Appendix 4: Risk Deep Dive – Future Funding and Inflation

1. Introduction

1.1. The Audit and Governance Committee requested a deep dive on two of the high scoring financial risks within the corporate risk register, specifically Risk Refs 1 – Inflation and 2 – Future Funding.

1.2. The aim of this deep dive is to give the Committee greater insight into these risks, their potential impacts and the mitigating actions the Combined Authority is taking.

1.3. As the first of these deep dives, feedback from the Committee on the presentation and coverage is welcomed to inform future exercises.

2. Future Funding – inherent risk score 25, residual risk score 22

Risk background and potential impact

2.1. The risk relating to future funding arises from the transition from a high funding certainty, high control operating environment which the Combined Authority experienced for the first 3-5 years of its existence to a low-funding certainty, low control environment currently being experienced.

2.2. In 2018, following the integration of the area's LEP into the Combined Authority, the Combined Authority had 3 multi-year capital funds: Transforming Cities Fund (£95m over 5-years for transport), the Affordable Housing grants (£170m over 5 years) and the Local Growth Fund (£147m over 6 years) for business and skills investment.

2.3. Each of these provided the Combined Authority with certainty over what funding it would have available to deliver its objectives over several years, and gave the Combined Authority devolved decision-making powers to decide which projects would best deliver its strategic objectives within the broad parameters of the funds – this is the underlying principal of devolution: allowing local areas to make decisions for themselves on what the important projects are that will deliver change for their area.

2.4. The table below, cut down from the Combined Authority's 2022-23 budget 2 months before the new risk register was implemented with this risk included, shows this stark difference. Setting aside the Highways Capital grants, which are passported to the County and Peterborough City Councils, 2022/23 in-year income was forecast at £71.2m, including Housing Capital grants and Transforming Cities Fund, by 2025/26 its £12.2m – an 83% reduction.

	2022/23					2025/6			
Source of Funding	Forecast balance at 1/4/22	In-year income	Approved Expenditure	Subject to Approval Expenditure	Balance at Year End	In-year income	Approved Expenditure	Subject to Approval Expenditure	Balance at Year End
	£,000	£,000	£,000	£,000	£,000	£,000	£,000	£,000	£,000
Capital Single Pot	(32,269)	(33,000)	6,157	37,902	(21,210)	(12,184)	-	-	(37,493)
Housing	(735)	(37,588)	28,389	-	(9,934)	-	-	-	-
Recycled Growth Funds / Getting Building Fund	(8,192)	(1,138)	5,250	-	(4,080)	-	-	-	(4,138)
Highways Capital Grants	-	(27,695)	27,695	-	-	(27,695)	27,695	-	-
Total	(41,196)	(99,421)	67,491	37,902	(35,223)	(39,879)	27,695	-	(41,630)

2.5. It's very unlikely that the Combined Authority will actually find itself with so few funds in 2025/26 as, instead of continuing to make devolved funding settlements to the Combined Authority, there has been a move toward centrally controlled bid-based funding allocation from Central Government.
This means that, while the Combined Authority can't forecast grant income in future years as it's not certain, it is expected that short-term, project specific funding will make up significant amounts of this gap. For example, the Combined Authority has secured the Home Upgrade Grant, worth up to £158m, and Levelling Up Funding of £47.9m for Peterborough Station Quarter amongst many others, but these funds are secured via a bidding process into Central Government which means there is no ability to plan what level of resourcing will be required, nor what can and can't be achieved, in the medium term as we can't know what calls for funding the Government will make and thus what projects may be fundable.

2.6. This bid-based approach to funding means the Combined Authority has little certain funding beyond the project-based awards currently in place. This has two impacts which the risk on the register recognises:

1) It limits the Combined Authority's ability to make plans, and set realistic ambitions, beyond the current project-based funding awards.
2) It could limit the Combined Authority's ability to deliver its strategically important projects as the lack of devolved funding means only projects which fit specific calls for projects from Central Government will receive funding.

2.7. As we are already in a situation where there is little funding beyond the Combined Authority's annual £12m gainshare secured beyond the next two financial years, the inherent likelihood of the risk is '5-certain'. The ability to deliver strategic change with £60m of gainshare over 5 years is significantly lower than the £472m the Authority had access to with gainshare, transforming cities, local growth fund and the affordable housing grants so the impact is rated 5, leading to an overall score of 25.

Risk Mitigations

2.8. There are a range of mitigating actions either being implemented or planned for implementation, some focus on what can be done locally, either with delivery partners or internally within the CPCA, and others are focussed nationally to influence Central Government.

2.9. The first of the internal mitigations is ensuring that our strategic framework is up to date and accurately reflects local priorities – a current example is the development of the Local Transport and Connectivity Plan. The fit with local strategies is a key element in demonstrating 'strategic fit' within business cases, something which is required for a successful bid on funding into Central Government.

