ENERGY FROM WASTE PLANT
MANAGEMENT OF FOREIGN CURRENCY EXCHANGE RISKS

REPORT

MARCH 2009

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SECTION ONE ~ INTRODUCTION

1. In January 2009 I announced that I would investigate the management of foreign currency exchange risks arising from a contract for the procurement of an Energy from Waste (EFW) Plant. The terms of reference for this review are set out in Appendix One.

2. In brief, the background to these matters is that:

   (1) In 2005 the States approved in principle the replacement of the existing incinerator at Bellozanne;

   (2) In July 2008, the States approved a detailed proposal for the replacement of the incinerator and the proposed arrangements for financing the replacement;

   (3) In accordance with the States' decision in July 2008, a contract was signed on 14 November 2008 for the procurement of a new EFW Plant;

   (4) Although it was originally intended that all payments under the eventual contract would be made in sterling, the contract when signed provided that a substantial proportion of the payments due under the contract should be made in euros; and

   (5) In December 2008, following an unexpected and material decline in the Euro:Sterling exchange rate, concern grew about the way in which the States had managed its exposure to euro currency exchange risk and the implications for the overall cost of the project.

3. The background to this review is described in greater detail in Section Three of this report.

4. I began this review by preparing a chronology of the principal events and decisions which led to the action which was taken to manage the States' currency exchange risk under the Engineering and Procurement Construction (EPC) contract. This chronology was based on a detailed examination of all of the records pertaining to the contract and the organisation of the necessary finances, supplemented by interviews with the people who have been principally involved. A list of the people who were interviewed in the process of this review is set out in Appendix Two. In accordance with the normal practice of the States' Assembly, I have referred

to people in this report by the titles of their positions rather than by name. The abbreviations that have been used in this way are listed in Appendix Three.

5. The chronology which resulted from this process is set out in Section Four of this report.

6. Having completed the chronology, it appeared to me that decisions made on two particular dates were crucial to the position in which the States now finds itself. Those dates are:

(1) 14 November 2008: the date on which the EPC contract was signed; and

(2) 17 December 2008: the date on which the Treasury and Resources Department (T&R) agreed the detailed policy for the purchase of euros which is now being applied.

7. However, as I will show, decisions made on 10 July 2008, the day after the States approved the procurement, were also important.

8. I have examined in detail the actions which were taken on these three days including the decisions which were made and the reasons for them. My analysis of these matters, together with my conclusions in respect of the appropriateness are set out in the following sections of this report:

(1) 14 November 2008: Section Five of this report;

(2) 17 December 2008: Section Six of this report; and

(3) 10 July 2008: Section Seven of this report.

9. The consequences of the decisions that were made about purchasing euros are analysed in Section Eight of this report.

10. As will be seen from the list of people interviewed for the purpose of this report (set out in Appendix Two), a large number of people have assisted in the conduct of the review and the preparation of this report. I am grateful for all of the assistance that they have given me in the course of this work.

11. A summary of the conclusions that I have reached as a result of this review is set out in the following section of this report: Section Two.

SECTION TWO ~ SUMMARY OF CONCLUSIONS

Introduction

12. In this section of the report, I summarise the conclusions I have reached in respect of the action taken at three dates. I start with the action taken on and after the signing of the contract on 14 November 2008 and subsequently on 17 December 2008. However, it appears to me that action could have been taken earlier: when the States approved the procurement on 9 July 2008 and I have therefore considered and reached conclusions on the action that was taken on 10 July 2008, immediately after the States' decision.

13. The currency exposure (which was disclosed to the States in P73/2008) led to the cost of the procurement being higher than the cost originally indicated to the States. Following summaries of my conclusions, I set out a table showing the additional cost.

14. Finally, at the end of this section of the report, I make observations concerning administrative practices within the T&R.

14 November 2008 (Section Five of the report)

15. The conclusions that I have reached in respect of the action taken on 14 November 2008 may be summarised in the following way:

What action was taken?

16. The exchange rate was not fixed.

17. The approach eventually arrived at envisaged that all of the euros required would be purchased at a time 'of favourable rate' prior to when the first payment was due in January 2009.

Was the action appropriate?

18. I believe that the action taken was not appropriate because:

(1) The States are not in a position to manage currency exchange rate exposures;

(2) Rather than limiting the States' risk, it exposed the States to an extension of the period during which there was a risk of loss through variations in currency exchange rates;

(3) The approach was inconsistent with the States' planning for the contracts;

(4) The recommendation that was accepted by the TT&R was based on a flawed analysis of the relative costs of different approaches to fixing the exchange rate;

(5) The approach was inconsistent with the normal approach of T&R; and

(6) The approach was inconsistent with the statements made in P73/2008 about the management of currency exchange risk.

Why was inappropriate action taken?

19. Inappropriate action was taken because reliance was placed upon flawed recommendations made by a member of T&R staff with limited experience of currency exchange questions, without appropriate review.

What action should have been taken?

20. As far as concerns the actions that should have been taken:

(1) There were strong reasons for fixing the exchange rate;

(2) One of the means of fixing the rate should have been chosen;

(3) The most straightforward means of doing this would have been to reach agreement with the contractor.

17 December 2008 (Section Six of the report)

21. The conclusions that I have reached in respect of the action taken on 17 December 2008 may be summarised in the following way:

What action was taken?

22. A policy was agreed by which euros would be acquired as and when needed to meet payments under the EPC contract, save that if the exchange rate passed various 'triggers' the opportunity would be taken to buy euros in advance of the contractual requirement.

Was the action appropriate?

23. I believe that the action taken was not inappropriate because:

(1) Although the approach adopted left the States exposed to further unfavourable exchange rate movements and placed the States in a position analogous to that of a speculator; and

(2) The approach adopted was the least unattractive of the choices available.

24. However, T&R should also have considered purchasing call options to ensure that if the exchange rate moved unfavourably, euros could be acquired at the rate ruling on 17 December 2008, thus creating a floor for the States' exposure.

Why did this happen?

25. That T&R found itself in this position is directly attributable to the policy mistakes made on 14 November 2008 and the failure of T&R to heed the warnings that these mistakes were likely to prove costly.

What action should have been taken?

26. Although action could have been taken to eliminate down-side risk (i.e. to eliminate the States' exposure to further unfavourable movements in the exchange rate), it is not clear that the costs that would have been incurred would have been justifiable.

10 July 2008 (Section Seven of the report)

27. The conclusions that I have reached in respect of the action taken on 10 July 2008 may be summarised in the following way:

What action was taken?

28. No action was taken to fix the exchange rate for the contract.

Was the action appropriate?

29. I believe that the action was not unreasonable in the sense that there remained some question whether the States' approval would prove to have been final and it was in any case consistent with the statements made to the States in P73/2008.

Why was this action taken?

30. The promised briefing paper (for the T&R Minister) was not prepared because there was thought to be material doubt whether the States' approval for the procurement would prove to have been final.

What action should have been taken?

31. The most straightforward approach would have been to transfer some of the States' liquid funds into euros.

Cost of the procurement (Section Eight of the report)

32. The report considered by the States in July 2008 estimated that the overall cost of the proposed procurement would be £106.36 million. It also stated that this estimate was subject to variations in the exchange rate at which the necessary euros would be purchased and that this rate would be fixed as at the date on which the contract was signed.

33. The effect on the overall cost of the procurement of the variations in the cost of acquiring euros is shown in the following table by comparison with the actual rate of exchange ruling on the date on which the contract was signed::

	Sterling equivalent cost of Euros	*Total Project Cost*	*Variation in cost*
14 November 2008 – contract signing Assuming that all euros had been bought at rate ruling on the date on which the contract was signed	64.73 m	114.23 m	-
Current approach Actual approach now being used by the Treasury & Resources Department (estimated using rates ruling at the date of this report and	69.75 m	117.29 m	+£3.06 m

thus still subject to currency fluctuations)			
17 December 2008 – the date on which the current approach was adopted Assuming that all euros had been bought at the exchange rate ruling on this day	70.29 m	119.79 m	+£5.56 m
10 July 2008 – the day following the States' approval of the procurement Assuming that all euros had been bought immediately the States approved the procurement	60.43 m	109.93 m	-£4.30 m

General observations

34. The problems encountered in managing the currency risks arising from this procurement were exacerbated by two factors:

35. Firstly, T&R does not have sufficient staff with appropriate skills and experience. I have referred in previous reports to the Department's difficulty in recruiting appropriate staff.

36. Secondly, this review has highlighted a number of instances in which T&R's performance suffered because of failures in basic administrative practice. For example, there is no record of TT&R's decision on 6 November 2008 about the way in which euros should be purchased with the result that there is some uncertainty about what it was and whether it was implemented correctly. As a further example, the handover from the Strategic Investments Manager on his departure on 3 October 2008 appears to have been unsatisfactory. As a further example, there appears to have been no follow-up for undertakings given in and at the time of the lodgement au Greffe of P73/2008.

37. These shortcomings may have been in part a result of the Department's limited resources.

SECTION THREE ~ BACKGROUND TO THIS REVIEW

Introduction

38. In this section of the report, I will review the background to the EPC contract and the eventual signing of the contract in November 2008.

Proposition P85/2005

39. On 13 July 2005, the States approved Proposition P85/2005 which proposed a Solid Waste Strategy and charged the then Environment and Public Services Committee:

> *"(v) to investigate fully alternative and conventional technologies to provide the final disposal route for the residual waste remaining following the implementation of the systems and facilities as set out in (previous) (paragraphs above) and to recommend a preferred solution for a replacement of the Bellozanne incinerator to the States with an accompanying cost/benefit analysis, environment and health impact assessment no later than December 2008."*

40. The Proposition also charged the Policy and Resources Committee:

> *". . . to propose the inclusion of a funding strategy for the capital projects identified in (v) above (i.e. including the replacement facility) within the States' Business Plan 2006 to 2010, if necessary, reprioritising or deleting existing projects and identifying additional sources of funds".*

41. On 28 June 2006, the States approved proposition P45/2006 that it be:

> *". . . agreed that any such technologies for the final disposal route for the residual waste to replace the existing Bellozanne plant should be located at La Collette II reclamation site, immediately to the south of the Jersey Electricity Company Power Station."*

42. The Minister for Planning and Environment (P&E) gave Permission in Principle for the proposed replacement facility on 27 October 2007. It was anticipated that a detailed planning application, incorporating the preferred bidders' designs would be submitted to the P&E Minister on 24 May 2008 to meet all of the conditions and reserve matters set out in planning in principle.

Procurement process

43. The Public Services Committee initially placed a notice in the Official Journal of the European Commission to advertise the project on 19 August 2003. The notice was deliberately non-specific regarding the technology required but stipulated that the solutions presented had to be able to deal with the whole of the Island's residual waste stream and any technology employed within the solution had to have been commercially operated on similar waste for at least two years. At the start of the procurement a cost estimate was developed by Babtie Fichtner (Fichtner), the procurement's technical advisers, which was updated throughout the procurement.

44. Initially nine companies formally expressed interest in the procurement. Over the next four years (during which time the solid waste strategy and location for the facility were approved), due diligence on all of these companies, and in total over fifty companies, was carried out. Concerns over the technology or financial validity of other technologies presented resulted in a short list of four acceptable companies and three reserves being approved on 8 December 2006 by the Waste Strategy Steering Group established to advise the Minister on the implementation of the strategy.

45. An outline planning application for an EFW facility was submitted on 9 January 2007 but the need to review the land use planning implications of vapour cloud explosions (following the Buncefield fuel facility explosion in December 2005) and to re-design the appearance of the proposed facility at the request of the P&E Minister, meant that planning Permission in Principle was not achieved until 27 October 2007.

