

## **Response to recommendations from the Finance Committee's Report: Inquiry into the Welsh Government's capital funding sources**

### **Recommendation 1**

**The Committee recommends that the Welsh Government considers infrastructure investment plans on a longer term basis, which prioritises and allocates funding sources to projects to ensure there is a clear picture of how much borrowing will be required in future years.**

#### **Accept**

Published in 2012, the Wales Infrastructure Investment Plan (WIIP) set out the Welsh Government's infrastructure investment ambitions over a ten-year period to ensure our capital investments are planned and delivered in an effective way and enable judgements to be made between competing demands. The associated WIIP project pipeline includes details of all those schemes (over £15m) that the Welsh Government is currently investing in or plans to commence in the next three years, providing a forward look of planned investment. The pipeline also sets out infrastructure projects that are financed and delivered by Local Authority partners, as well as water, energy and rail sector projects financed by the private sector.

To ensure the plan remains relevant we also published a WIIP mid-point review last year updating our strategic direction, and we are now starting to develop the principles on which the next infrastructure strategy, as the successor to the WIIP, will be built. In developing that strategy, we will explore the opportunity to utilise a range of scenario modelling to assess what our central funding position could be in the future. Identifying what the "gap" is between investment opportunities and available funding will allow us to better understand what our future public and private borrowing requirements could be. We will also look to respond to the recommendations made by the National Infrastructure Commission for Wales (NICW) in its first 'state of the nation' report in 2021, and how this can influence our approach to borrowing.

### **Recommendation 2**

**The Committee recommends that the Welsh Government considers matching funding sources to project risk across a project's lifecycle, in order to maximise available capital and minimise financing cost.**

#### **Accept**

The Welsh Government recognises that, should there be a need for borrowing beyond the aggregate £1bn currently available, then the matching of funding sources to project risk across a project's lifecycle is an important factor to consider. Given the

vast majority of Welsh Government infrastructure projects are currently funded from our Capital Departmental Expenditure Limit (augmented by capital borrowing), the cost of these sources of finance does not depend on the risk of the project which they are funding. Consequently, there is currently no cost of borrowing benefit in allocating loan finance to project risk. We will review this approach as part of the developments of the successor to the current WIIP.

Where we do use private sector finance (for example, within our Mutual Investment Model - MIM), this is already allocated to specific projects, and those which are considered “low risk”, therefore minimising costs. For example, though road construction may be technically complex, a mature market exists for the design, build, financing and maintenance of these assets. The exclusion of “soft services” from MIM contracts demonstrates that more expensive finance is not used when cheaper conventional funding can be better utilised.

As we develop different financing models, and gain control of additional financial levers, we will consider whether a more detailed matching approach between projects and sources of finance becomes necessary. The development of our next WIIP provides us with the backdrop to do so.

### **Recommendation 3**

**The Committee recommends that the Welsh Government further considers how Financial Transactions Capital could be utilised as a rolling loan facility for the housing sector, in order to support housing providers outside public control**

#### **Accept**

Despite the restrictions placed on this source of funding, we remain committed to using every pound available to invest in infrastructure and boost economic growth in the long-term. We have already successfully developed a range of schemes that utilise financial transactions (FT) capital on a recyclable basis, where repayments received from initial recipient are re-issued to new borrowers, including schemes that provide loans to Registered Social Landlords (RSLs) to bring forward housing developments. We are also currently considering options for social housing development which explore providing RSLs with a mix of grant funding and zero or low interest rate loans, thereby reducing the need to access private finance at a higher cost.

Other housing developers can access the Wales Property Development Fund and Wales Stalled Sites Fund (a total of £64.1m to 2019-20) which already utilises FT capital to provide loans of between £150k and £4m. These loans can be used for developments of residential, mixed-use and commercial development projects in Wales and residential site projects that cannot be progressed with traditional development funding respectively. The risk premium attached to utilising FT capital for other housing developers can however make this a costly financing option, which will be an important consideration in the overall appraisal.

#### **Recommendation 4**

**The Committee recommends that the Welsh Government should continue to work with Local Authorities across Wales to explore innovative approaches to utilising Financial Transactions Capital and accessing private investment in capital projects.**

#### **Accept**

The Welsh Government always endeavours to work collaboratively to ensure we get best value for money from the funding available to Wales. As we have set out in previous correspondence with the Committee, the restrictions on the use of FT capital mean that we are not able to use it to make direct loans to local authorities. We also can only use it to make loans or equity investments and only to third parties where lending would not score against public sector net borrowing. This also means that we cannot use FT capital to finance the Welsh Government's own capital expenditure, grants or the NHS.