2.10. Alongside this, the work on the improvement plan during 2022-23 identified the need to improve our internal bidding function as a reaction to the move from devolved funding to bid-on funding sources – this work is being taken forward through a review of the PMO function and internal training on business case development being offered across the organisation.

2.11. These two actions together should maximise the success of bids on funding into Central Government and mitigate the impact of the change in funding approach on the Authority's ability to deliver its strategic objectives.

2.12. Alongside this drive to maximise bid-based grant income we are working alongside our delivery partners to identify opportunities to deliver projects and outcomes without relying on central government grants. This is done routinely on a project-by-project basis, supporting delivery partners to identify if there is private sector, or applicable S106 funding to reduce the call on CPCA resources. A wider piece of work on this, being led on by the Authority's S73 officer, is in its early stages but will involve looking more holistically at opportunities across the area for strategic projects to be delivered by local funding whether private, institutional, or public.

2.13. The Combined Authority has also been increasing its public affairs capacity in order to more effectively lobby government, both for specific strategic projects, and for a longer-term funding settlement with greater devolved decision-making powers.

2.14. The most recent example of project specific influencing is the Combined Authority convened, Ely Rail Summit which brought together key stakeholders from across Business, Transport, Industry and Politics to send a message to Government highlighting the benefits funding the Ely Area Capacity Enhancements would bring to the nation. This approach seeks to secure funding for the most important projects to our area.

2.15. To try and address the holistic lack of long-term, locally determined, funding available to the area the Combined Authority is working with the M10 network (the network of the Mayoral Authorities) to persuade Government to expand the powers and flexibilities of the Combined Authority via a round 2 devolution deal like those seen in Greater Manchester (GMCA) and the West Midlands Combined Authorities (WMCA).

2.16. Of particular relevance to this risk is the opportunity to secure a ‘single funding settlement’ – this would mean the Combined Authority receiving a single multi-year award of revenue and capital funds from Government to replace the patchwork of individual grants which it currently receives.

2.17. If a potential settlement can secure the Combined Authority a devolved share of national funding streams from Government departments this has the potential to remove this risk from the register for the period of the settlement, however what will be included in GMCA and WMCA’s settlements is still being negotiated so the scope of this opportunity is still uncertain.

Conclusion

2.18. While the actions identified should maximise the Combined Authority’s ability to make a persuasive case for further investment into the area, and thus reduce the likelihood of reduced future funding, the decision over future funding and whether to put in place a ‘single settlement’ is ultimately outside of the Combined Authority’s control. Alongside the impact of not securing future funding still being a fundamental inability to achieve our objectives means that the residual risk score is still very high at 23

3. Inflation – inherent risk score 23, residual risk score 20

Risk background and potential impact

3.1. The risk of inflation is ubiquitous to all organisations, however the impact is significantly heightened in the case of the Combined Authority as the majority of our funding is granted by Government with none linked to inflation, so the options for the Combined Authority to raise its own income to meet the ever-increasing costs of delivery are very limited.

3.2. This risk can be separated into the risk of inflation to the organisation’s core operations and to its portfolio of projects.

3.3. Taking the impact on core operations first, the 30-year funding settlement agreed within the devolution deal is inherently unsustainable as it is £20m a year (£12m capital and £8m revenue) regardless of inflation. This is a significant amount of money, but each year the buying power of that money reduces due to inflation. if inflation stayed low, averaging 2% over those 30 years, the £8m revenue in the first year would be equivalent to £4.45m in year 30, a reduction of 44% - if inflation averages 5% this becomes £1.80m, a reduction of 77%.
This is a national issue being felt by Combined Authorities across the country, however most have some insulation from this in the form of additional 'core' funding through locally retained business rates which increase both with growth in the area, and the business rates multiplier which is pegged to inflation.

3.4. Given the scale of ambition for the Combined Authority locally the option to plan for the long term – i.e. staying small and limiting delivery to hold back funding in the first 10-15 years to top-up inflation impacted budgets 20 years later - was not possible. As such the Combined Authority faces a position of reducing buying power each year with costs (staffing, electricity, bus services, etc) increasing while most of the Authority's funding does not.

3.5. Without a sustainable funding solution being identified the impact on the Combined Authority will be a decline in its ability to deliver the area's strategic objectives and services resulting in cuts to both services and additional funding being brought into the area due to the Combined Authority's bidding and advocacy.

3.6. While the nuances of the drivers for inflation on the portfolio of projects will be different to those of the core running costs, for example the cost of raw materials has little impact on the core running cost of the Authority but a very significant one on construction projects, the fundamentals of the risk are the same.