46. A design and build procurement strategy had been advised by PricewaterhouseCoopers and the Institute of Chemical Engineers Red Book contract form was confirmed on 8 February 2007 by the legal adviser (Eversheds LLP) as being the most appropriate. A functional specification and contract terms based on the Red Book were prepared in the Summer of 2007 and confirmed by the technical adviser and legal adviser as being fit for purpose and a true and accurate representation of and consistent with the employer's performance requirements.

47. Tenders were issued on 1 November 2007 to the four short listed companies, including CNIM which eventually became the Preferred Bidder, with a deadline for the return of tenders by 29 February 2008.

48. In June 2007, CNIM confirmed they intended to bid as a joint venture together with Spie Batignolles/Camerons. Following discussions the proposed joint venture structure was confirmed as viable by the procurement legal adviser.

Tender receipt

49. Three bids were received and opened in accordance with the financial regulations on 29 February 2008.

50. The tender received from the CNIM joint venture was confirmed as being compliant and was progressed to detailed evaluation.

51. A second bid was non-compliant on grounds of the parent company being unable to guarantee a fixed price tender, following a revised civil sub-contractor fee schedule being received on the day before the tender deadlines. Subsequently, on request, a fixed price tender was provided in 6 March 2008. This tender has been progressed for detailed evaluation but under financial regulations could only be considered for appointment if the compliant bid had proved unviable.

52. The third bid was non-compliant as it provided only a budget price and no securities and was therefore not progressed for detailed evaluation.

53. CNIM was eventually selected as the Preferred Bidder.

States' approval

54. After selection of a Preferred Bidder, the States approved P72/2008 'Energy from Waste Facility: establishment and acceptance of tender' on 9 July 2008 which approved the preferred solution proposed by the Preferred Bidder. Subsequently the States also approved P73/2008 which permitted the withdrawal of an additional £102,810,000 from the Consolidated Fund to fund the provision of the preferred solution, in addition to £3.5 million which had been allocated for the project in 2008.

Subsequent negotiations

55. Subsequently negotiations proceeded with the Preferred Bidder to the point where it was recommended that the contract should be entered into. The P&E Minister gave approval in

respect of most reserved matters at the end of a Ministerial Hearing on 23 October 2008. A Transport and Technical Services Ministerial Decision which approved the signing of the contract was itself signed on 14 November 2008.

56. The contract as signed incorporated a number of variations from the proposal which was considered by the States in July 2008. In particular, additional costs were agreed in respect of:

(1) The requirements of the P&E Minister for higher quality materials and standards of finish which were communicated in the process of securing detailed planning permission. The revised design received approval but led to an increase in cost;;

(2) Clarification of the interface between the Jersey Electricity Company and the Engineering Procurement and Construction Contract following detailed design work also led to changes in cost;

(3) An increase from the £10 million tendered to the £20 million professional indemnity insurance originally requested in the tender;

(4) The cost of an advanced payment bond to ensure that the amount of payment outlay to the contractor does not exceed the value of the performance bond plus the value of where it is carried out; and

(5) The cost of fixing the euro element of the contract works to be carried out by CNIM and Spie Batignolles within the consortium arrangements.

57. As a partial off-set to these cost increases, some detailed changes to the specifications which reduced costs were agreed with the CNIM joint consortium.

58. A comparison between the cost estimate contained within P73/2008 and the Total Project Cost as at the date the contract was signed is set out in Section Eight of this report.

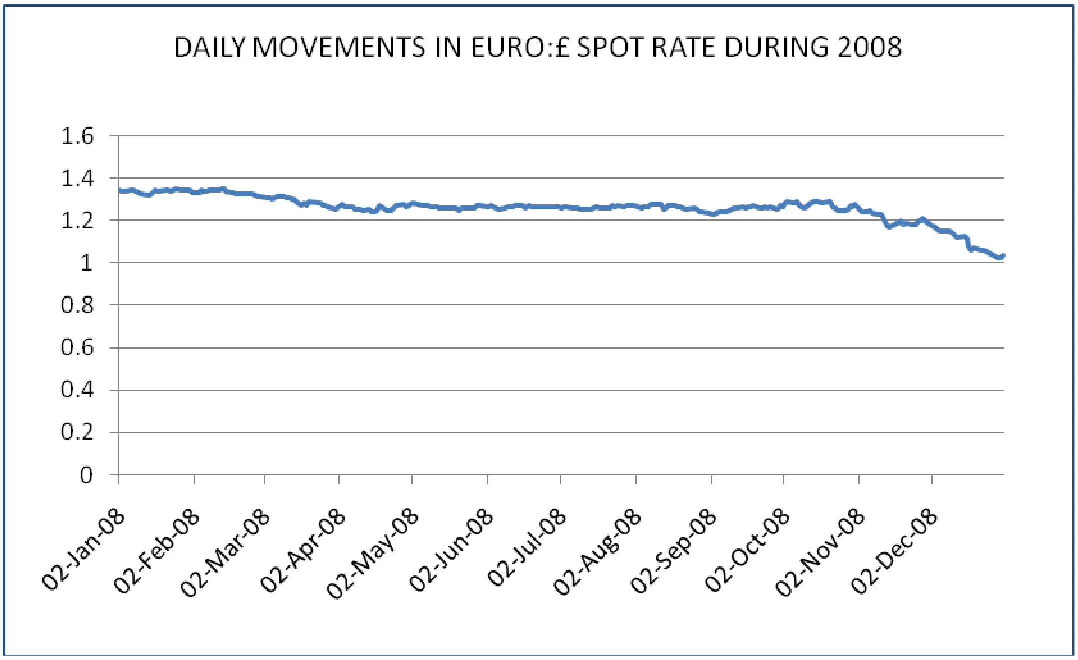
Euro exposure

59. A Funding Working Group was established in August 2007 to consider arrangements for financing the proposed EFW facility. When bids were received for the Engineering Procurement and Construction Contract on 29 February 2008, these all envisaged that some element of the contract charges would be paid in euros rather than in pounds as stipulated under

the tender. At the point of appointing the preferred bidder to the contract on 30 April 2008, the Euro/Pound exchange rate was € 1.2729.

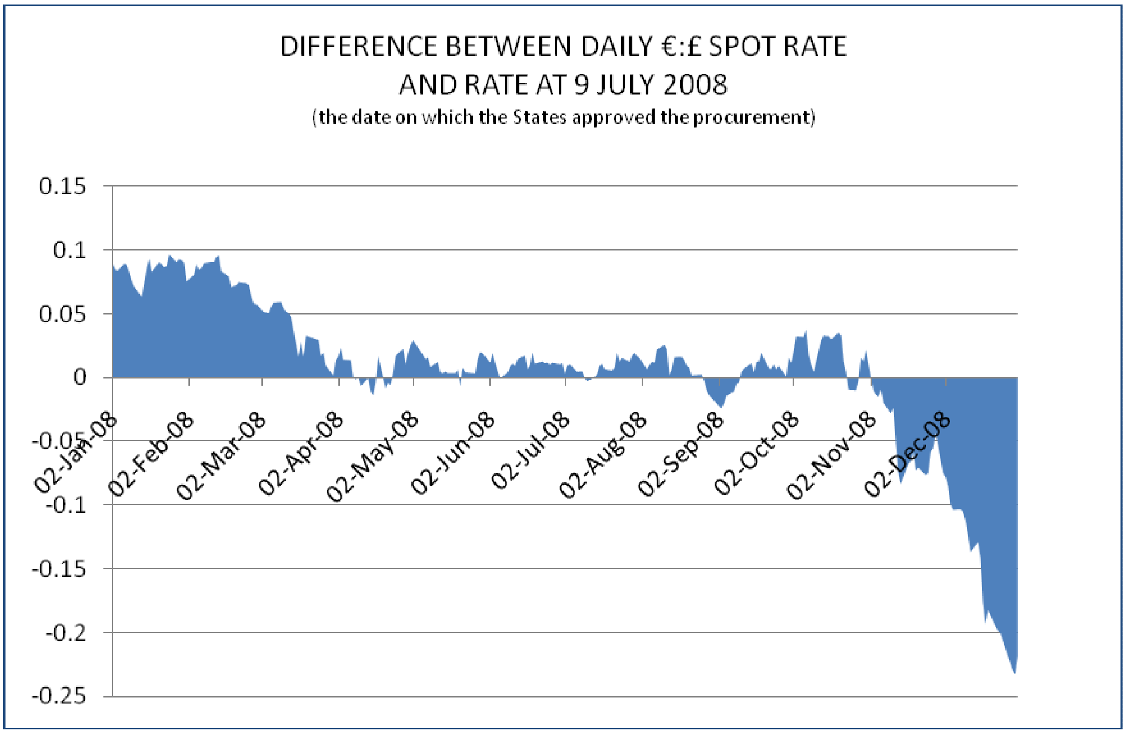
60. The Funding Working Group considered the option of fixing the Euro rate on 1 May 2008 and again on 1 September 2008 by which date the Euro/Pound exchange rate had fallen to €1.26. The Euro rate continued to fluctuate but remained above € 1.20 to the pound between the start of September and the start of November 2008. Thereafter, the rate deteriorated quickly.

61. Graph One reproduced below shows movements in the daily €:£ spot rate during 2008[1]:

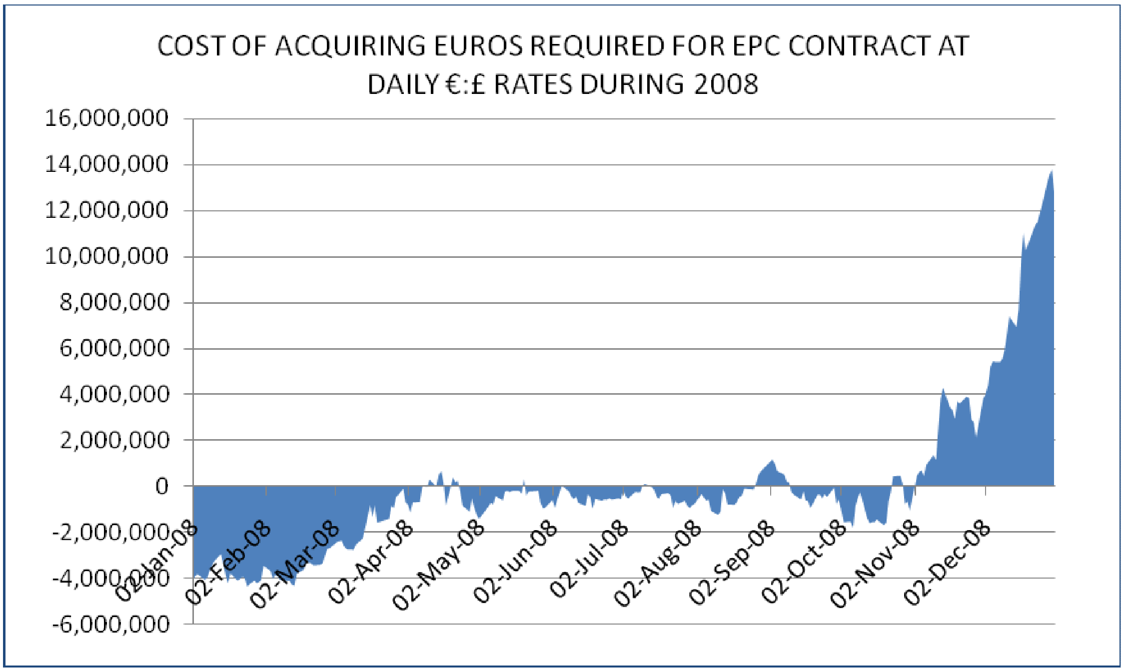


62. To demonstrate the significance of these changes for the States' euro liabilities under the EPC contract, Graph Two reproduced below compares the daily spot rates shown in the above graph with the rate ruling on 9 July 2008, the date on which the States approved the procurement.