However, local authorities can be an intermediary to deliver schemes at a local level. Some examples of such schemes already in place are the Town Centres Loan Fund, Houses into Homes and the Home Improvement Loans Funds (totalling £61.6m to 2019-20).

In line with our commitment to using every pound available to invest in infrastructure and boost economic growth in the long-term, we will continue to explore opportunities to maximise all of our capital levers. A working group has been established with HM Treasury and the other devolved administrations to share best practice and examples of how financial transactions is being used. In undertaking these explorations we will explore with local authorities how FT capital can be used to unlock private sector investment.

#### **Recommendation 5**

**The Committee recommends that the Welsh Government should focus on closer collaboration with local government to deliver a more integrated approach to delivering infrastructure investment at a national and local level.**

#### **Accept**

The Welsh Government recognises the importance of continued close collaboration with our public sector partners to ensure that investments are aligned and targeted to where they can have maximum impact.

Since 2012, the WIIP pipeline has provided an ongoing picture of infrastructure investment plans in Wales, including those of local government, to support private

and public sector investment decision making, facilitate strategic planning and promote collaboration.

We continue to deliver the second wave of our 21<sup>st</sup> Century Schools and Colleges programme in partnership with local authorities across Wales, which will see anticipated investment of £2.3bn across Wales, supporting an estimated 200 projects to rebuild and refurbish schools and colleges.

Additionally the Local Government Borrowing Initiative addressed capital spending pressures on Local Authorities. The Welsh Government enabled around £340m of investment in public infrastructure by Local Authorities through the provision of long-term revenue funding.

Following the success of these schemes, we have established the Coastal Risk Management Programme, which will see a capital investment value of around £150m in Local Authority flood assets.

Building on our current approach, as we develop our next infrastructure strategy, we will engage closely with local government to explore how we can deliver a more integrated approach to delivering infrastructure investment at a national and local level.

## **Recommendation 6**

**The Committee recommends that the Welsh Government ensure that projects delivered through the Mutual Investment Model are fully transparent, clearly identifying project costs and related data.**

### **Accept**

Increasing transparency has been a central concern of the Welsh Government while developing the Mutual Investment Model (MIM). As such, reporting requirements that enhance transparency have been embedded in the model, and will be incorporated as contractual commitments into agreements between public sector procuring authorities and private partners. The public sector will also be entitled to nominate a Director on to the board of the project company delivering MIM schemes.

As regards the cost of MIM schemes, all schemes delivered using the model will be required to use the Five Case Model for the development of the requisite business case. Furthermore, all schemes will be subject to a rigorous tier of additional scrutiny using Commercial Approval Points (CAPs) during their development and procurement. CAPs are carried out by notable experts in the field. CAPs for the two MIM schemes currently in procurement (dualling of the A465 and the 21<sup>st</sup> Century Schools and Colleges Programme) have been conducted with experts from the European Investment Bank, Scottish Futures Trust and the Infrastructure and Projects Authority.

During operations, MIM schemes will be funded from an Annual Service Payment (ASP) which will be calibrated to the specific scheme using a Payment Mechanism. The chief principle underpinning the Payment Mechanism is that provided the infrastructure is fully available, the ASP will be paid in full. If there is no availability of the infrastructure, there will be zero payment to the private partner. Where infrastructure is partially available, the Payment Mechanism will determine the appropriate deduction to be made to the ASP. Efficient contract management will be required to ensure that the Payment Mechanism is applied as foreseen.

