

Spending Review 2010 Headlines

20 October 2010

The Coalition Government has now delivered its long-awaited Spending Review. Behind the Chancellor's words, it represents one of the harshest settlements in the post-War period.

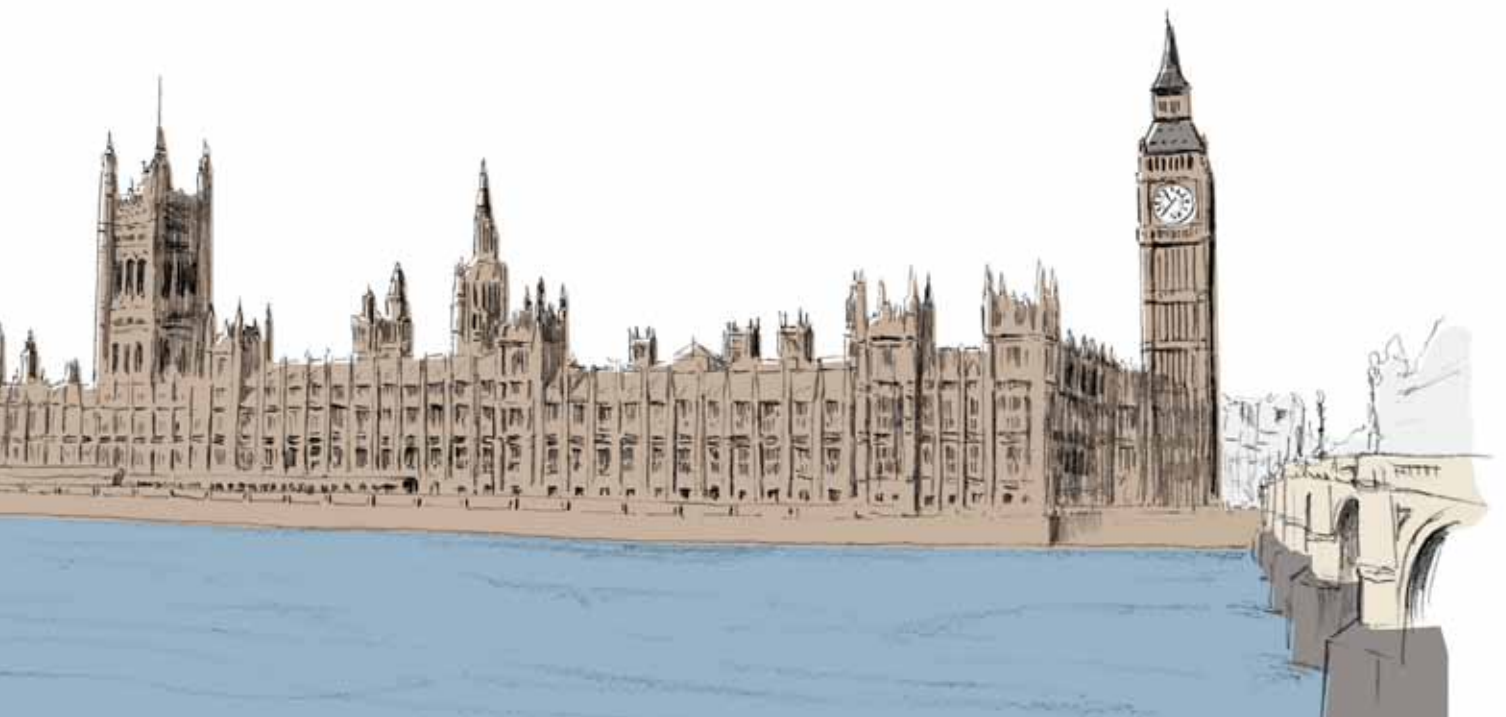
“Within the high level numbers there are winners and losers. Local Government appears to be one of the real losers within the settlement, facing cuts of 26% over the next four years. On the upside, the sustained support for Big Society will move the centre of gravity away from Whitehall, to localities.”