[1] Rates taken from the Bank of England database.


DIFFERENCE BETWEEN DAILY €:£ SPOT RATE
AND RATE AT 9 JULY 2008
(the date on which the States approved the procurement)
0.15
0.1
0.05
0
-0.05
-0.1
-0.15
-0.2
-0.25
02-Jan-08
02-Feb-08
02-Mar-08
02-Apr-08
02-May-08
02-Jun-08
02-Jul-08
02-Aug-08
02-Sep-08
02-Oct-08
02-Nov-08
02-Dec-08

63. Graph Three shows the effect of these changing rates on the cost of acquiring the euros required by the EPC contract[2]:



64. In the following section, Section Four, I will set out a detailed chronology of the steps taken to monitor and then manage the euro exchange rate risk from the creation of the Funding Working Group but especially during October and November 2008.

[2] The graph shows the difference between the cost of acquiring the required euros (at the rate of exchange ruling on each day in turn) less the cost of acquisition at the rate of exchange ruling on 9 July 2008, the day on which the States approved the procurement.

SECTION FOUR ~ CHRONOLOGY

Introduction

65. The chronology set out in this section of the report refers to the principal events in the consideration of the euro exposure arising from the EPC contract and the way in which that exposure was eventually managed. It does not therefore set out all of the events in the consideration of the procurement and the eventual contract, or all less significant administrative steps.

66. Moreover, as the chronology has been largely based on the records which still exist (e.g. letters, working papers and e-mails) it does not capture all telephone calls, informal meetings or conversations unless they are mentioned in the documents.

67. For ease of reference, a list of all of the people mentioned in this chronology (and elsewhere in this report) is set out in Appendix Two to this report. A list of abbreviations is set out in Appendix Three.

68. The period covered by the chronology is divided into three:

(1) The period to the States' approval of the procurement and of the proposals for financing the procurement;

(2) The period from the States' approval to the signing of the contract; and

(3) The period from the signing of the contract until the beginning of January 2009.

Tuesday, 21 August 2007

69. The first meeting of the Funding Working Sub-Group[3] took place.

70. The meeting discussed the roles and responsibilities of the Group among other matters. and the minutes record that:

[3] The Funding Working Group was set up to deal with funding issue identified in 2005 when the States approved the project in principle, and reported to the Project Board which was responsible for managing the project and the procurement.

> *"GB [Strategic Investments Manager (SIMT&R)] and RF [Assistant Director, Finance and Investments (ADFIT&R)] asked whether, if the appropriate budget was secured and made available to the phasing required whether the T&TS wanted or needed to be involved in discussions and negotiations with funders. This was for two reasons. Firstly, if other sensitive projects were involved then Treasury needed a probity distance in the projects. Secondly, the independence of the EFW Project Board might be compromised if the scale of the EFW Project influenced the funding source unduly.*
>
> *JDR [Chief Officer,T&TS (COT&TS)] indicated that as Treasury would have to formally request the money this was sensible and would avoid considerable work for the Project Team. WG [Director, Waste Strategy Project (DWSPT&TS)] indicated this would be acceptable provided that the funding could be secured on a sufficiently flexible arrangement to avoid penalties and claims under the contract.*
>
> *[ADFIT&R] noted that the funding source risk then fell to Treasury and Resources and this would have to be considered against the amount of risk falling to the EPC contractor under the contract. [SIMT&R] and [ADFIT&R] would consider this further at the monthly Capital Projects Sub Committee meeting held in Treasury to consider amongst other things externally funded projects."*

71. The meeting also discussed the procurement and role of a financial adviser:

> *"[DWSPT&TS] outlined the financial adviser brief that had been prepared for the project. [SIMT&R] indicated that he would have to review in detail but queried whether the role was needed if the funding source could be delivered by Treasury. [ADFIT&R] suggested it would be sensible if the EFW project adviser role were limited to providing financial models evaluations and life cycle analysis with the funding source role being a sub-cliented[4] role for Treasury to call on as and when required for negotiations with funders.*
>
> *[COT&TS] indicated that this would be acceptable and asked [DWSPT&TS] to revise the brief to enable the financial advisor role to be procured as quickly as possible. [DWSPT&TS] indicated that the EFW project financial adviser role could then be reduced to developing a financial model based on the existing technical model commenting on the financial capability and suitability of the bidders and assisting in evaluation of whole life costs."*

72. The Funding Group considered draft terms of reference for the financial advisers to be appointed. Among other matters, the financial advisers were:

> *"(i) To provide ongoing financial and commercial advice on the procurement approach and ensure compliance with appropriate legislation and regulations liaising with legal and technical advisors when necessary.*

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4 I understand that this meant that in the event that T&R decided to seek advice from the Group's financial adviser, T&R would do so as a sub-client of that adviser.

(ii) *To investigate and advise the States of Jersey's Transport and Technical Services and Treasury and Resources Departments on the most appropriate (best value for money) funding source for the Energy from Waste Project, contributing to the Project Board Working Group on funding as required.*

(xiv) *To monitor the commercial position and sensitivity analyses consequent on shifts in risk apportionments as the programme developed throughout the procurement process.*

(xv) *To regularly review and update the States of Jersey's financial position as the programme progresses to closure and review and advise on the value for money of the programme as it develops.*

(xxv) *To ensure that proper financial advice is provided to States of Jersey to enable it to take a robust decision on the proposed scheme".*

73. After a competitive process, Deloitte were appointed to act as financial advisers to the Funding Group.

74. It is clear from these minutes and the minutes of other early meetings of the Group that the initial assumption was that the procurement would be financed by borrowing, possibly by means of a bond issued by the States, and that companies tendering for the contract to build the new plant would be expected to denominate their bids in sterling so that the States would not be exposed to any currency exchange risk.

Thursday, 1 November 2007

75. On appointment, Deloitte quickly became involved in assessing the Invitation To Tender for the main procurement contract. It was clear from an early stage of Deloitte's involvement that foreign currency risk would be a significant matter in the evaluation of the various bids which might be received in response to the procurement invitation to tender. This was subsequently covered in Deloitte's Evaluation Report dated 9 July 2008.

Monday, 26 November 2007

76. The second meeting of the Funding Working Group took place. Amongst other matters, the Group discussed and confirmed the proposed role of the financial adviser and discussed the intended arrangements for the borrowing that was being considered at the time as a possible source of funds for the project. The minutes record that:

> *"[SIMT&R] indicated that the Minister for Treasury and Resources was now minded to fund the project from reserves rather than sovereign bond or other external funding. This would necessitate a requirement for an internal charge for the capital sum and a separate charge for an interest payment".*

Tuesday, 18 December 2007

77. DWSPT&TS circulated a note on the milestones in the timetable for achieving approval for the proposed procurement. The key milestones were intended to be as follows:

(1) 29 February 2008 – bids to be received;

(2) A six week period for evaluation of bids leading to appointment of a preferred bidder by 17 April 2008;

(3) It was envisaged that a meeting of the Funding Working Group would be required at about that time to discuss particular issues arising from the selection of the preferred bidder on the funding route;

(4) It was hoped that a report and proposition on the procurement could be considered by the States meetings in the week commencing 1 July 2007 which would mean that the report and proposition would have to be submitted six weeks beforehand i.e. by 25 May 2008. The T&R Funding Paper would have to follow the same timetable;

(5) The detailed planning application would have to be approved by 21 August 2008 so that contract completion could be achieved by 28 August 2008;

(6) The EPC construction period would then commence on 29 August; and

(7) Before construction could commence funding would have to be agreed and in place.

78. A copy of a T&R paper on options for funding the contract was attached to the e-mail from DWSPT&TS[5]. It considered five principal options:

(1) Funding from reserves;

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[5] Presumably prepared by SIMT&R.

(2) Funding from a sovereign bond;

(3) Funding guaranteed on the energy from waste asset;

(4) Hybrid option 1: re-finance during construction; and

(5) Hybrid option 2: re-finance after the plant had been commissioned.

Thursday, 24 January 2008

79. As I have indicated, it was expected that tenders would be denominated in sterling, On this day, CNIM, one of the bidders, sent the following e-mail:

> *"You have stipulated that the tender prices should be given in pounds with a fix mechanism for the foreign currency.*
>
> *As you may understand, most of your prices will be originated from the euro area. It would be very costly for us to obtain a guaranteed conversion rate at the date of tender submittal.*
>
> *We propose to submit a price splitted in Pounds and Euros and to fix the conversion rate if we are declared preferred bidder."*[6]

80. Having received this e-mail on 24 January 2008, BabtieFichtner sent the e-mail to DWSPT&TS and others saying:

> *"Please find below an email from CNIM on the submission of the euro priced elements of the bid.*
>
> *This will affect all the bidders to varying degrees and we will need to be mindful of what is stated in tenders. It is likely that the successful bidder will fix the exchange rate at the effective date of the contract rather than at appointment as preferred bidder which is likely to be in September, 5 – 6 months ahead of appointment".*

81. ADFIT&R responded to DWSPT&TS by saying:

> *"I think the important thing is to ensure that: a) all bids are compared on a like for like basis – I suggest that the submitted cost in sterling is used for comparative purposes and b) cost certainty in respect of currency movements is established at the contract date.*
>
> *In practice as we are dealing with bids in € versus £ and not multiple currency bids versus £ the impact of a move in the £/€ conversion rate will have a similar effect on bidders so should be neutral in terms of assessing respective bids.*

6 The e-mail was sent by the Commercial Director of CNIM.

> *A significant move on the £/€ exchange rate between tender and contract would impact on the budget position and is flagged up as a risk."*

Friday, 8 February 2008

82. DWSPT&TS circulated a note to members of the Funding Group and others suggesting that it would be appropriate to brief the full Project Board and others about the state of this contract in view of certain material developments. One of these developments was:

> *"Recent (8%) detrimental movements in the currency markets with the increasing strength of the euro which may add 5% to the contract price."*

Wednesday, 13 February 2008

83. BabtieFichtner sent an e-mail to DWSPT&TS concerning the latest estimate of project costs. His e-mail referred to the inclusion of currency as one of the outstanding risks and set the financial provision for this risk at 5% of the contract price commenting:

> *"Clearly this is just a guess and I don't pretend to be able to predict €/£ rates but it highlights this is a sizeable risk."*

Monday, 17 March 2008

84. In an exchange of e-mails between SIMT&R and DWSPT&TS, responsibilities for the development of proposed material for the reports and propositions to be laid before the States were clarified. In particular, it was noted that SIMT&R had agreed with Deloitte that they would provide information on options on hedging currency. This was confirmed in an e-mail from Deloitte to DWSPT&TS and others on 17 March 2008 which confirmed that "options around currency hedging" represented one of the principal areas to be dealt with by Deloitte in the context of the work required to complete the report.

Thursday, 20 March 2008

85. Deloitte sent an e-mail to SIMT&R setting out in an attachment the indicative quotes that had been received from certain banks in respect of financing and hedging options.

86. Deloitte also sent to SIMT&R an outline of the funding options memorandum which Deloitte were to produce in preparation for submission to the Council of Ministers. One of the sections of this memorandum was to include currency risk:

> *"[Exposure to currency risk due to a delay in the programme – exposure to currency risk and options to hedge against the risk, include summary of options and prices received from some banks – Deloitte to include]"*

87. It was subsequently agreed that SIMT&R would produce the report incorporating input provided by Deloitte. This input was provided by e-mail.

Tuesday, 25 March 2008

88. Deloitte sent an e-mail to SIMT&R enclosing draft material on currency exposures and the way in which they could be managed.

