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To: Corporate Policy Overview Committee – 14 November 2008

Subject: Effect of the downturn in the economy on Corporate Services

Classification: Unrestricted

Summary: Members are asked to note the impact that the economic downturn is having, or could have, on the Chief Executive's Departmental budgets

1. BACKGROUND

- 1.1 The global and UK economic position has fundamentally shifted over the past year and by any independent assessment that shift is a deterioration, and one likely to worsen. The consequences and likely impacts are wide spread.
- 1.2 This report provides a brief commentary on the national position, how this could affect KCC, and more specifically what the impact and potential impact is on the Chief Executive's Department's budgets.

2. KEY FACTS AND FIGURES - SOME HEADLINES

- 2.1 The Consumer Price Index hit 5.2% in September. The Retail Price Index was 5.0%. The CPI has never been higher, since the current methodology began in 1997.
- 2.2 CPI and RPI have both been on an upward trajectory, but CPI has now crossed over with RPI (in terms of which measure is highest) and it is likely RPI will start to fall sooner than CPI as house prices fall (lower house price means lower depreciation to charge on house costs in RPI indices) and that interest rates will come down further still (if inflation worries permit).
- 2.3 Worryingly, the Bank of England's assessment is that people's expectations of inflation have risen and there is a danger that this will spill over into wage demands which in themselves become inflationary, pushing up the costs of goods and services which become even more inflationary.

- 2.4 The three main causes of the current high inflation measures are the escalation in fuel prices, food prices, and other commodities. A depreciating Sterling (which recently touched a twelve year low against a basket of world currencies and is currently at a five year low against the US dollar) is adding to the pressures (making imports dearer still in Sterling terms). Oil reached a record \$145 a barrel in the summer but has since dropped significantly given the concerns over a global slowdown and falling demand for oil (now trading at \$62 a barrel – 28 October 2008 – despite OPEC agreeing to cut production to try and limit supplies and raise prices). This should mean the rapid spike in prices and consequent impact on inflation should work relatively rapidly but painfully through the global economy and be reflected in lower inflation in future years.
- 2.5 These increases have had a knock on effect on gas and electricity prices, exacerbated by the Pound falling against the US Dollar. European gas contracts are mostly indexed to oil prices and as the UK is a net importer of gas, wholesale prices have risen but are falling back in the short term. A not insignificant element of gas is also actually used to generate electricity (around one third comes from burning gas) putting price pressure here too, although prices are expected to ease back before the turn of the year. The further gas and electricity price rises for consumers we have recently seen were thus inevitable in the short and medium term and, crucially, substantially added to inflation levels particularly for low earners, pushing yet more people into fuel poverty (where more than 10% of disposable income is spent on heating and lighting).
- 2.6 Individual inflation faced by consumers varies according to their spending patterns, and headlines are often misleading. Those on low incomes whose spending on food and fuel is a disproportionately larger amount of disposable income are actually facing much higher levels of inflation and hence more people are being pushed into fuel poverty.
- 2.7 At the same time as spiking inflation rates we have seen bank base rates moving significantly downwards. The Bank of England's Monetary Policy Committee cut base rates to 4.5% in October 2008, following three separate 0.25% percentage cuts since their most recent peak in autumn 2007 at 5.75%. The Bank of England is facing a clear dilemma over future interest rates: rising and rapidly escalating consumer and retail prices well above the long run 2% target should result in a tightening of monetary policy and increases in interest rates but to do that at a time when the economy has slowed significantly runs the risk of pushing the economy further into recession.
- 2.8 The Bank of England has clearly decided that the risk of recession in the medium to longer term outweighs the currently reported high levels of inflation and we can expect further base rate cuts to come.

- 2.9 Figures released by the Office for National Statistics in October 2008 confirmed what has been assumed for some time, the UK economy is indeed entering recession. The economy shrank for the first time (by 0.5%) in 16 years between July and September 2008.
- 2.10 Meanwhile we have seen turmoil in the financial and credit markets result in the failure, or nationalisation, or forced private sector takeover, of a range of UK and international banking institutions. Seizure in the credit markets having affected the banks ability to lend to each other has spilled over into their inability or desire to lend to households and companies. As debts come due for refinancing there is increased risk of failure by individuals and entities to secure new lines of credit and a risk of rising business failures and mortgage repossessions in the 'real economy'.
- 2.11 In a measure to ease the current credit situation, Government announced an intention to help SMEs by ensuring local authorities, amongst others, reduce payment terms from the general 30 days down to 10 days. This would almost inevitably require additional staff, at least in the short term, but the higher cost to KCC would be the loss of interest from our daily cash holdings. This could be anything upwards of £0.5m