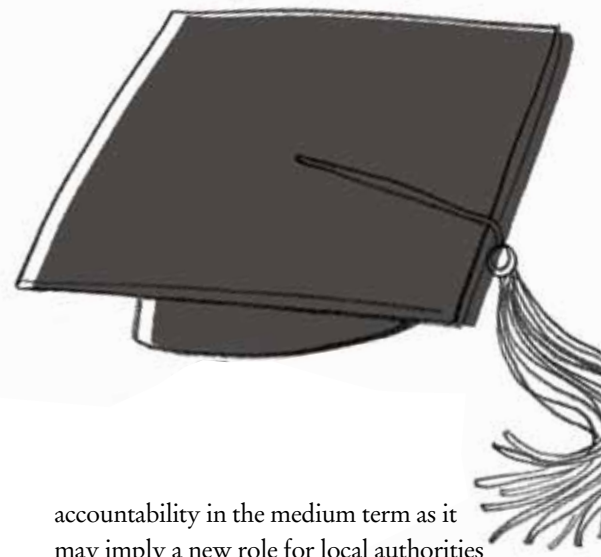
Karl Eddy, Head of Government & Infrastructure Advisory



Karl Eddy
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The focus on priorities that support economic activity is clear. The investment in transport and green energy is welcome alongside the positive announcements on skills and Regional Growth Funds which will harness enterprise and drive growth.





The UK economy

In the October 2010 Spending Review, the Coalition Government continued its commitment to slash the huge budget deficit, by announcing £83 billion of cuts.

The aggressive reduction in government spending will help to put the economy on a firmer footing over the longer term. Sound public finances will reassure the financial markets, keep market interest rates low and encourage the private sector to invest and create new jobs.

Real risks remain

Most consumers and households will not be thinking about the benefits of these austerity measures. Instead, one of the main outcomes of the Spending Review will be an increase in the level and fear of unemployment - particularly among the 490,000 employed in the public sector who will soon start to lose their jobs. This will put a large dent in consumer confidence, which is bad news for all, considering that signs of improvement in the UK economy have only just begun.

The balance between current and capital spending cuts is a cause for concern. Maintaining investment in transport, schools and science is good news for both business and families. But the increase in the capital spending over the last Budget will hardly do much to improve the productive capacity of the economy over the long-term.

Addressing the deficit early will mean lower debt interest payments of £5 billion over the next three years, providing some limited scope to increase capital spending, vital for driving forward economic growth over the next three to five years.

Rebalancing the economy will take time

The private sector will eventually create the jobs required to offset losses in the public sector. New jobs will be created

by the UK's labour market adjusting and from new private sector activity being created through innovation and enterprise. But the process will take an inordinate amount of time. Economic restructuring on this scale will take at least a decade if not more.

Big changes needed to make Big Society

We welcome the sustained support of Big Society, which should be the upside of smaller government. The Chancellor is signalling a wider reshaping of government, its centre of gravity moving from top heavy Whitehall departments to localities. Local decision-making will better target scarce resources on the areas of greatest need and contribute to the activation of community resources. This will result in more agile and focused services, delivered more effectively by the right combination of public, private and civil society organisations.

The Spending Review promises a reduction in the bureaucratic burdens that tie up frontline professionals and deter new entrants from social enterprises, charities and SMEs. Currently front line organisations waste precious time and effort on labyrinthine bidding exercises and disproportionate monitoring. Therefore it is good news that we will see a shift from a top-down performance management culture to one which enables the front line to deliver and measures their outcomes rather than their inputs.

Ultimately, this agenda points to the devolution not just of service provision but also of prioritisation and commissioning. The real question is of

accountability in the medium term as it may imply a new role for local authorities as more devolved accountability structures develop.

Choice devolved across the education sector

Schools

The small increase in direct funding is positive news for schools, although the re-distributional impact of the pupil premium will favour schools teaching poorer pupils. However, cuts in child welfare benefits and local government services may put pressure on families leading to greater pressures on schools to support disadvantaged pupils. Capital spend on schools falls by 60% as the BSF programme winds down leaving funding only for demographic pressure and major maintenance, so many schools may face increased operational costs.

Higher education

If the recommendations of the Browne report are adopted, the swinging 40% cut to government core funding for teaching in universities is likely to be offset by higher tuition fees but this will put more of the financial burden on students and their families. Consequently, more students will demand degrees that lead to better job and income prospects rather than those simply providing personal development. The combination of differential fees and more selective students is likely to result in winners and losers but greater risk for all higher education institutions.

Further education

Further education will see a 25% cut in funding including an end to Train to Gain in favour of SME focused training. There will be more apprenticeships, with a student loan system for those over 25 and proposals for a training levy on employers. The transfer of funding from general taxation to targeted users and the focus on growth generation parallels changes in higher education.