> *"Should the States of Jersey wish to hedge this risk there are two main options for hedging that could be pursued. Firstly, an amount equal to the expected euro element at today's rates could be transferred within reserves from a sterling account to a euro account. Secondly, an option could be purchased now to obtain euros equal to the expected euro element at a future date.*
>
> *Transferring money within reserves from a sterling account to a euro account would provide an effective hedge as long as the actual euro amount requirement did not exceed the amount transferred. However, the following issues would need to be considered:*
>
> > *There is a significant difference between the bids in terms of the euro amounts known so it would be difficult to identify the correct amount to transfer in advance of appointing a preferred bidder.*
> >
> > *This sort of hedging removes/mitigates upside and downside risks so any potential upside should sterling strengthen against the euro would also be removed.*
> >
> > *Any mismatch between the amount transferred and the eventual euro requirement would result in a mismatched amount being transferred between currencies at a future date and profits/losses resulting.*
> >
> > *Once transferred the money would accumulate interest at a rate in line with other euro deposits and it is likely that this interest rate would be lower than could have been achieved had the money remained as sterling.*
>
> *After approaching several banks, one bank . . . provided an indicative price for a currency hedge of 15 basis points (BPS). This would equate to a fee of £117K for CNIM's bid and £59K for Earthtech. This is an indicative estimate and the actual amount would depend on the actual timing of the cash flows and prevailing market conditions. Issues with the currency option include:*

The fee for the option would be payable upfront regardless of whether the project went ahead or was delayed. If sterling strengthened against the euro the option would be effectively worthless as the States of Jersey would allow it to lapse and obtain euros at the more advantageous rate at the time.

Any delay to the project timetable could take the draw-down of monies outside the option period, whereupon the option would lapse. At this point the States of Jersey would have to choose whether to exercise the option and obtain euros at the agreed rate or allow the option to lapse. Any attempt to make the option period longer at the outset is likely to result in significant increase in price.

As this is an option, the upside potential remains as the States could allow the option to lapse if interest rates have moved in their favour between taking the option out and the requirement for euro currencies.

There is a significant difference between the bids in terms of the euro amounts known and it would be difficult to identify the correct amount of hedge in advance of appointing a preferred bidder."

89. Subsequently, a draft of a report to the Council of Ministers was prepared incorporating Deloitte's material on currency exposures.

Thursday, 3 April 2008

90. The report was submitted to the Council of Ministers.

Friday, 4 April 2008

91. Deloitte sent an e-mail to DWSPT&TS seeking advice on the exchange rates to be used in evaluation exchange rate risk in the evaluation model.

"The exchange rate we are currently using in the financial model is that used by Fichtner in their payment schedules (1.30221 at 14 March 2008). We need to decide the following:

(1) The rate to use for the base case scenario.

(2) The rate to use as the sensitivity for sensitivity analysis.

For the base case rate it is difficult to argue that it should be anything other than the rate at the time the analysis is being done unless there is a particular reason for thinking that rate is anomalous (e.g. severe recent currency movements).

The sensitivity rate is more difficult as none of us are in a position to predict future currency movements . . . we have prepared the following analysis of how rates have gone over the last year and how they would look if exactly the same overall trend were followed.

This analysis showed that the € to £ monthly average rate in December 2008 might be 1.19776 and that the € to £ exchange rate at the end of December 2008 might be 1.14566."

Monday, 7 April 2008

92. Babtie Fichtner circulated advice on the rates to be used in the analysis:

"My view is that for evaluation purposes we fix the rate on the evaluation date (likely to be 29 April). Sensitivity should reflect the scale of the last six months exchange that is, if it were done today (€1.28/£) I would model 1.08 to 1.48. Everyone should be aware that this is not a prediction but an indicator of what happens if things change outside our control".

Thursday, 10 April 2008

93. ADFIT&R responded:

"For base case scenario modelling purposes I would suggest that you take the rate of 14 March 2008 as Louise suggests.

For sensitivity modelling – this depends on how we are going to manage arbitrage risk.

If we retain all funds allocated in £ then we will need a range. The current 1.25 €/£ is probably at the lower end of any forecast range but it's anyone's guess as to where it will go over the course of the contract. Your 1.08 – 1.48 range is probably to wide to be of any use – I would suggest 1.15 – 1.40".

94. This suggestion was subsequently used in the evaluation model.

Tuesday, 6 May 2008

95. The third meeting of the Funding Working Group took place. The minutes record that:

"[DWSPT&TS] explained the evaluation process and indicated a clear winner in each of the categories (financial, technical and legal/commercial), and therefore CNIM Consortium were recommended to be the preferred bidder.

[Deloitte] explained that review of euro price sensitivity suggested that the CNIM Consortium bid would still be likely to offer the best value. The Group discussed whether the euro could weaken this year. Sensitivities conducted on general and power inflation had also been conducted also the 2.5% figure used was considered too low and would be revisited."

Friday, 16 May 2008

96. At this time, SIMT&R and others were completing a draft of the Proposition on the financing of the procurement to be put to Ministers for subsequent lodgement au Greffe[7]. In response to a request for information, at 1259 hours, Babtie Fichtner set out his understanding of the basis on which contract negotiations were proceeding:

> *". . . the basis of the contract is sterling and unless your Treasury advise they want the contract signed in euros and sterling the intention has always been to sign a fixed price sterling contract. CNIM have helpfully split their bid into euros and sterling at this stage as they have always said they will not take exchange risk prior to contract award. The fixed sterling price of £93.35M is therefore only valid at a €/£ rate of 1.27285.*
>
> *How the foreign exchange risk is covered will be up to Treasury to decide . . . Whilst CNIM can hedge if you insist, as this should be a case of just getting the best hedge rate commercially available at the time, it is probably better for you to arrange the hedging so it is open. Prior to contract award we would have a finally agreed contract price (in £ and €) and a milestone breakdown which will enable you to purchase the euros in advance at the time you need them. This is normal practice for this type of contract."*

97. At 1518 hours, SIMT&R telephoned Hewitt, the States' strategic investment advisers, to pass on the details of a currency option for which a quotation was required[8]. The details of the option whose purchase SIMT&R was considering was that it was proposed to purchase €75.8 million on or before 31 October 2008 at a rate of 1.2729.

98. At 1910 hours, Hewitt responded to SIMT&R in an e-mail which read:

> *"Further to our telephone conversation earlier, we have received an indicative quote of c. £1.97 million (equivalent to approximately 3.2%).*
>
> *This would involve purchasing an American style call option on the euro (contract size €75.8 million) with a strike price of 0.7856 (1/1.2729). The American style option effectively enables the option holder to exercise their right to execute at the strike price at any time between now and 31 October 2008, (this will cover the period 1 July*

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[7] The Proposition was eventually lodged on 20 May 2008 as P73/2008 together with P72/2008 (lodged by the Transport and Technical Services Minister) which sought approval for the procurement itself.

[8] The quotation was required for inclusion in the draft Proposition.

> *to 31 October 2008). To cover the period between 1 July 2008 and 31 October 2008 exactly would require a tailored contract".*[9]

Saturday, 17 May 2008 1613 hours

99. SIMT&R responded to Hewitt in an e-mail which read:

> *"Fantastic! Not the price! But thanks for getting me the quote in time! We weren't going to go for it at a cost of £1 million so think I can safely say it's out of the question now!"*

100. I infer that the reference to "we weren't going to go for it at a cost of £1 million" implies that consideration had been given to purchasing an option provided that the cost was within £1 million. None of the officers within T&R can recall such a consideration or conversation.

Sunday, 18 May 2008

101. SIMT&R sent to T&R Minister a briefing paper asking the Minister to consider the draft proposition of the Minister for Transport and Technical Services to procure an Energy from Waste Plant and to agree a preferred funding solution for the plant and to lodge a report and proposition (which was attached in draft form).

102. The briefing paper summarised the overall costs of the project in the following way:

	Capital cost (£ million)
Enabling works	3.63
Engineering Procurement and Construction (EPC) Contract	93.35
Jersey Electricity Company (JEC) Connections	0.40
Decommissioning of the Bellozanne incinerator	2.08
Project Management (including incurred feasibility costs)	6.85
TOTAL COST	106.31

[9] The contrast between the quotation obtained by Hewitt (£1.970 million) and that obtained by Deloitte (£0.117 million, see the e-mail quoted under 25 March 2008 above) appears to be attributable to differences between the types of option for which quotations were obtained. Hewitt obtained a quotation for an American style option which could be exercised at any point before the end of the option period. Deloitte obtained a quotation for an English style option which could only be exercised at the end of the option period. The difference between these two types of option does not appear to have been appreciated by T&R. In practice, an English style option would have served the purpose of hedging the euro exposure until the expected contract signing date (31 October 2008).

103. It also referred to the risk of currency exchange rate fluctuations in the following way:

"The Engineering Procurement and Construction (EPC) contract is subject to currency risk with exposure to the rate of exchange between the euro and sterling. The exposure relates to contract costs of €75.8 million or £59.5 million of the £93.35 million contract sum quoted above.

The exchange risk will be eliminated upon the signing of the contract at which time the Euro/Sterling rate will be deemed to freeze for the purposes of the contract payments. All contract payments will be made in sterling. The sensitivity analysis below indicates the extent of exposure to currency fluctuation."

Exchange rate €/£	*EPC Contract Cost*	*Variance (from rate at bid)*
1.27 (rate at bid receipt)	£93.35 million	n.a.
1.40	£87.9 million	-£5.5 million
1.15	£99.7 million	+£6.3 million

The Treasury has obtained an indicative quote for the purpose of the currency option that would eliminate the exposure to euro fluctuations between 16 May 2008 and 31 October (the date by which the contract must be signed). The option would cost £1.97 million. It should be noted however that this cost is based on buying the option now (before a States decision to proceed with the scheme). As the exchange rate will fluctuate over the six week period to 1 July 2008 the cost of the option will also vary.

To cover the period between 1 July 2008 and 31 October 2008 exactly as at 16 May 2008 would require a tailored contract. The cost of this has not been determined as it is not readily available in the markets. The tailored contract would in any event be of little use as the department would not purchase it prior to the approval of the scheme by the States. The cost would of course vary between now and that point in time.

A "worst case scenario" has been sought from the Treasurer's investment adviser Hewitt. Hewitt has indicated that is very unlikely the euro exchange rate would move below €1.10 to the £ in the period to 31 October 2008. This equates to an additional sterling cost of £6 to 7 million on the EPC contract.

In view of the risk detailed above, all of the £3.6 million unallocated balance in the fluctuations element of the States Capital Reserve Vote has been earmarked for this project. It is proposed that the currency risk be monitored up to the States approval of the scheme at which point a paper will be brought back to the Minister recommending how the risk should be managed between the approval date and the signing of the EPC contract. The earmarked £3.6 million is considered a reasonable sum from which to address the risk at that time. The cost of the risk being c.£1.97 million now (the price of the option) and a worse case scenario being £6 to 7 million with no option in place for the entire period to 31 October 2008 (based on the Hewitt exchange rate advice)."

104. As far as I can discover, the papers held by T& R including copies of emails, do not record any such advice provided formally by Hewitt. I have therefore sought from Hewitt confirmation of the advice allegedly provided by Hewitt in respect of a "worst case scenario".

