenditure from 2018/19 onwards

	City Fund £m	City's Cash £m	Bridge House Estates £m	Total £m
Major Projects	950.9	1,365.1	-	2,316.0
Capital and SRP Programmes	365.3	180.1	120.4	665.8
Pipeline/Funding Unconfirmed	225.0	150.5	-	375.5
TOTAL:	1,541.2	1,695.7	120.4	3,357.3

10. The total cost of capital and SRP schemes is currently forecast at £3.4bn as summarised above. The latest medium-term financial plans cover the period from 2018/19 to 2022/23, and already anticipate significant external borrowing being required to meet the costs of the major projects on the basis that these are one-off, once in a generation, projects.
11. However, in addition to the financial pressures arising from the major schemes, the capital and SRP forecast expenditure includes a significant number of pipeline

schemes with a current cost (at the time of preparing this report) estimated at some £375.5m (see details in Appendix 1, noting that this is an indicative estimate due to the immature status of these projects and will exclude some unforeseen schemes). A number of these pipeline schemes (totalling £106m) are providing repayable loan financing to internal departments, e.g. City Corporation schools, which will be repaid. The repayment terms are up to 20 years so represent a significant commitment of capital funding which cannot be used for other schemes.

12. If all these projects were to be allowed to progress, it is anticipated that by the end of the current MTFP period (2022/23) virtually all the available reserves for both City Fund and City's Cash would be exhausted without external funding or borrowing. This would leave a shortfall in financing available to complete/progress future capital and SRP spend from 2023/24 onwards, placing City Fund and City's Cash in a financially unsustainable position. It would also leave both funds lacking the capacity to finance future unforeseen but essential projects, including for instance the replacement of major components of the property estate (which are not fully quantified in the current plans).
13. Through the preparation of the MTFP it has already been demonstrated that the servicing of external debt for the major projects poses a significant financial challenge for the City and will require a fundamental review. Therefore, it would be imprudent and unaffordable to plan a blanket extension of external borrowing to fund these 'business as usual' projects and moreover would be a change in funding strategy, as such projects have traditionally been met from existing reserves.

Addressing the Funding Shortfall for Pipeline/Unconfirmed Funding Capital and SRP Projects

14. The majority of projects working their way through the early gateways are generally funded either from internal existing local risk budgets and ring-fenced sources such as the City Surveyor's Designated Sales Pools or from external sources such as Section 106 deposits and Government/Transport for London grants which are restricted for specific purposes.
15. Ad hoc funding for small one-off schemes is through the £3m annual provisions for new schemes and therefore the need for a more robust prioritisation process applies in particular to focus on larger value requests (>£1m) which cannot generally be accommodated within the annual provisions.
16. To differentiate between these pipeline schemes and to demonstrate the impact of the capital requirement, officers have grouped the schemes into the following categories:
 - a. Corporate schemes: includes corporate IT system and corporate building investment (mainly Guildhall complex) projects;
 - b. Service schemes: cover a wide range of service areas and range from replacement of essential infrastructure (e.g. cremators) to improvements and new initiatives; and

- c. Repayable loans: investments generating a payback and therefore providing cash flow finance. A significant proportion relates to the City's three private schools. It is proposed that funding should be allocated to these schemes in a ring-fenced provision (which may be funded by external borrowing), subject to the relevant robust business case.

17. The table below sets out the pipeline capital schemes in the categories described above across the medium-term planning period. Of the £375.5m total, £224.1m would be funded in City Fund and £151.1m would be funded in City's Cash (some corporate schemes cross over funds and have been apportioned accordingly).

Table 2: Pipeline capital and SRP schemes - Summary from 2018/19 onwards

ALL FUNDS	Essential	Advisable	Desirable	Total
	£m	£m	£m	£m
Corporate Schemes	43.5	48.4	3.0	94.9
Service schemes	93.5	67.9	13.4	174.8
	137.0	116.3	16.4	269.7
Repayable Loans	47.5	58.3	-	105.8
Total Pipeline	184.5	174.6	16.4	375.5

18. If the prioritisation criteria detailed in paragraph 6 above are applied to the pipeline schemes, a relatively small proportion (15%) would be eligible. This demonstrates that there is a need to revise the prioritisation criteria to make them fit for purpose by providing a better balance between corporate priorities and affordability, sustainability and prudence.