3 IMPACT ON KENT COUNTY COUNCIL AND THE CHIEF EXECUTIVE'S DEPARTMENT BUDGETS

- 3.1 The impact in general terms on KCC will be felt during this financial year and beyond. The major concerns include:
- Level of price increases requested by private and voluntary sector service providers
 - Increasing numbers of people needing access to public services
 - Increase in rate of 'wealth depletors'
 - Failure to realise capital receipts
 - Government's increasing levels of borrowing, allied to falling tax receipts, and the potential impact on future grant settlements
- 3.2 We will continue to monitor the general state of the economy and ensure KCC is ready to act and react wherever possible, to mitigate the impact the downturn in the economy has on our resources.
- 3.3 The more direct impact the downturn is having, or could potentially have, on the Chief Executive's Department's budgets is provided below, by service unit.

3.4 Finance

- 3.4.1 The much reported problems with the Icelandic banks has put the spotlight on our treasury management function. The audit of our policies and procedures continues. We remain focussed on recovering as much of the £50m as possible, of which £24m is core KCC funds. Until we have some clarity on the outcome, it is not possible to say what the precise financial impact on the budget will be. In the current year, we expect the savings on debt charges as a result of the review of the capital programme, to broadly offset any possible loss of interest from the £24m. Members will be kept fully informed of the outcome of this issue.
- 3.4.2 While the forecast drop in interest rates is good news for borrowing, it is not such good news for interest income from cash and investments. Our revenue budget currently assumes £9m of interest, but this may need revising down for the 2009/10 budget given the forecast drop in bank base rate. However, any loss of interest earned is likely to be offset by the saving on interest payments associated with our borrowing to fund our capital programme.
- 3.4.3 The stagnation of the building industry means that assumed growth in the Council Tax base, resulting from new properties, is under threat. While the forecast growth of 1% for the 2009/10 tax base still looks sound, future years' projections will need to be carefully monitored.

3.5 Property

- 3.5.1 The Property group were tasked with delivering £184m of capital receipts between 2008/09 and 2010/11 to fund our capital programme. When it became evident that this was not going to be possible, a recommendation was made to, and approved by, County Council to establish a second Property Enterprise Fund (PEF2).
- 3.5.2 The basis of PEF2 is built on the assumption that land and property values will return to their January 2008 values within five years. Despite all that has happened in the economy, even since PEF2 was approved in September 2008, there is no intelligence to suggest that this is a false assumption. Indeed, the Centre for Economics and Business Research (CEBR) has predicted that house prices will recover to their 2007 peak, in 2013 (BBC News web-site 27/10/08). However, PEF2 will be carrying a deficit of up to £85m, so it is important that a very close eye is kept on land and property values throughout the next five years. On a positive side, lower interest rates, if they happen, would reduce the costs of operating PEF2, and if they happen quickly, aligned with the government's intervention in the banking sector to stimulate borrowing to individuals and business, it may improve the outlook for the building industry and land values.

3.5.3 The Property Group are beginning to see signs of the supply chain in the construction industry becoming a little less stable and it is apparent that there is considerable nervousness in the construction market. On the positive side, current tenders are being received at less than expected figures as contractors reduce their margins to accommodate the downturn in workloads. This results in lower costs to KCC, but it poses a greater risk of insolvency during construction, and therefore could result in higher overall costs and delays in project delivery.

3.5.4 A number of SMEs are looking to diversify, mainly away from house building into more general building activity. This is leading to increasing competition for KCC funded projects, even relatively small revenue projects.

3.6 Commercial Services

3.6.1 Based on gas and electricity purchases made in October, the energy costs for the main KCC buildings (which account for approximately 70% of KCC consumption), compared to pre-October contract rates, show electricity is up by 62% and gas up by 18%, for the period to March 2009.

3.6.2 There is increasing competition from scholastic equipment and stationery suppliers, who are offering significant discounts to schools if they move from County Supplies to them.

3.6.3 There is also increasing pressure from suppliers at annual price negotiations. While many are keen to retain KCC business, they are having to respond to higher costs and are likely to press for RPI increases as allowed under the terms of many of the contracts, whilst previously many costs have been held.

3.6.4 There is increased competition for hard landscape and small building works, as a result of the current house-building stagnation.

3.6.5 More positively, it has been easier to recruit temporary staff into Kent Top Temps, and therefore they have been able to fill many more of KCC's temporary vacancies than previously. Also, recent tenders for Home to School transport are at costs less than current prices.