105. I have received the following response from Hewitt:

> *"With regard to the point on the worst case scenario . . . this issue came up when I was talking to [SIMT&R] generally about whether he wanted to run exchange rate risk or take out some form of protection. I said to him that one of the things he needs to consider is possible worst case scenarios, then ask himself the question on whether the States could afford those positions. Hence, I would have used merely as an example a rate a long way away from the current rate and said to him why don't you work out the sterling costs of the contract using a rate like that and decide whether you could afford that particular amount of sterling outgo. I would also have encouraged him to use various rates to give him an idea of the sensitivity of the sterling capital cost to different scenarios on the exchange rate over time. At no time did I forecast an exact exchange rate by a particular period of time and I have made it very clear to the States that Hewitt does not forecast short term currency rates. What I have tried to do is explain some of the issues in working out whether protection or exchange rate risk is taken . . . I would not have included words such as included in the briefing paper to the T&R Minister . . . in any advice from me".*

Tuesday, 20 May 2008

106. Proposition P73/2008 entitled "Energy from Waste Facility: Funding" was lodged au Greffe on 20 May 2008 by the Minister for Treasury and Resources and accompanied Proposition P72/2000 which was lodged by the Minister for Transport and Technical Services and dealt with the procurement itself. As far as exchange rate fluctuations are concerned, P73/2008 observed:

> *"The engineering and procurement construction (EPC) contract is partially subject to currency risk with certain agreed payments being quoted in euros. The States therefore has a currency exposure to the rate of exchange between the euro and sterling.*
>
> *This exchange risk will be eliminated upon the signing of the contract with the preferred bidder at which time the Euro/Sterling rate will be deemed to freeze for the purposes of the contract payments. All contract payments will be in sterling.*
>
> *The Treasury has conducted a sensitivity analysis of the currency exposure and obtained expert advice on anticipated currency fluctuations. As with all States capital projects the Treasury will monitor and manage the fluctuations risk. The cost of any currency fluctuations will be met from the Capital Projects Reserve vote in the event this increases the cost of the project".*

107. As I have observed above, I have attempted unsuccessfully to identify the "expert advice on anticipated currency fluctuations" to which the proposition refers.

Wednesday, 9 July 2008

108. The States approve Propositions P72 and P73/2008.

109. Deloitte's signed Evaluation Report was received.

Friday, 11 July 2008

110. SIMT&R submitted his resignation from the States' employment and requested that the T&R Department should agree to shorten his period of notice. TT&R did not agree to this request.

Tuesday, 12 August 2008

111. DWSPT&TS circulated an e-mail to SIMT&R, ADFIT&R, COT&TS, and Deloitte, proposing that the Funding Working Group should meet in the first week of September which would act as a handover meeting for SIMT&R.

112. The e-mail included the following observations:

> *"As discussed, a Hopkins Redesign has partially delayed our detailed planning submission and will have a significant impact on risk reserve estimated at £1.8 to £2.5 million at current figures.*
>
> *We still hope to obtain financial close before indexing hits at the end of October – this now looks difficult however. We therefore have indexing details from CNIM attached and a Fichtner analysis of these.*
>
> *You indicated that the exchange rate had moved in our favour this week for the first time since approval of funding and the need for expediency which we are striving for".*

Thursday, 28 August 2008

113. The Connétable of St Helier lodged au Greffe a Proposition which invited the States to request the P&E Minister not to give final planning permission for the new EFW plant until a public inquiry had been held into the project.[10]

Monday, 1 September 2008

114. A meeting of the Funding Working Group took place attended by COT&TS, ADFIT&R, SIMT&R, DWSPT&TS and (by telephone) Deloitte.

115. As far as exchange rate fluctuations are concerned, the minutes of this meeting read as follows:

> *"[SIMT&R] noted that the euro element of the tender was approximately €78 million based on a rate of 1.2729 to the £. The rate was now €1.26 and could fall further. [ADFIT&R]indicated that the £ had fallen to €1.21 at one point and risen beyond €1.27.*
>
> *Sterling had weakened considerably this year. The cost of making payments in euros could be of the order of £2 million. [SIMT&R] indicated that once the contract had been fixed the States could choose to hedge the payments in euros. [SIMT&R] confirmed Treasury would need to understand which contract payments when required to do so and what flexibility in these payments was likely to occur. It would be possible to transfer the full euro element into a euro account on the day of contract – either by the contractor or via the Treasury's currency advisors. [SIMT&R] would want a price for either to compare value as there might be a premium applied by the contractor. [SIMT&R] indicated Treasury would ideally want to close out the risk at the point of signature of contract. It may be possible to cut the cost of the euro pot over time through making investments in euros rather than sterling. However, this would reduce the flexibility of the investment manager. [Deloitte] indicated he had conducted euro sensitivity on the EPC contract awards and that the possible threshold had been €1.25. [SIMT&R] indicated that he had done work which indicated that the euro rate of €1.18 cost £7 million".*

116. It was agreed that DWSPT&TS would obtain a price for fixing the euro via the EPC contractor and that SIMT&R would confirm what capability the States had for making euro investments.

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[10] P136/2008. The Minister for Transport and Technical Services presented comments on 16 September 2008, following which the Proposition was withdrawn.

117. As I will show, DWSPT&TS did obtain a price from the EPC contractor. I have not found evidence that SIMT&R confirmed the States' capability for making euro payments.

Thursday, 4 September 2008

118. The Deputy of St Clement lodged au Greffe a Proposition which asked the States to agree that a Committee of Inquiry should be established to investigate the procurement process for the replacement of the Bellozanne incinerator.[11]

Monday, 29 September 2008

119. CNIM confirmed that CNIM's proposals for the arrangements surrounding fixing of the exchange rate within the contract would be given during the next negotiating meeting on 1 October 2008.

Wednesday, 1 October 2008

120. A formal negotiating meeting took place between the States and CNIM/CSBC[12] at Eversheds offices in London. The minutes of the meeting record that as far as currency is concerned:

> *"CSBC outlined that the markets are moving every day. CSBC will confirm current position this week. The rate will be valid for one week. If the price is set at the signature date CSBC will hedge the rate.*
>
> *CSBC outlined 1.75% of the euro amount is the hedging rate.*
>
> *TTSD requested that the mechanism for hedging the outlined and indicative "on the day rate" and hedged rate would be provided for comparison.*
>
> *TTSD to confirm whether a fixed rate is required".*

Tuesday, 14 October 2008

121. CNIM/CSBC confirmed the costs that might be incurred if the choice is made to fix the exchange rate in the contract:

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11 P139/2008. The Minister for Transport and Technical Services presented comments on 14 October 2008, following which the Proposition was withdrawn.

12 CSBC was the Jersey company established by the CNIM consortium for the purposes of the contract.

> *"Concerning the £ to £ conversion, we confirm our statement given during our meeting of 1 October.*
>
> *There is two ways to convert the euro amount to £'s.*
>
> *The first one is to calculate the conversion rate the day before the contract signature with a hedging rate that is, as today, equal to 1.75% of the euro amount. Despite that the €/£ conversion changed since October 1 the hedging rate remains the same but could change until the end of the month.*
>
> *The second one is to convert the £ to£ earlier and in such case CSBC will have to buy options on the currency markets. These options have a price that is presently with the hedging rate of 3 to 4 %".*

Frida y, 17 October 2008

122. DWSPT&TS confirmed this information to the colleagues within T&TS team in the following way:

> *"If we wish to fix the euro rate at the point of contract CNIM have indicated that for the process elements of the EPC contract they were offered a rate of 1.75%. Spie Batignolles have indicated that for the civil element they were only able to get an RBS rate on Jersey of double this amount. Assuming the revised EBC cost indicated above this would indicate the cost of fixing the euro would be as indicated in the spread sheet. This is not included within the project costs as previously".*

Friday, 17 October 2008

123. DWSPT&TS circulated an e-mail to the following amongst others: DWMT&TS; ADFIT&R; COT&TS.

124. To the e-mail were attached draft spreadsheets for the design review anticipating the costs that would be notified to T&TS by CSBC. These spreadsheets showed that the net position, after all of the cost provisions expected, would be an additional cost of £3.256 million.

125. The e-mail continued:

> *"If we wish to fix the euro rate at point of contract CNIM have indicated that for the process elements of the EPC contract they were offered a rate of 1.75%. Spie Batignolles have indicated that for the civil element they were only able to get an RBS rate on Jersey of double this amount. Assuming the revised EPC cost indicated above this would indicate the cost of fixing the euro would be as indicated in the spreadsheets. This is not included within the project costs as previously.*

I would be grateful if everyone would provide their comments on the above".

Sunday, 19 October 2008

126. Subsequent responses by DWMT&TS, and ADFIT&R indicated that they both believed that it would be unwise to embark upon the project with insufficient contingency. In other words, they agreed that it would be unwise to sign the contract unless the budget that had been approved was sufficient not only to cover the expected cost the time of signing, but also to provide a contingency which appeared sufficient to allow for contingencies. These would include increased costs arising from changes in specification that became necessary in the course of construction. The concern was that in effect, the cost of fixing the rate of exchange reduced the planned contingency margin. Whilst it was possible not to accept the contractor's charge for fixing the exchange rate, that would leave the States to bear the risk of exchange rate movements and this would have to be covered by the contingency margin.

Monday, 20 October 2008

127. In an e-mail dated 20 October 2008 to DWMT&TS and others , ADFIT&R set out a number of options for dealing with this problem. These were:

(1) Increase the absolute budget;

(2) Phase the project using approved funds for phase 1 and bid for new funds for demolition (phase 2);

(3) Transfer funds from other projects; and

(4) Postpone a T&TS project until the extent of the contingency sum applied is known.

128. Finally, ADFIT&R commented:

"The currency markets are all over the place at the moment but as I write the euro is moving in the right direction to the tune of about £1 million favourable variance. Any scope here?"

Wednesday, 22 October 2008

129. At 0954 hours, ADFIT&R sent an e-mail to the Deputy Treasurer (DTT&R) which reads as follows:

> *"As you will be aware, [the former SIMT&R] sat on a funding sub group for the EfW project to provide advice and guidance from a Treasury/Investment perspective.*
>
> *An issue which would have been for[the former SIMT&R] to take forward is now becoming urgent.*
>
> *The majority of the contract sum for the main works is in € (c75m). The two external parties involved in provision of the contract have provided a total price of approximately £1.28m to 'fix' the exchange rate on the date of contract signing (aiming for 31/10/08) for the duration of the contract. The rate to fix the actual sum will vary up to the point of fixing – in the current market such variation may be considerable.*
>
> *This will provide us with a known sum in sterling for the staged payments throughout contract period and the project funding can be managed as a 'normal' capital project.*
>
> *An alternative to this approach is to (simplistically) open a euro account with our bankers, deposit the sterling equivalent at current exchange rates and draw down the funds in euro's for each staged payment. There will be a direct cost in arranging and managing the account and an indirect (opportunity) cost in any differential between the interest available to invested general funds and the interest that may be obtained from the euro account. This needs some research for which the project team do not have the skills or resources – who in Treasury could obtain the information?*
>
> *A third approach which I would not recommend – is to remain on a floating exchange rate basis throughout the contract duration and take the risk of arbitrage profits or losses through movements in the currency market.*
>
> *Can you please give this some thought and advise on Treasury's preferred way forward."*

Thursday, 23 October 2008

130. DTT&R passed the e-mail from ADFIT&R to the Head of Decision Support [HODST&R] (at 0928 hours) asking him to do an option appraisal ("mini business case") on the various ways of arranging for payment and to make recommendations. He set out his own thoughts in the following way:

> *"My own thoughts are:*
>
> *It seems we have three options.*
>
> *The criteria against which to assess them must be something like: certainty, risk, cost.*
>
> *This can then recommend a suitable approach for the project."*

131. HODST&R then (at 1035 hours) asked the Regulatory Adviser (RAT&R) whether this was a suitable matter on which Hewitt might advise and RAT&R called Hewitt to seek advice on obtaining euros to meet obligations under the contract.