### **Recommendation 7**

**The Committee recommends that the Welsh Government should review the level of expertise in place for contract management, and take steps to maintain this expertise to ensure effective delivery throughout the project lifecycle.**

#### **Accept**

The Welsh Government recognises that value for money is not only achieved through the robust specification and procurement of capital infrastructure, but also through efficient contract management. Work is in hand to assess the levels of resource required to manage contracts on the existing pipeline of MIM schemes with a view to ensuring that a contract management function is established prior to MIM schemes starting construction in 2020. The public sector contract management function will need to be a collaborative undertaking between the Welsh Government and other contracting authorities for MIM schemes]

### **Recommendation 8.**

**The Committee recommends that the Welsh Government should continue to utilise the Mutual Investment Model for projects requiring continuity over the lifetime of the contract and where the private sector can deliver the greatest value for money.**

#### **Accept**

The Welsh Government intends to retain the MIM as a funding option alongside other sources of capital funding. Its deployment beyond the existing pipeline would be dependent upon a number of factors, including demand, the availability of traditional capital and financial transactions capital, capital borrowing limits, and in due course, the integrated appraisal and assurance of any given proposition

## **Recommendation 9**

**The Committee recommends the Welsh Government provide an update as to what consideration it has given to utilising alternative financing models to unlock further private investment for capital projects in Wales**

### **Accept**

As set out in the *Wales Infrastructure Investment Plan – Project Pipeline Update 2019*, the Welsh Government, working with its partners across all sectors, has developed a comprehensive pipeline of infrastructure investment, which is an essential aspect of the government's mission to create an equal, prosperous and green Wales. Since the publication of the *Wales Infrastructure Investment Plan* in 2012, a range of alternative financing schemes have been developed and deployed.

The first alternative financing scheme to be implemented by the Welsh Government following adoption of the Plan was the Local Government Borrowing Initiative (LGBI). This scheme, which addressed capital spending pressures on Local Authorities, saw around £170m of additional capital investment between 2012 and 2015 in local highways. The success of this scheme saw a second tranche of the LGBI implemented in 2015 in order to accelerate delivery of Band A of the 21<sup>st</sup> Century Schools programme – seeing further capital investment of around £170m.

City and Growth Deals, whilst not a panacea, are an important tool in our strategic approach to regional economic development and leveraging in additional funding, including private sector investment. For example, the £1.3bn Swansea Bay City Region Deal aims to boost the local economy by £1.8bn and generate almost 10,000 new jobs over 15 years, attracting £637m from the private sector.

There is a detailed programme of work currently in progress in respect of local taxation, which is looking at alternative approaches to raising revenue for public services, which may contain features designed to unlock the growth potential in our communities. The principle of Tax Increment Financing allows a local authority to raise loan finance to support infrastructure development, and retain the resultant increase in property tax (i.e. non-domestic rates) to repay the loan, though this is linked to local rates retention. The Welsh Government has concluded that rates retention in its fullest sense is not suitable for Wales at this time, due to issues of scale and the capacity of some local authorities to benefit from such arrangements. However, we are exploring more specific rates retention proposals to support the development of city and growth deals. Whilst any new methods of financing which involve changes in our approach to local taxation need to be considered alongside wider reform of local government in Wales, we will continue to keep the progress of wider Tax Increment Financing elsewhere in the UK under review.

In the Housing sector, the revenue-funded Housing Finance Grant (HFG) was developed to operate alongside the Social Housing Grant. The first tranche of HFG saw 19 Welsh Registered Social Landlords raise around £130m of new funding to finance delivery of around 1000 affordable homes. Earlier this Assembly term, a new

£250m tranche of the Housing Finance Grant was launched, which will triple the size of the original scheme. This second tranche of investment, which is currently in its third year of operation, is expected deliver between 1500 and 2000 housing units, making a sizeable contribution to the Government's affordable housing target. It is also expected to see a number of Local Authorities benefit directly from the funding.

This Financial Year, a new alternative financing scheme, the Coastal Risk Management Programme (CRMP) has begun operations. Having financed feasibility and design work, the Welsh Government is now providing revenue funding to support 75 per cent of the construction costs in new Local Authority flood defence assets. This scheme will run for three years and is expected to foster capital investment of around £150m.

As regards the MIM, its development required extensive consideration of the Scottish Government's Non-profit Distributing and Hub models. The MIM builds on these approaches. The 21<sup>st</sup> Century Schools and Colleges Programme (MIM) introduces a number of innovations on the Scottish Hub model, while adaptations have been made to address *inter alia* its classification. Of the three schemes in the MIM pipeline – dualling of the A465, the 21<sup>st</sup> Century Schools and Colleges Programme, and redevelopment of the Velindre cancer centre – the first two are now in procurement and are expected to reach financial and commercial close respectively in 2020.

The LGBI, HFG, CRMP and MIM schemes are contributing to more than £2bn of additional investment in public infrastructure in Wales that would otherwise have not gone ahead, or would have been unaffordable in the short to medium term.