Real estate – asset sales and new opportunities on horizon

Achieving a year on year saving of 7.1% for the next four years will be a massive challenge for councils and implementation may involve a large scale disposal of assets. If so, getting best value for those assets in the current market will be difficult and timing of disposals will be critical in both value and service terms.

New capital funding to local government is falling sharply. We therefore anticipate new developments, to a large degree, will rely on a combination of: localisation powers of recycling assets; public private partnerships; and using new tools to raise money.

The Government has applied a principle of supporting capital projects that it believes contribute most to economic growth and a rebalancing of the economy, this has resulted in strong investment in transport and green projects. However, there are difficult cuts for social housing of around £5 billion.

The cuts run alongside a reform programme which may provide leverage for councils to innovate in order to continue investment albeit at a more modest level. New social tenants will pay 80% of market rents, this extra income is forecast to raise £4.5 billion to fund the development of 150,000 new social homes over the next four years.

The removal of ring-fencing for all local authority revenue grants, a general promotion of localism and new mechanisms such as tax increment financing and housing revenue account changes are radical reforms, and give councils some additional tools to innovate. We think councils will be keen to use these and quickly understand the potential to raise money for new housing and other capital facilities in their areas.

Infrastructure spend to support low carbon agenda but at expense of housing and other community builds

The Spending Review has confirmed that the government support for infrastructure will remain largely at similar levels to those previously announced. This involves a cut in overall capital expenditure from £59.5 billion in 2010/11 to £45.6 billion in 2013/14. What is clear is that investment in certain sectors, particularly those supporting economic growth, such as transport, and the low carbon economy have been favoured at the expense of other areas, such as housing and other social infrastructure.

The Government also confirmed the importance of the low carbon agenda as a stimulus to growth. The Chancellor confirmed the injection of £1 billion of public capital to establish the Green Investment Bank and a green light for the introduction of a Renewable Heat Incentive with £860m of new funding.

While the eagerly anticipated National Infrastructure Framework from Infrastructure UK will provide more detail on the infrastructure schemes being supported, confirmation that a number of regional transport schemes such as the

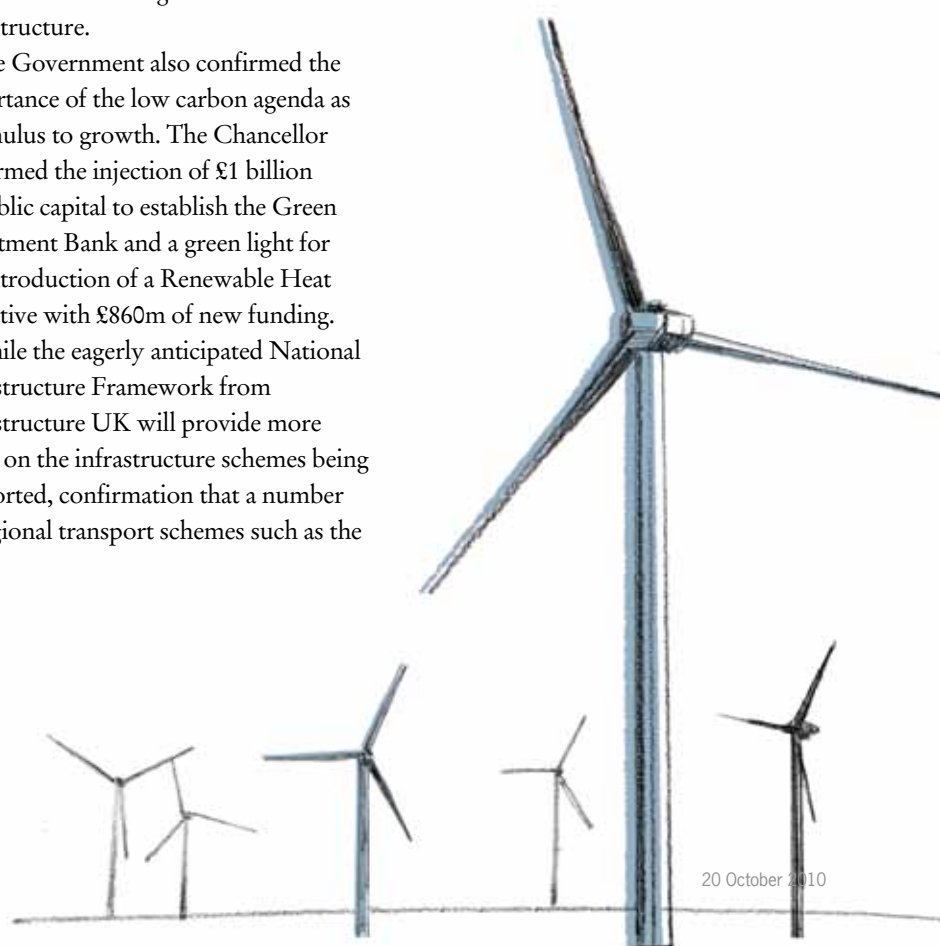
Mersey Gateway Bridge will proceed, will come as a relief to large parts of the construction industry.