3.7. In terms of potential impact this would be seen in increased costs to deliver the same project or service, exacerbated by any slippage in projects. The result of this could be anything from individual projects being re-phased or becoming unaffordable, to cuts to bus services and adult education provision for our residents. If the fundamental unsustainability of the Authority's core funding is not addressed it will eventually result in the Combined Authority being unable to effectively operate and fulfil its obligations under law and the devolution deal.

3.8. Taking into account that inflation is nearly certain, and the high levels of inflation seen over the last 12-18 months, the likelihood of the risk is certain, and the impact is significant. As the impact is likely to build over time rather than a significant short-term cliff-edge this has resulted in an inherent risk score of 23.

Risk Mitigations

3.9. Actions relating to the risk to individual projects within the Combined Authority's portfolio predominantly fall into two categories – transference and mitigation of the impact of inflation.

3.10. Transferring inflationary risk within a project is done via the legal agreements the Combined Authority enters into with delivery partners. On a commercial basis this could be a fixed price construction contract, as the Combined Authority entered into on behalf of its subsidiary, the Peterborough HE Property Company Ltd, for the construction of the first teaching building in the University Quarter. Contacts like this lock in a price for construction of infrastructure regardless of the level of inflation and mean that inflation risk sits with the contractor.
It's worth highlighting that this approach transfers both upside and downside inflation risk i.e. if inflation is lower than was built into the fixed price this approach may end up costing more than it would have if the contract hadn't been at a fixed price.

3.11. On a grant-based project this transfer would be done via terms in the Grant Funding Agreement, which would set out that the Combined Authority's grant is a fixed contribution, and that the delivery partner is responsible for managing inflationary risk and cost overruns. This is a standard approach taken by Central Government when providing grants to Local Authorities and is used in the vast majority of grants the Combined Authority awards, reflecting that the Authority's role is predominantly in commissioning and sponsoring works rather than delivery and that risk should sit with the entity which has day to day management of delivery of the project.

3.12. In practice, while this is the standard approach to Combined Authority grant agreements, the lack of financial resilience within the Local Government sector as a whole following more than a decade of austerity often means that our constituent authorities are unable to fund such cost increases (whether due to inflation or unforeseen additional costs) so additional funding is requested from the Combined Authority. In these cases, while the risk has not been effectively transferred, it does still give the Combined Authority the flexibility not to increase funding rather than being contractually committed to doing so.

3.13. It is also good practice for projects to include a degree of contingency within their project budget – this is an allowance for 'residual known risks' i.e. risks which still exist in the project as they cannot be transferred or entirely avoided. Inflation is one such risk and so the calculation of contingency within project budgets includes an estimate for meeting inflationary pressures. As future levels of inflation cannot be known, there is a balance between providing a sufficient contingency to avoid cost overruns and not over-allocating and tying up budgets which could be delivering other priorities at the same time.

3.14. While the approach to this will heavily depend on the individual standards put in place by the delivery partner, an assessment of the proposed project budget, including the contingency, is taken into account when the Combined Authority reviews business cases both on a financial basis and on deliverability.

3.15. Given the recent substantial increase in inflation following a long period in which inflation has remained very low, Combined Authority finance officers consider it highly likely that project and service budgets which were set more than a year or two ago will not have factored in a sufficient allowance for inflation. In response to this the Combined Authority have been recommended, and adopted, two increases in the Authority's reserves to create a greater corporate 'contingency' to allow it to meet additional inflationary pressures in its portfolio when they arise.

3.16. The first of these was approved as part of the 23-24 MTFP and increased and more than doubled the minimum revenue reserve from 2% of gross revenue expenditure to 4.5% (£1.8m in 23-24) and created a £1.5m capital reserve. The second was the decision to set aside a proportion of the increased treasury management income received due to increased interest on lending to crease an additional 'inflation reserve' of £2.4m.

3.17. In addition to the setting aside of these contingencies, officers within the Combined Authority engage with delivery partner's teams regularly to understand cost pressures, alongside non-financial risks, on the projects it funds. This is fed into the MTFP setting process each year when responsible officers are given the opportunity to flag inflationary pressures and risks within their project and service budgets. Where these are certain (e.g. inflation-linked contracts) these are built into the baseline budget, where this is a risk rather than certainty these are collected and considered during the budget process and allocation of corporate contingency to increase budgets will be considered.

3.18. While the Combined Authority has limited ability to increase it's income, it does have some local fund raising powers and the consideration of the use of these is another key element in mitigating the potential impact of inflationary risk. The three main revenue raising powers the Combined Authority has are its ability to raise a Mayoral General Precept (council tax), the ability to create a business rates supplement and the ability to set the transport levy on the Local Highways Authorities (the County and Peterborough City Councils).