3.7 Business Solutions and Policy

3.7.1 There has been little impact on ISG, but there may be opportunities to keep any price increases to a minimum as providers in the IT services market look to retain existing business.

3.7.2 There is an issue about Brussels based staff who are paid in pounds but have to spend euros - some have seen a 20% reduction in real pay. Equally, the ability to maximise European funding (which only pays a percentage) is starting to be compromised by the need to trim expenditure so this type of activity tends to be down-played because of the longer pay-back time-scales.

3.8 Legal Services

3.8.1 With the opening up of the legal markets and the relaxation of the restrictions on local government lawyers being able to work for the wider market, there is the potential for KCC Legal Services to capitalise on these opportunities, as are the opportunities to work in partnership with our local government colleagues in raising standards across the public sector and driving out real efficiencies. There is no evidence that this opportunity is diminishing, and could in fact increase as the market looks for increased value for money.

3.8.2 The demand for legal services, both internally and externally, continues to increase. The bringing in of more external legal work will continue to subsidise the internal provision. Work for Legal Services continues to increase – up 21% in hours and 30% in value for the first six months of this year compared with last year.

3.9 Strategic Development Unit

3.9.1 The economic climate is having a negative impact on the Kent Film Office as a lot of the productions that currently come to Kent are independent film makers - these are often partly financed by private individuals and these private individuals are harder to find in times of economic difficulty. It is also having an impact as companies are more likely to go to places that are offering money to film; Kent is not. Kent has actually seen an increase in the number of filming days in the County but these have mainly been lower budget productions, therefore bringing proportionately less to the Kent economy.

3.9.2 Kent TV - It is going to be increasingly difficult to get sponsorship and /or advertising revenues as there is not as much advertising/marketing money in the pot and people are more likely to stick with proven advertising techniques rather than new ones at such times. There is an outside chance that people with less disposable income will be less likely to have broadband in their own homes (in other words broadband take-up may slow down) which may affect viewing but we have no evidence of this. On the plus side, with fewer people travelling abroad, more people may turn to Kent TV for information on holidays or days out in the County.

3.9.3 Gateways - partner organisations' ability to pay a contribution for the space they occupy or would like to occupy, is something to bear in mind, although there are no immediate concerns.

3.10 Personnel & Development

3.10.1 There has not yet been a notable rise in the number of applicants for job vacancies, but it is anticipated that there will be an increasing pool of candidates available, particularly from the private sector, in many types of work. This provides an opportunity for the Authority to improve still further the quality of recruits to KCC.

3.10.2 Pressure on business unit budgets means that managers will have to look carefully at whether vacancies should be filled, and Personnel and Development will be working closely with managers to look for creative solutions to cover the work resulting from vacancies without necessarily recruiting more people.

3.10.3 Some of our staff may find themselves in personal financial difficulties in the current economic conditions and we will be ensuring that we offer support and advice to staff on how they can help themselves if this happens.

3.10.4 Opportunities to work with other public sector organisations on the provision of HR services is likely to increase in the current climate, in the same way as is noted for Legal Services. There are opportunities to work in partnership with our local government colleagues in raising standards across the public sector and driving out real efficiencies. The same is true of other potential areas of income generation across HR as value for money becomes an absolute necessity for organisations in all sectors. It is possible, however, that the opportunities to generate external income in learning and development will become more challenging as training budgets are often first to be reduced in times of economic difficulty. The uptake of training programmes within KCC will be monitored.

3.11 General

3.11.1 Corporate Services rely significantly on income from schools, other local authorities and agencies, and the other KCC directorates. As the financial belt tightens for all of these customers, we will have to continue to innovate, modernise and offer high quality value for money services, in order to retain existing service levels. Failure to do so will reverberate across KCC and beyond, and failure is therefore not an option.

4 SUMMARY

- 4.1 The Chief Executive's Department is by no means immune from what's happening to businesses and residents of Kent as a result of the current economic climate. We will need to adapt as conditions change. We will need to provide high quality services if we are to retain market share in what will become increasingly competitive markets. However, as both purchaser and provider of services, we can also benefit from the up-side of increasing competition.
- 4.2 The Chief Executive's Department faces a number of significant financial risks. These will, of course, appear on our risk register and named officers will be accountable for managing those risks, putting in place mitigation, and for ensuring that we revise our financial forecasts as the economy and the general financial landscape changes.

5 RECOMMENDATIONS

- 5.1 Members are asked to note the impact that the current economic condition is having, or could have, on the Chief Executive's Department's budgets.

Background Documents: None

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