Against this backdrop, the previously announced cancellation of much of the Buildings Schools for the Future programme and the cancellation of seven waste PFI projects means that the spoils may fall unevenly.

The housebuilding industry will not find welcome confirmation of a £5 billion fall in capital expenditure on social housing coupled with reform to limit housing benefits, which may mean new development relying on tenants being able to meet higher rents.

Support for the renewable sector

The Chancellor noted that one of the Spending Review principles was to invest in renewable energy as a sector likely to support growth. He made a number of positive announcements which will continue to support the sector and the associated investment, jobs and tax income.



- Government will provide £1 billion to fund the Green Investment bank in 2013/14 and hopes that asset sales and the private sector will provide additional capital. The issue here is how long before the new bank starts lending and on what terms.
- Government will provide up to £1 billion public capital funding for Carbon Capture and Storage (CCS) demonstration projects. The objective is that this will both reduce CO2 emissions and help the UK establish a world lead in the emerging CCS technology.
- £860 million of funding for the Renewable Heat Incentive which will be introduced in 2011/12. This is a positive move as there had been some uncertainty around this subsidy. It is also simple and transparent as the subsidy will be funded by the Government rather than a complex energy levy as was previously proposed.
- The Chancellor did not refer to the Feed-In Tariffs (FITs) so it is interesting that the accompanying speech notes stipulate that the tariffs will be rebalanced towards more cost effective technologies at the next formal review probably in 2014/15. This leaves open the possibility that Solar FITs will be reduced if they are too successful. This is a negative signal to investors in renewables as it insinuates the government may change the rules if the FITs are seen to be too successful. The UK needs to be seen as a good country with stable regulations by global investors if it is to hit its renewable energy targets.

Significant changes for the waste sector

The effective support for renewable waste technologies, in particular anaerobic digestion, through RHIs and continued FITs had been generally expected but the effective withdrawal of support for some of the UK's biggest waste schemes was not. This will have a dramatic impact on the current landscape of the waste industry. Although the announcement about Project Transform (Coventry, Solihull and Warwickshire) was made some weeks in advance of the CSR, the withdrawal of support for the North London Waste Authority (NLWA) project must be seen as a surprise. NLWA had long been seen as a flagship project for government and was seen as being critical to enable the UK to meet our diversion targets. What the Department for Environment, Food and Rural Affairs is now saying is that support for these seven projects is being withdrawn as the UK no longer needs these projects to meet the EU 2020 targets for landfill diversion.