19. The table below separates out the pipeline capital schemes within City Fund.

Table 2(a): Pipeline City Fund Capital & SRP schemes summary from 2018/19 onwards

CITY FUND	Essential	Advisable	Desirable	Total
Corporate Schemes	24.4	28.8	1.5	54.7
Service schemes	90.4	50.0	2.8	143.2
	114.8	78.8	4.3	197.9
Repayable Loans	11.5	15.0	-	26.5
Total Pipeline	126.3	93.8	4.3	224.4

20. Within City Fund, there are two sources of funding that are under the control of the Resource Allocation Sub-Committee which could provide funding for some of the City Fund schemes; the On-Street Parking Reserve (OSPR) and the Community Infrastructure Levy (CIL). Some £82m of the schemes within the pipeline list above could be eligible for funding from one or both these sources.

21. Based on the latest OSPR and CIL forecast receipts, there is a potential sum of £88m available to finance eligible schemes. However, there may be elements of the major projects that could be funded from these sources, e.g. public realm works and therefore a robust prioritisation process to ensure resources are appropriately allocated will need to be applied.

22. The table below separates out the pipeline capital schemes within City's Cash.

Table 2(b): Pipeline City's Cash Capital & SRP schemes -Summary from 2018/19 onwards

CITY'S CASH	Essential	Advisable	Desirable	Total
Corporate Schemes	19.0	19.7	1.5	40.2
Service schemes	3.1	17.9	10.6	31.6
	22.1	37.6	12.1	71.8
Repayable Loans	36.0	43.3	-	79.3
Total Pipeline	58.1	80.9	12.1	151.1

23. If all the pipeline schemes with a total cost of £375m were to be funded, assuming that the OSPR and CIL funding of £88m was applied in full, there would be a funding requirement of £287m. If external borrowing was the source of funding for this requirement the revenue impact would be £10.4m p.a. by 2022/23 across City Fund and City's Cash. As noted in paragraph 14 above, this would be an unsustainable pressure on revenue budgets and does not allow for the capital schemes that will emerge and require funding in future years.

Proposals

24. It is suggested that the fundamental review recommended on the revenue position is widened to also include capital and supplementary revenue. Pending the application of revised criteria to capital requirements for 2020/21 onwards, some interim criteria will be required to address urgent capital requirements in 2019/20; these may include:

- a. A hold on gateway 5 approvals in the project procedure and all new projects pending the review, with the possible exception of schemes requiring internal loan funding (subject to the ability to repay being clearly demonstrated as part of a robust business case). Resource Allocation Sub-Committee could defer projects that are not critical for 1 year.
- b. The definition of 'critical' in this context to be defined as essential schemes that:
 - i. Address a risk on the corporate risk register, and
 - ii. Have a sound business case that clearly demonstrates the negative impact of deferring the scheme, i.e. material penalty costs or loss of income.

25. To avoid any unnecessary delays in funding being allocated to essential projects, it is recommended that a special meeting of Resource Allocation Sub Committee takes place in March using the above criteria, amended as necessary, to scrutinise the bids and prioritise resources. This meeting would be in addition to the scheduled Sub Committee. To facilitate this process, officers will prepare a proposed prioritisation of schemes for Member consideration.
26. As in previous years, it is proposed that the Chamberlain should determine the final financing of the capital budgets.

Conclusion

27. The current prioritisation criteria for capital schemes are not effectively determining which projects should be funded. A revised set of criteria need to be agreed with Members. This will form part of the fundamental review.
28. In the meantime, schemes progressing in 2019/20 will be subject to interim prioritisation criteria, deferring projects where possible to be assessed by the revised criteria.

Appendices

- Appendix 1 – Pipeline Capital Projects

Background Papers

- Capital Programme – Project Funding: Policy and Resources Committee, 7 June 2012 (Non-Public)
- Risk Management Update – Audit and Risk Management Committee, 15 January 2019 (Public)

Caroline Al-Beyerty
Deputy Chamberlain

T: 020 7332 1113

E: Caroline.Al-Beyerty@cityoflondon.gov.uk