132. HODST&R responded to DTT&R at 1457 hours in an e-mail to which a first draft of a note on the available options was attached[13]. This note mentioned three options (i.e. fixing the exchange rate within the contract which the contractor had indicated would cost £1.28 million, depositing the full sum in an euro account at the beginning and making payments as they fell due, and making payments at the exchange rates ruling at the date of payment). He commented that to pay £1.28 million to fix at the current rate could turn out to be an expensive option.[14]

133. DTT&R acknowledged receipt of this e-mail at 1523 hours, commenting:

> *"I'm also struggling with option 1 costing £1m to secure the same deal as placing cash in a euro account."*

134. Separately, the P&E Minister held a Ministerial Hearing at which he considered a report concerning reserved matters relating to the EFW plant. The Minister received representations made by the Connétable of St Helier and the Deputy of St Peter. Although the Minister reserved his decision on the colours and materials to be used, all other reserved matters were approved subject to the conditions detailed in the officers' report which had been submitted to him.

Friday, 24 October 2008

135. At 0927 hours, HODST&R sent an e-mail to Hewitt which reads as follows:

> *"I understand [RAT&R] spoke to you yesterday regarding a contract we have where payments are to be made in euros. We have the option to fix the exchange rate as at the date of signing (assume 31 October 2008) for £1.28 million. Other options we are considering are to deposit the full sum in a euro account or take a chance on the prevailing rates on the payment dates. No doubt there are others. I attach a payment schedule. I would be grateful if you could advise me what would appear to be our best approach".*

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13 In due course, this became the basis for HODST&R's recommendations on 6 November 2008.

14 £1.28 million was the estimate provided by CNIM of the cost of the contractor agreeing to fix the rate of exchange.

136. At 1541 hours, Hewitt responded to HODST&R (copying the e-mail to RAT&R). The e-mail reads as follows:

> *"There is no single obvious way forward here which is necessarily better than the other alternatives, and much depends on your requirements on certainty of price of sterling and how much you wish to be dependent on the future vagaries of the foreign exchange markets.*
>
> *Although sterling has been reasonably stable against the euro in recent weeks, it has today moved 2.5 cents down against the euro and we have seen by the movements of sterling against the dollar how large variations can occur in short periods of time. For example, the pound will have declined from $2 = £1 to $1.56 = £1 in less than three months. This shows the potential of gains and losses from foreign exchange on this type of transaction.*
>
> *The most obvious way that most companies would deal with a payment series such as this would be to engage in a series of forward foreign exchange rate contracts for example, a contract for £15 million to deliver euros and receive pounds at a rate known today for January 2009. Money is not required to be put up front for these contracts. It may well be that the £1.28 million cost you mention is the difference between the spot and forward rates for all the cash flows for this series of transactions but I have been unable to contact you by telephone to ascertain this.*
>
> *Your second suggestion is to hold a euro cash balance for the whole sum required for the relevant period. Again this achieves sterling price certainty for the cost of the initial euro balance for the total sum, although some uncertainty over euro interest payments (unless these are also agreed with the bank) will still be present. Since the pricing of forward foreign exchange contracts mentioned in the previous paragraph has regard to the levels of interest which are paid on balances in sterling and euros, you should not find a dramatic difference between the financial cost of this method and the method in the previous paragraphs.*
>
> *It is possible to make no advance provision for the euro payments and to fund them as they come through. This may cause some concerns for budgeting in that you do not have control over the sterling cost of this project but it does give an opportunity for perhaps gaining, or losing, from a change in the fortunes of sterling. Since 35% of the total cost is payable within six months, there is more of a short term chance effect on exchange rate movement and little time for any long term macro effects to come through.*
>
> *In summary therefore, most UK Treasurers would. I think, buy a series of forward exchange contracts to fix the sterling cost at this time and to remove exchange rate uncertainty".*

Monday, 27 October 2008

137. At 0755 hours, HODST&R forwarded Hewitt e-mail to ADFIT&R with the following comment:

> *"For info. Will discuss with [DTT&R] but not sure that we are geared up to arrange a series of forward contracts."*

138. At 0926 hours, HODST&R forwarded Hewitt's e-mail to the Investments Manager IMT&R, who was the principal day-to-day contact with HSBC, the States' bank, with the following request:

> *"Please see advice below. I have no idea how difficult it is to set up forward contracts or who would do it. If it's complicated it may be better to deposit the whole €75 million but get an interest bearing account. Should we discuss this with the bank? I have also attached the provisional payment schedule."*

139. In the event, IMT&R was not in the office so that no contact was made with the bank until the next day.

140. At 1109 hours, HODST&R sent an e-mail to DTT&R and ADFIT&R to which was attached a paper[15] dealing with various options for funding the contract and commenting:

> *"Managing exchange risk is paramount."*

141. The e-mail invited comments.

142. At 1242 hours, ADFIT&R responded to HODST&R (sending copies to DTT&R and DWSPT&TS) in an e-mail which reads:

> *"Thanks for the speedy turn round – very helpful in assembling thoughts.*
>
> *I see the actions as:*
>
> *Option 1 – obtain current costs of fixing – have they moved much due to volatility in the currency market - (T&TS) via consultants.*
>
> *Option 2 – ascertain interest available (if any) for a euro account with this profile - (Treasury HODST&R via shared services)*
>
> *Option 3 – discount NFA*
>
> *Option 4 – Hewitt's to advise on complexity (Treasury HODST&R)*
>
> *My current view is that Option 4 looks messy and complex and perhaps not possible in the time available but we need Hewitt's advice.*

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[15] This was an early draft of the paper which was eventually to be considered by the Treasurer and Deputy Treasurer on 6 November 2008. At this stage, the draft did not include the recommendations that were included in the final version of the paper.

That then leaves a straight choice between Options 1 and 2. As security is the same, the choice comes down to cost. We will need to do a discounted cash flow model to compare the two costs at today's values and then translate the difference into a rate required on the euro account to achieve parity. This can then be compared to the actual rate.

[HODST&R], is this something your team could do when we have the data?"

Tuesday, 28 October 2008

143. After an oral exchange with IMT&R (who had not been in her office on 27 October 2008), at 0838 hours, HODST&R asked her to:

> *". . . contact the bank asap to find out:*
> - *If we can get an interest bearing euro account*
> - *If so*
>   - *What rate would it pay*
>   - *And what charges would be*
> - *If they can arrange 16 forward contracts for euros should we choose to go down that route."*

144. At 1540 hours, HODST&R sent the following e-mail to HSBC:

> *"Please find payment schedule. We are assuming Jan 09 for 1st payment but this could move slightly. On the basis we want to sign the contract on Friday (although this may move by 2 weeks) it would be ideal to know by then whether we are better going for the option of a fixed payment to the contractor to freeze the rate at the date of signing."*

145. At the end of the afternoon, CNIM agreed to extend by fourteen days the period during which their bid was valid (i.e. the deadline for signing a contract was put off until 14 November).[16]

Wednesday, 29 October 2008

146. At 1117 hours DWSPT&TS sent an e-mail to ADFIT&R (sending copies to Deloitte and COT&TS). This e-mail read as follows:

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[16] Per e-mail from CNIM to Babtie Fichtner. HODST&R was told of this extension of the deadline by way of an e-mail from DWSPT&TS on 29 October 2008.

> *"We would agree that 3 would be a nightmare and 4 too complex."*

147. At 1452 hours,IMT&R who had been out of the office on the previous day when HODST&R sent an e-mail concerning the proposed contract payments, responded to that e-mail in the following way:

> *"I have just opened this one with the provisional payment schedule.*
>
> *If you need £15,000,000 in January I need to let RLAM [the States' cash managers] know this NOW. I am just going to give them a ring and I will also make enquiries what they can offer us on euros."*

148. At 1459 hours, HODST&R responded:

> *"Until we know what we are doing I can't really confirm the payment schedule. It may be we want v£75 million next week.*
>
> *HSBC have said interest on euros at the moment is virtually nil."*

149. IMT&R appears to have been responding to HODST&R as if she was being asked to make arrangements for payments to be made as they fell due. She appears not to have been told that the object of the exercise was to ensure that 'managing exchange risk is paramount'. [17]

Friday, 31 October 2008

150. Following her exchange of e-mails with HODST&R on 29 October 2008, IMT&R spoke to RLAM. He responded in an e-mail on 31 October 2008 to which was attached a brief note setting out his preliminary thoughts on how the States' requirement for euros might be met. Two options were presented:

(1) Book forward contracts through HSBC (the custodian for the liquid funds managed by RLAM for the States; and

(2) Raise €75 million in January 2009 and make the payments to EFW as they fall due.

151. It is evident from this note that RLAM were not aware of the exchange risk management concern to which HODST&R had referred in his first draft paper circulated on 27 October

[17] Per HODST&R's first draft paper which was circulated on 27 October 2008. This paper was not made available to IMT&R at this stage.

2008. This is not surprising since he had been instructed by IMT&R who was herself not aware of this concern.

152. Following receipt of RLAM's e-mail (at 1029 hours), IMT&R sent a copy to HODST&R at 1119 hours. He then spoke to RLAM as he confirmed in an e-mail which he sent to ADFIT&R and to DTT&R at 1146 hours:

> *"Have just spoken to . . .Royal London. They are doing a cost comparison for us between forward contracts and a euro account. We can then compare this to the amount offered by the contractor to fix the rate. RLAM have promised to get back by the end of Weds so we should have an answer on Thurs."*

Monday, 3 November 2008

153. DWSPT&TS sent an e-mail to ADFIT&R asking whether a decision had been made about the way in which the euro exchange rate risk was to be managed:

> *"Please can you confirm if we have determined which option is preferred.*
>
> *CSBC want to know if they should prepare a price for us or not by Wednesday."*

154. ADFIT&R replied at 1737 hours (also sending a copy to HODST&R):

> *"Waiting for feedback from Treasury – see attached.*[18]
>
> *[HODST&R] – any news?*
>
> *My gut feel is to open a euro account."*

155. DWSPT&TS responded (at 1746 hours):

> *"Thanks . . ..*
>
> *We need to bare*[19] *in mind the level of uncertainty associated with the CSBC solution too.*
>
> *They were saying they were only able to fix that afternoon!"*

---

[18] A copy of HODST&R's' draft paper was attached to the e-mail.
[19] Sic.

Tuesday, 4 November 2008

156. At 0729 hours, HODST&R circulated an e-mail to DWSPT&TS and ADFIT&R reporting that he would not get any figures from RLAM until late Wednesday. The e-mail ended:

> *"Apparently the base rate for euro accounts is 0.75% less than sterling which by my reckoning means that we lose about £600k in interest compared to keeping it in sterling which makes a euro account cheaper on the face of it than the CSBC solution. It may be that forward contracts are cheaper still as the exchange rate is improving and we could earn sterling interest. On the whole I think it looks like the CSBC solution would not be the cheapest option for us but I won't be able to say for certain until late Weds or early Thurs."*

157. At 1018 hours, DWSPT&TS responded:

> *"Excellent – thanks . . ..*
>
> *That is helpful and enables me to know how to run with this. We have a contract meeting in London on Friday. That would probably be the latest we could opt for a CSBC driven solution if your analysis indicated this was worthwhile."*

Wednesday, 5 November 2008

158. At 1433 hours, in an e-mail to IMT&R, RLAM submitted some further suggestions about how the euro exposure could be managed:

> *"It is very difficult to provide any definitive answer as to whether it is most cost effective to either raise €75million in January 09 or to use a series of forward foreign exchanges to purchase euros to co-incide with the dates that bills become due. This is because of the number of uncertainties involved in trying to calculate the costs of either option . . .*
>
> *A further consideration may be the administration associated with each option? If the forward foreign exchange route is followed then it is very likely that HSBC will want additional documentation relating to the security that they will require in order to enter into the forward contracts. As the longest dated contract will be open for approximately 18 months this may also present accounting issues? Certainly, it would be difficult for our systems to incorporate open foreign exchange liabilities into the current reporting package.*
>
> *If the foreign exchange is done in one go in January 09 then the ongoing administration would be easier. . .*
>
> *. . . I am sorry that I cannot offer a more definitive answer. However. . it is our opinion that option 3, purchasing all of the euros in January 09 is the preferred*

> *policy. It provides a known cost in sterling, ensures the euros are available when required and that the return on the euros is maximised in the intervening period."*

159. IMT&R sent a copy of RLAM's e-mail to HODST&R at 1446 hours and he in turn sent a copy to DTT&R at 1511 hours with the following covering message:

> *"See attached. Will talk to [Hewitt] tomorrow but unless he violently disagrees suggest we go with the euro account."*[20]

160. At 1625 hours, HSBC, sent an e-mail to HODST&R to submit 'some solutions' to manage the States' euro exposure. He indicated that he understood that the T&R preference was for a solution that offered certainty and did not involve complex structures.