3.19. The first of these, the Mayoral General Precept has been used for the first time in 2022-23 specifically to address the substantial increase in costs of supporting the passenger transport network in the region in face of substantial inflationary driven cost pressures. The precept is the power to raise council tax on every residential dwelling, the income can be used on a wide variety of costs and, unlike all other council tax raising bodies, there is no existing referendum limit on the Mayoral General Precept i.e. there is no requirement to hold a referendum if an increase is proposed.

3.20. As such the precept is an extremely versatile tool, and its use is entirely within the Combined Authority's control as it can agree, or vote down, any precept proposed within the Mayor's budget. However it is an increase in taxation on the area's residents and as such can rightly be contentious, especially against the backdrop of a cost of living crisis.

3.21. The Combined Authority can also create a business rates supplement, which would increase business rates paid in the area by up to 2p per £1, however it's use is limited to delivering a specific project (or package of projects) which deliver economic growth and a business case must be consulted on which demonstrates the need and impact of such a supplement – as such it is a relatively long process with limited application in reacting to inflationary pressures and rather a tool to be examined in the context of funding large strategic projects.

3.22. The final tool the Combined Authority has to raise income is the levying of a Transport Precept. This power allows the Combined Authority to charge the Local Highways Authorities for the costs it incurs in the delivery of its responsibilities around local transport – predominantly these are the creation of the Local Transport and Connectivity Plan, the operation and costs of the national concessionary fares scheme, and the subsidisation of the privately operated bus network. The latter of which would be replaced with the operation of a franchised bus network were bus franchising to be implemented.

3.23. As Members will be aware one of the areas of most significant inflationary pressure is the subsidisation of passenger transport, and the Combined Authority has the legal power to increase the levy each year by the Retail Price Index (RPI) measure of inflation however increasing the levy shifts the burden from the Combined Authority to two of its constituent authorities which are facing their own substantial pressures. As such the increase in the Levy is locally agreed each year, for 23-24 RPI was 12.6% however the increase in the levy was locally agreed at 2% effectively creating a 10.6% inflationary pressure which the Combined Authority had to manage in order not to pass this on to its constituent authorities.

3.24. Due to the financial pressures facing the constituent authorities it's unlikely that increases in the levy will meet the inflationary pressures within the transport service so this is, at best, a partial mitigation of inflationary risk in one service area, admittedly a very significant one.

3.25. With the exception of a widespread expansion of the mayoral general precept, the above actions would not address the fundamental unsustainability of the Combined Authority's funding settlement from Government. As this is a critical risk both to this Combined Authority and to others nationally, there is continued lobbying of government within regular discussions with civil servants, in responses to funding consultations, and when responding to information gathering exercises from Government.
Alongside this general lobbying the Combined Authority is currently pursuing the opportunity to agree local retention of all growth in business rates within the Combined Authority area as part of ongoing discussions surrounding a second round of devolution deals following the model of GMCA and WMCA's trailblazers announced in the spring budget.

3.26. This is an arrangement which is in place in the majority of Mayoral Combined Authorities already and would result in the Cambridgeshire and Peterborough area keeping an additional £60m per year which is currently redistributed nationally by Central Government.

3.27. As this funding is redistributed to local authorities nationally, agreeing to the retention of these funds within the Combined Authority area would be fiscally neutral for the Treasury. A relatively small fraction of this could address the sustainability of the Combined Authority's funding settlement (as business rates increase with business growth and in-line with inflation), leaving the majority available to unlock the delivery of the area's wider aspirations covering transport, skills and economic growth. The further benefit of this would be the creation of a virtuous cycle – where investment into these areas leads to growth in the local economy, leading to increased business rate income, and increased investment.

3.28. As one of the few net contributors to the Treasury the case for these arrangements is clear, and the impact on the area's ability to deliver the growth and potential improvement for resident's is substantial – however the decision on whether to agree this sits with Government and so the residual likelihood of this risk remains high until an agreement with Government can be reached.

Conclusion

3.29. While there are a range of actions being taken, and planned, to transfer or mitigate the risk of inflation to the Combined Authority, those related to projects and services are limited in scope as the Combined Authority's funding streams fundamentally do not keep pace with inflation so the scope for Combined Authority to deliver the range and scope of services will decrease, and more rapidly when inflation is 6-10% than when it has been less than 2%.

3.30. The existing income raising powers at the Authority's disposal are limited by the pressures being faced by those who would be required to pay, whether that's constituent authorities with their own financial challenges, or the area's residents who are being impacted by the current cost of living crisis and living standards squeeze.

3.31. Finally, there is a chance of a significant agreement with Government, through a new devolution deal, to fundamentally address some of these issues and mitigate the risk the Combined Authority faces, however the decision as to whether this negotiation is successful lies with Government and so is uncertain until an agreement is reached.

3.32. Based on the above the likelihood of inflationary pressures impacting the Combined Authority is high, but mitigated by the project specific actions, and the potential impact, in the long term, is fundamental. As such the residual risk score is still significant at 20.