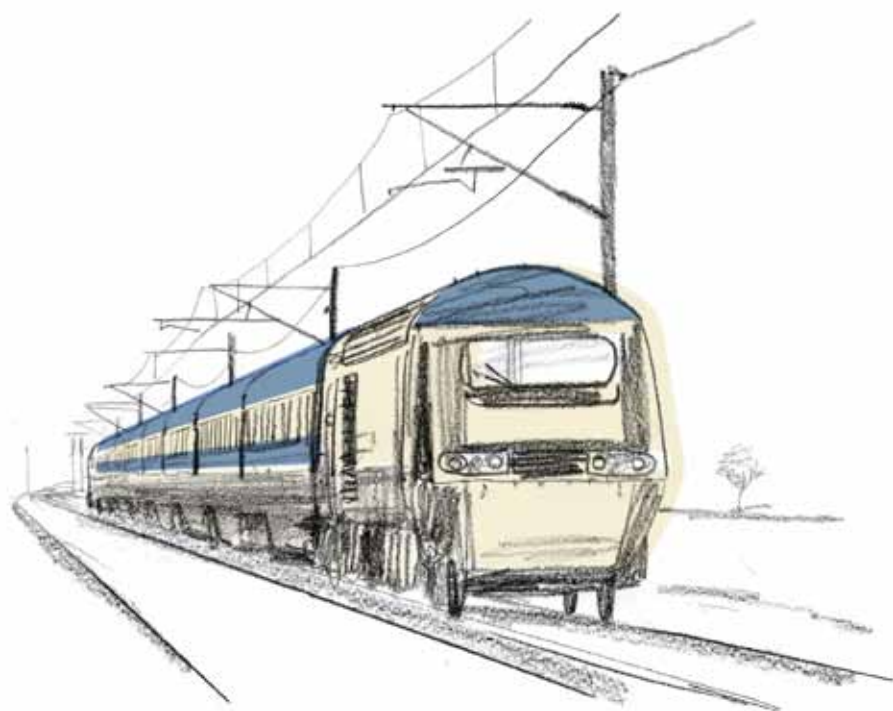
Government's commitment to transport is good news for the sector

The Chancellor's announcements of spending cuts to transport were better than originally feared.

The Government's £30 billion expenditure commitment to transport over the next four years recognises transport's key role in supporting economic growth in the UK. In addition, the commitment to the capital's Crossrail project together with Underground upgrades is very positive for London.

Plans to extend the Midland Metro is excellent news as it will take it to the heart of the city centre. Continued investment in the Tyne & Wear Metro supports the key role that metro schemes play in the prosperity of our regional cities but this project was confirmed by the coalition government in June and were never likely to come under the axe.

There was no specific mention of large rolling stock projects such as Thameslink or Intercity Express Programme with an implication that increased rail fares would support this investment on a more incremental basis.



Overall, when Crossrail and revenue expenditure on the national road and rail network are taken into account there will still be significant pressure on local government transport expenditure and we estimate that 10% year on year transport expenditure reductions will be required at local government level.

Defence spending cuts: opportunities from within the gloom

The Spending Review shed light on further efficiencies and savings to supplement yesterday's Strategic Defence and Security Review (SDSR), which focused on changes to key procurement programmes. In contrast to the largely negative implications of the SDSR, some of today's announcements may offer interesting opportunities for private sector organisations.

The rationalisation of the defence estate will make substantial property holdings available for potential acquisition by developers. In addition, the savings target of £350 million associated with running the defence estate may provide incremental business opportunities for support services organisations.

Providers of communications services will have the opportunity to bid for telecommunications spectrum, likely to be released by the military. Other assets on the block in the coming months are likely to include the Defence Support Group, a sale that has been mooted for some time.

Following the announcement of the cancellation of the Defence Training Rationalisation project, the Ministry of Defence still faces the challenge of reforming the provision of training across the three services. With other options now being considered, we expect the private sector to feature in the final decision.

Support services will ride out spending review cuts

Following the Chancellor's Spending Review, support service providers in the private sector need to ride out initial cost cuts, before they can benefit from the opportunities created by the reform of public services and the adoption of best business practice in procurement.

In his Spending Review, the Chancellor indicated how departments will be affected by total spending cuts of £81 billion and average real budget cuts of around 19% by 2014-15.

In the next 18 months support service providers will also be hit by rough and ready measures to cut spending across the public sector. By 2012, the public sector is expected to refocus on delivering quality services and getting value for money. Providers that can deliver cost effective support services should benefit disproportionately from this transition.

The fact that finance directors in government departments are increasingly held personally accountable to deliver savings should make it easier for support service providers to identify who to approach with offers that deliver such savings.

The public sector clearly needs to adopt best business practice in procurement if it wants to achieve efficiency savings while providing the quality services expected by the taxpayer. This should particularly benefit large support service providers with the ability to provide economies of scale.

In terms of subsectors in support services, the Spending Review is bad news for those affected by cancellation of the £14 billion Defence Training Rationalisation project. On the other hand, reforms such as those to the sentencing framework will mean good news for private sector providers offering to run programs that reduce re-offending.

The support services sector is expected to consolidate in the next couple of years as companies strive to make the most of opportunities generated by the pressing need for the public sector to cut costs.

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