161. His advice was that the outlook was one of volatility so that the option of doing nothing (i.e. paying euros at the rate ruling at the time of the payment) was 'relatively high risk'. He suggested two approaches that would better manage the risk and meet the States' needs:

(1) To fix the rate of exchange by buying forward. A rate of 0.8192 (i.e. €:£ 1.22) was quoted.

(2) To enter into currency options or participating forward contracts which would offer some benefit if sterling should strengthen against the euro. A rate of .8395 (i.e. €:£ 1.1911) was quoted.

Thursday, 6 November 2008

162. At 0845 hours a meeting took place at Cyril Le Marquand House attended by the T&R Minister, TT&R, ADFIT&R, T&TS Minister, COT&TS, the Finance Director, T&TS (FDT&TS) and DWSPT&TS.[21]

163. The meeting was called to discuss the funding position of the Energy from Waste Plant Project. COT&TS explained that, following the intervention of the P&E Minister, a number of

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20 This conversation appears not to have taken place.

21 These notes are based on draft minutes prepared by DWSPT&TS which have not yet been confirmed by attendees. The meeting had been requested by T&TS by e-mail on Wednesday, 29 October 2008. At the beginning of the following week, on 3 November 2008, TT&R asked for a briefing note on the matters to be discussed and this was provided by T&TS on 5 November 2008. Shortly after having received the briefing note, TT&R) sent an e-mail to ADFIT&R saying that ADFIT&R was presumably his adviser on the funding of the scheme, asking him to attend the meeting and asking him for some advice 'pronto'.

design changes had been made to the original specification which had increased costs of the project by approximately £4 million. The result of this, together with variations in the sterling equivalent cost of the euro payments envisaged by the contract, was to exhaust the contingency provision which had been included in the original contract estimate published in P73/2008.

164. COT&TS believed that it would be unrealistic to suppose that a further contingency margin would not be required. It was agreed that T&TS has taken reasonable steps to control the costs of the project.

165. The meeting briefly reviewed the steps that had been taken to manage the euro currency exchange risk and was told that the preferred option was to transfer the euro element required into an euro account and to make the payments when due. Given the changing situation this was still under review. T&R would review the position with advisers and would advise T&TS on the preferred option prior to contract signature.

> *"In answer to a question from [TT&R],[DWSPT&TS] confirmed that euro currency risk had been included in the project's risk register but that the scale of any large scale movement in currency had been considered manageable within the £2 million contingency identified for the preferred bidder period. The £4 million impact of architectural requirements was not anticipated and therefore contingencies were deficient without the additional support identified in the affordability sheets."*

166. Later that day, at a meeting at 1630 hours with the TT&R and DTT&R, HODST&R submitted a paper recommending the approach that should be used in dealing with euro payments under the contract.[22]

167. This paper identified five principal options:

(1) Fix the exchange rate as at the date of signing contracts for one off payment to the contractor (c. £1.28 million);

(2) Deposit the full sum in an euro account and make payments when due;

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[22] Although there are no e-mail exchanges on 6 November 2008 between HODST&R and the DTT&R, HODST&R thinks it is likely that he would have discussed his draft paper with the DTT&R before the meeting with the Treasurer which was scheduled by the Treasurer's PA at 1259 hours on 6 November 2008. HODST&R believes that he discussed his paper with the DTT&R at some point between 1200 hours and 1300 hours on that day, and, at the end of this time, requested the Treasurer's PA to arrange a meeting with the Treasurer to discuss the paper. The metadata attached to the options paper show that it was last amended at 1502 hours on that day.

(3) Make payments at the exchange rate prevailing at due dates;

(4) Purchase a series of forward contracts for the due dates at the date of signing contracts; or

(5) Purchase a series of participating forward contracts for the due dates at the date of signing contracts (50% will be at an agreed rate, 50% at "capped rate").

168. The full text of this paper is reproduced in Appendix Five to this report, however the conclusions were as follows:

> *"The most risky and potentially costliest option is to make payments at the exchange rates prevailing on the due dates. Whilst a favourable movement in exchange rates would benefit the States, the difference in the cost between 52 week high and low rates would have been £7.8 million. This is considered to be too great a risk so the option has been discarded.*
>
> *All of the other four options provide complete certainty for the States so cost is the deciding factor. The first option (paying c.£1.28 million) to fix the rate bracket would have essentially the same effect as depositing the full sum in a euro account although it would involve commission payments. RLAM have confirmed there will be no additional charges for operating the euro account. The interest earned on euros would however be slightly less than sterling (differential c.0.75% per RLAM) equating to c.440k.*
>
> *Advice was sought from the States' Investment Advisors (Hewitt). Their recommendation was to purchase a series of forward contracts. HSBC could operate these straightforwardly and this would appear to be the second cheapest option (by c. £245k). Participating forward contracts are another action. With these should the sterling rate against the euro improve dramatically, the States would benefit from these improved rates but be protected from adverse moves. This option appears to be only fourth cheapest.*
>
> *Advice was also sought from RLAM. For ease of operation they recommend operating euro account and depositing the full sum prior to first payment. With this option the States would retain flexibility e.g. could deposit other euros as received but not currently earning interest.*
>
> *In summary this would appear to be a straight choice between operating a euro account and purchasing forward contracts. The euro account appears to be £245k cheaper, more flexible and simplest.*
>
> *It is recommended that RLAM be requested to open an interest bearing euro account and that the full contract sum is deposited at a time of favourable exchange rate prior to the first payment date".*

169. There does not appear to be a formal record of the outcome of the meeting. The only note takes the form of e-mails sent by HODST&R to various people informing them of the decisions reached.

170. At 1703 hours, HODST&R sent an e-mail to DWSPT&TS and ADFIT&R to which the options paper was attached and confirming that the CSBC solution would not be taken up:

> *"I can confirm that we will NOT[23] be taking up the CSBC solution based on the attached analysis."*

Friday, 7 November 2008

171. At 1338 hours HODST&R sent an e-mail to IMT&R confirming that the TT&R had decided to 'go with' the euro account managed by RLAM and asking her to deal with the administrative steps that would be necessary to implement this decision. A copy of HODST&R's paper was attached to this e-mail which appears to have been the first occasion on which she was made fully aware of the issues under consideration. She in turn asked RLAM (by an e-mail at 1617 hours) to make arrangements for the opening of the account.

Tuesday, 11 November 2008

172. IMT&R met RLAM to review the steps necessary to open an euro account and subsequently (on 12 November 2008) sent an e-mail to RAT&R and HODST&R about decisions which would have to be taken.

173. As for timing of the arrangement, the e-mail observes:

> *"[RLAM] is of the opinion that it would be better to buy the full €75million just before the first payment is due in January – Happy with this makes the year end much cleaner.[24] Do you agree?*
>
> *RLAM will have to open a Euro Custody account with HSBC. They are going to get that in motion it should take 2 to 3 weeks.*
>
> *Please let me have your views."*

[23] Emphasis in the original e-mail.

[24] I understand that the reason for the comment that such an approach would be 'cleaner' was that if the first deposit were made in January 2009, there would be no balance in the account as at 31 December 2008 and thus there would be no need for accounting entries to deal with exchange rate fluctuations in the end of year balance sheet.

Wednesday, 12 November 2008

174. At 1444 hours, RAT&R replied to IMT&R's questions about timing in the following way:

> *"I think that we should take [RLAM's] advice on when to purchase the euros – he is the expert. It would be cleaner if after 1.1.09 but we would have to live with it if we needed to purchase before this.*
>
> *Hope the above is a quick and dirty suitable answer."*

175. At 1551 hours, HODST&R sent an e-mail to DWSPT&TS and ADFIT&R asking for detailed information about the contractors to enable the necessary payments to be made. The e-mail ended:

> *"Our cash manager's advice is to put the euros in the account in January just before the first payment is due. Trust this is acceptable."*

Thursday, 13 November 2008

176. COT&TS whose Minister was about to sign the contract, sent an e-mail (at 1010 hours) to TT&R about the effect of movements in the euro exchange rate upon the contract price. Copies of this e-mail were sent to the T&R Minister, DWSPT&TS, FDT&TS), ADFIT&R , the T&TS Minister and the Chief Executive. (CMD).

> *"As a result of the very significant change in the euro exchange rate over recent days, we have incurred a large increase in the contract price for the new EFW plant. We are due to sign the contract tomorrow which is the last day of the extension we negotiated to the fixed price tender, thereafter we are faced with the indexing rates that are built into the tender.*
>
> *As part of the project team's work, we have been working with the Treasury to establish the most appropriate method of paying for the euro element of the contract. The recommendation from the investment advisory team was to open a euro account and place the requisite amount in that account to meet the milestone payments throughout the contract.*
>
> *The movement of the euro vs. sterling over the past 48 hours has had a very significant impact on the contract value as shown below:. . ."*

Date:	*Euro exchange rate*	*Contract value*	*Contingency including Bellozanne de-commissioning*
10 November (morning)	1.2729	£95,85,639[25]	£7,520,804 (7.81%)
10 November (afternoon)	1.2329	£97,857,292	£5,515,151 (5.61%)
12 November (afternoon)	1.1953	£99,785,370	£4,187,535 (4.19%)

The current view from the Treasury is that we should only deposit sufficient in the euro account to meet the first payment that is due 14 days after signing the contract which has a value of approx €13 million. The remainder of the euro contract value would be placed in the account in January by when it is hoped that the rate will have improved. Indications today are that Germany, France and Italy are likely to announce that they are in recession which should help the euro.vs. sterling rate.

I would like confirmation from the Treasury that firstly, we should proceed with the contract signing tomorrow, and secondly, whilst TTS has made very effort to absorb the fluctuations so far, as outlined in the meeting with Treasury on Monday 10 November, it cannot meet these unprecedented fluctuations in the Exchange Rate. In the event of the euro staying at this all time low or falling further, the Capital Risk Reserve has sufficient funds within it to meet the currency fluctuations to ensure the EFW contract retains a minimum of 5% contingency."[26]

177. TT&R asked HODST&R to prepare a formal response to this e-mail (by e-mail at 1042 hours).

178. At 1130 hours, HODST&R sent an e-mail to RLAM which appears to have followed a telephone conversation:

"As discussed I would be grateful if you would confirm as a matter of urgency:

That, given the current exchange rate, it would seem to be a reasonable course of action to deposit only sufficient euros to meet the initial payment due in December – the remainder to be deposited when the rate is more favourable.,

- *In practical terms we would be able to set up the account and make the first payment before the due date of 11 December."*

[25] sic

[26] In this e-mail, COT&TR was raising two concerns. One concerned the level of risk that attached to the contract that was due to be signed on 14 November 2008. The other related to the adequacy of the budget to cover the possible costs of the contract. Under the Public Finances Law, it would not be legitimate for an Accounting Officer to approve expenditure if the result would be that the approved budget would be exceeded.

