Capital Funding Sources for the Welsh Government.

The following remarks may appear rather obvious, even trite. It may be worthwhile, however, to state some rather basic points as a background to the discussion.

Need for a proper plan

Firstly, if the Welsh Government (WG) is going to optimise its use of capital funding sources it needs to have a medium-term investment plan extending out 5 to 10 years. It began the process of constructing such a plan some seven years ago when the first Wales Infrastructure Investment Plan (WIIP) was produced. That plan, however, was little more than a wish-list of projects put forward by spending departments and collated by the Finance Department. There were no priorities established among the projects and no target dates for their completion. Their financing depended on the capital budget allocated to each department. Two projects were earmarked to be financed by what has evolved into the Mutual Investment Model.

At that time, it was not possible to calculate from the WIIP what the borrowing requirements of the WG would be. It had been WG. practice to consider only the next three years because HMG announced Barnett allocation in a three-year cycle. Of course, there was no certainty about revenue beyond that horizon but it is necessary to make projections in planning investments. Where uncertainty is acute a scenario approach can be adopted. Even with such projections, however, a borrowing requirement can still not be calculated without target dates on all projects. At the time of the first WIIP, if the plan had been to complete the target list over 20-plus years there would have been little need to borrow at all given expected revenues. If the plan was for ten years it would have been necessary to borrow several billion pounds.

Since then things have evolved quite a lot. The 2018 interim report on the WIIP recognized the need for a co-ordinated all-government approach to establishing priorities. There was recognition of the need to make longer term economic and revenue projections and apparently techniques for doing so have been developed and are being refined. The statements in the report about how the WIIP would be drawn up in future were all exemplary. One might have hoped that after seven years they would be established procedures rather than good intentions but no doubt austerity can be blamed.

Which should be published

Secondly any long-term investment plan should be published in full. With a priority ordering of large projects and target dates for meeting them, the required expenditure can be compared with revenue projections and a borrowing programme derived. There is no reason why any of that should be secret. The public can discuss the priorities and timing, encouraging public debate and buy-in. With projects, provisional costings and dates in the public domain for 5 to 10 years ahead, there are likely to be plenty of offers of assistance and suggestions from private sector companies and financiers for ways to obtain capital. Lobbying is always self-interested but can also convey information and ideas to the public authority, which of course must remain alert and sceptical. The 2018 report is a big advance on its 2012 forebear and the government is to be commended on publication of the project pipeline.

It is full of retrospective case studies with glossy pictures showing completed projects with copy that reads like a press release from an advertising agency. That cannot be criticized; politics is also about salesmanship and it is appropriate to point to what has been achieved. But the selling is more authoritative and persuasive when there is full information on a worked-up future plan behind it. Everyone should understand that plans change and evolve under the pressure of events, especially long-term ones, so governments should not be fearful of giving hostages to fortune.

Three sources of finance

When such a plan exists there is a known borrowing requirement. The Welsh government now has limited but not insignificant powers to borrow from the Debt Management Office who will issue UK government bonds (gilts) to finance. That is likely to be the cheapest form of borrowing. Local authorities can also tap the gilt market in effect by borrowing from the Public Works Loan Board. That is also cheap finance but the Welsh government itself is not supposed to use it to exceed the borrowing limits imposed on it by the Treasury. It can work in conjunction with local authorities but it must not be seen too obviously to be relieving them of their debt burdens. The third major source of capital is private finance of which the Mutual Investment Model is an example.

The principle behind private finance is that the private provider of capital for a project is supposed to take on much of the risk associated with it. That may be construction risk, maintenance or operation risk. Although the public sector ultimately pays for the services it is procuring it has to demonstrate that risks have been shifted if the project is to come off its balance sheet, It is then, in effect, paying a lease on an asset perhaps with associated services rather than borrowing to construct the asset. If the asset reverts to the public sector at the end of a contract period, it is employing a form of what used to be known to consumers as hire purchase. Like all hire purchase agreements this turns out to be more expensive in the long run than outright purchase. Interest charges are higher reflecting the risks being run by the provider of the capital. In practice shifting risk is not so easy since the state is always responsible in the end for providing the services that the infrastructure is there to sustain – which makes the higher interest charges a bit irritating.

When should they be used?

The Welsh government says in the 2018 report on the WIIP that it will always use the cheapest sources of finance first before resorting to more expensive forms. That sounds sensible and if you are proceeding hand to mouth it is the best you can do. If a medium-term plan is in existence, however, one can do better. With such a plan it would be clear whether the borrowing requirement over any time period was likely to exceed the amount of the cheapest finance available (gilts). If it did not there is nothing to discuss; all borrowing would be done through issue of UK bonds via the DMO. Where the borrowing requirement exceeds the available gilt borrowing however, things are more interesting. Then there is the possibility of matching finance and projects rather than simply using up gilts first.

The aim should be to minimize the total cost of the borrowing programme. The significant fact to bear in mind is this: gilt interest rates are the same whatever the money is used for; that is not true of private finance. Recall that the interest rate on a private finance deal (including MIM deals) will reflect the risk born by the financier. It follows that private finance should be used for the least risky projects. Riskier projects should be financed with gilts. Risk can take several forms: construction, maintenance operation. A project can be sliced up in numerous ways. The state could acquire an asset itself and license a private operator to run or maintain it, for example, so the comparison is not straightforward. Nonetheless the principle is clear. Carve up projects appropriately and use private finance where the risks to the financier are relatively low.

A second consideration is how the project will ultimately be paid for. For services free at the point of delivery, like much health, education and most road provision, the taxpayer foots the bill. Some services, like use of railways and toll roads or bridges incur user charges. Taxes, like death, are held to be inevitable but with most services for which you pay there is an element of choice. This means the government may be more relaxed about the financing cost of services that are self-financing. This argument, however, does not dominate the first one; minimizing overall cost should be the priority.

The ideal project for private finance, therefore, is one of which there are plenty of past instances so the risks are known and can be managed successfully. Anything highly innovative is likely to be expensive. Moreover, if the user will pay for the service so that servicing costs can be met out of user charges, so much the better. It follows that if the M4 relief road is to be built it should be financed by MIM since motorway construction is a routine procedure. Moreover, the case would be reinforced if it were a toll road – for which there are strong arguments. There is no obvious reason why tax payers in Anglesey should pay for commuters around Newport. And if the latter don't want to pay a toll they have the option of crawling along through the Bryn Glas tunnel. Wales' gilt allocation would then be used for riskier projects, which would certainly describe the Swansea Bay lagoon or the Carmarthen to Aberystwyth railway, should those be contemplated. Of course, that assumes the WIIP is ambitious enough to exceed capital budgets and the gilt allocation and that it includes some innovative projects. Those assumptions may or may not apply.

Gerald Holtham
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