179. At 1216 hours, HODST&R sent an e-mail to TT&R explaining one aspect of the e-mail from COT&TS:

> *"The suggestion to deposit only the sum of euros needed for the initial 20% payment in December came from [ADFIT&R] at a meeting of their Project board this morning, I have spoken to . . . Royal London and he confirms that this seems like a sensible option in the current climate (am awaiting e-mail confirmation from him).*
>
> *Have spoken to [ADFIT&R] and he confirms the Capital Risk Reserve can fund the currency fluctuation.*
>
> *In summary I think we can say there is no reason from our perspective not to sign the contract tomorrow."*

180. HODST&R drafted a response for TT&R to send to COT&TS and (by e-mail at 1247 hours) asked ADFIT&R to confirm the draft response which was as follows:

> *"From the Treasury's perspective with regard to the arrangements for euro payments there is no reason why you should not proceed with the contract signing tomorrow.*
>
> *Up until the date the euro account is set up and the relevant sum deposited TTS is at risk from two perspectives:*
>
> *(1) If the rate falls further between now and deposit of sufficient euros to make the first payment in December; and (if applicable)*
>
> *(2) If the rate falls further still from the rate of first deposit to deposit of the remainder of euros needed to make the account up to the full contract sum.*
>
> *I can confirm however that sufficient balances will exist in the Capital Risk Reserve to transfer to the TTS capital head of expenditure to maintain contingency of 5% and that my minister would support and authorise such transfers.*
>
> *Advice from Royal London (our cash managers) confirms that, unless the rate improves significantly in the next week or two, the initial deposit should be only sufficient to cover the first payment. This extends your period of risk but that risk will effectively be underwritten by the Risk Reserve. If the rate improves significantly in the next week or two we would deposit the full sum as soon as possible."*

181. ADFIT&R responded at 1250 hours:

> *"Looks fine to me."*

182. At 1318 hours, HODST&R sent the draft response to the TT&R with a message indicating that the response suggested would indicate that a subsidy of £1.1 million would be met by T&R.[27]

183. At 1338 hours HODST&R sent a copy of this e-mail to ADFIT&R with the following message:

> *"For information. Ian wanted to cap the subsidy. My calcs so may be slightly off but seems right."*

184. At 1551 hours, ADFIT&R responded:

> *"Didn't know [TT&R] had that much influence in the currency market."*

185. At 1320 hours, RLAM sent an e-mail to HODST&R which in part reads as follows:

> *". . . I have contacted our relationship manager at HSBC and we have begun the process of opening the required accounts. I have been told that they will be operational by 11 December.*
>
> *Given the current economic climate your question with regard to timing is slightly more difficult to answer. I have attached a graph which shows how far the exchange rate has moved in the last few days. The Global outlook is bleak and currently the UK is seen as the most exposed European economy, hence the collapse in sterling. If the data continue to worsen and the UK is forced to cut rates more quickly than the Eurozone then sterling will continue to fall. However it may be that markets have overdone the pessimism over the UK and so the exchange rates moves back a bit in favour of sterling.*
>
> *Whether it is better to buy in December or January will only be known in January and so buying some euros now and the balance later is a sensible way of dealing with this issue. You mention only buying sufficient euros now to cover the initial payment, a further development of this thought would be to buy half of the whole requirement now and half in January."*[28]

[27] This is an indication of the additional cost caused by the further deterioration in the exchange rate since 6 November 2006.

[28] HODST&R sent a copy of the e-mail from RLAM to IMT&R and RAT&R at 1557 hours commenting: 'I think we just take their advice when the time comes. Also for information it is likely the first payment in December will be around €13 million'.

186. At 1323 hours, the TT&R sent the Treasury & Resources Minister the draft response to COT&TS with the following message[29]:

> *"Please confirm that you would indeed support the transfers from Capital Risk Reserve to cover euro exchange rate fluctuations so I can send the e-mail below. My advice is that you should."*

187. At 1417 hours, the Minister confirmed his agreement to the transfers from the Reserve. The confirmation was then duly forwarded to COT&TS and to HODST&R. TT&R's e-mail to COT&TS includes the following confirmation:

> *"I can confirm, however, that sufficient balances will exist in the Capital Risk Reserve to transfer to the TTS capital head of expenditure to maintain contingency of 5% and that my minister would support and authorise such transfers. I confirm that transfers would be made should the applicable euro rate(s) at the date of deposit fall below 1.2167, which I believe gives you your target 5% contingency including decommissioning Bellozanne. Should there be a balance on the head of expenditure on completion of the project this would be used to reimburse the Capital Risk Reserve for any subsidy provided."*[30]

188. Quite separately from these exchanges, at 1347 hours COT&TS and DWSPT&TS received an e-mail from Babtie Fichtner:

> *"The incessant fall of the pound is obviously a major problem . . . We are not advisors on currency risk, but we have seen how this is done on various projects. I believe your current approach is to buy all the euros now, and put them in a euro account to earn interest. This is secure, but means that you are hit by the current low rate, plus . . . you will also take a hit from a lower interest rate . . .*
>
> *Can I suggest you confirm this is still the best approach? Our understanding is that currently forward rates for £/€ offer slightly more advantageous rates than buying euros today . . .*
>
> *You clearly need better advice than this . . . but I think you need to make sure you are getting the best advice possible here as it is costing £Ms at present."*

189. COT&TS responded that he was in discussions with T&R about the matter in a reference to the e-mail that he had sent the Treasurer that morning:

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29 At this point, TT&R would not have been aware of the e-mail RLAM at 1320 hours.

30 E-mail sent at 1511 hours. This was the clearance that was necessary to deal with the budget concerns mentioned above under 19 October 2008 and 6 November 2008.

> *". . . the view seems to be to place sufficient euros in the account now to meet the first payment and then look forward. I am waiting for confirmation from Treasury on this point . . ."*

190. Later (at 1544 hours) DWSPT&TS sent a copy of the e-mail from Babtie Fichtner to ADFIT&R.[31]

Friday, 14 November 2008

191. The contract was signed.

192. The Briefing Paper prepared by T&TS for the Minister for Transport and Technical Services who was to sign the contract included the following observations on exchange rate risk:

> *"The cost of fixing the euro element of the contract has been considered by the Funding Working Group (Treasury and TTS) established to identify the funding for the Project. Four options were considered by Treasury and the preferred option when balancing cost against risk is to deposit the relevant euro sum in a euro account and make payments when due under the contract."*[32]

193. A related Ministerial Decision by the TT&R Minister approved the necessary budget transfers and gave delegated authority to the Treasurer to approve the actual sum required once the exchange rate position had been finalised and to effect the budget transfer.

Thursday, 20 November 2008

194. The Investment Officer, (IOT&R) sent to HODST&R a copy of an e-mail she had received from RLAM setting out the stage which had been reached in arranging the euro account:

> *"Apologies for not getting back to [IMT&R] today, I was waiting for HSBC to come back to me and it took longer than expected. The current situation is that the necessary forms at HSBC need in order to open euro cash and security accounts are now completed and ready for signing by the States of Jersey".*

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[31] I have not been able to establish that ADFIT&R sent any response to this e-mail save that on the next morning he sent to DWSPT&TS and e-mail entitled 'A crumb of comfort' to which was attached a copy of a BBC News report warning of a coming recession.

[32] This Briefing Paper was drafted in advance by T&TS on the basis of what was understood at that time of T&R's proposals. It did not necessarily reflect T&R's position as at 14 November 2008.

Friday, 21 November 2008

195. At 0803 hours, IOT&R confirmed to HODST&R that the agreement for opening an euro account had been sent to T&R by RLAM on the previous evening.

Tuesday, 25 November 2008

196. The Funding Group met again and the draft minutes recorded that:

> *"HSBC would establish a euro account within the current week. It would then be left to the States cash managers to advise when to deposit the sterling within the account. The latest advice was that it might be better to deposit half the euro amount initially and then the rest later. The position was changing fast so this may change over the period until payment was required . . . [HODST&R] had documented advice from Royal London and HSBC confirming the least risk approach. This had been confirmed verbally by [Hewitt] the States cash management adviser".*[33]

Thursday, 27 November 2008

197. HSBC sent an e-mail to HODST&R following a conversation on the previous day:

> *"I would just like to provide some extra information to you regarding the spot effects risk we briefly discussed. That is a drawback of your chosen strategy. By deciding to not fix your rates now and engage in a spot transaction in for example three weeks you are taking on . . .risk between now and then".*

Tuesday, 2 December 2008

198. At 1606 hours, IMT&R confirmed to HODST&R that RLAM had confirmed that the accounts had been set up and asked:

> *"Are we still instructing RLAM to purchase the full €75m or has that changed at all?*
>
> *As yet we have not had anything to instruct us to make the first payment to the contractor which I believe is due to be paid next week."*

199. HODST&R responded to the e-mail sent by HSBC on 27 November 2008 providing some further information:

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[33] I have searched the e-mails exchanged at the time to trace e-mails (other than those mentioned in this chronology) to which this e-mail may have been referring. There do not appear to have been any others.

"Thank you for this information. As you know at the time we initially considered our options (three weeks ago) we concluded that depositing the full contract sum in an account denominated in euros was the best approach for two reasons:

At that time this was the cheapest option for the States by c.£250K.

It gave us more flexibility in dealing with euro income and any future contracts denominated in euros (one looks likely at the moment). It has never been our intention to engage in spot transactions and expose ourselves to FX risks.

Having said that however exchange rate movements since then may have reduced the price differential and possibly made the forward contracts even cheaper. I would be very grateful if, based on the attached updated payment schedule, you could advise me what the total cost to the States would be based on a series of forward contracts. Please note the first application for payment has not yet been made – payment will be due approximately 28 days after it is made. We therefore need to make a final decision very shortly."

Wednesday, 3 December 2008

200. At 0737 hours, HODST&R responded to IMT&R's e-mail sent on the previous afternoon:

". . . Will need to take RLAM's advice about whether to transfer the whole 75m, half or only enough for the first payment. Incidentally the rate has worsened so badly since we made our decision that I have asked HSBC to resubmit forward contract rates in case they are now a cheaper option. The position changes every 5 mins!

As far as I know we have not had a claim yet from the contractor which starts the 4 week payment clock[34] ticking.. . ."

Friday, 5 December 2008

201. The Assistant Director, Solid Waste Strategy Project (ADSWSPT&TS) asked HODST&R what the payment time scale for the first milestone payment should be.

202. HSBC responded to HODST&R's e-mail on 2 December 2008 in the following way:

"I am refreshing the pricing based on the discussion we had last week. You had made a comparison with the strategies presented and decided that making a spot transaction would be the most cost effective. I proposed that the comparison only holds true if you engage in the spot transaction at the same spot rate that the forwards are based on.

34 Under the terms of the EPC contract, when the contractor makes a claim for payment, the States has a period of two weeks in which to validate the claim. Assuming that the claim is validated, the payment must then be made within a further period of two weeks.

> *Since you made that decision, the spot rate for you to sell GBP has deteriorated. I indicated the potential cost increase in GBP in my email last week.*
>
> *I agreed with the rationale of performing a transaction now and holding the EUR until the specified payment dates. The only issue with this strategy is that you still have a currency risk between making the decision and when you actually purchase the EUR. This can also be significant as can be seen just in the currency movements since the start of the month (5 days)".*

Monday, 8 December 2008

203. HODST&R responded to the e-mail dated 5 December 2008 from ADSWPT&TS at 1503 hours in the following way:

> *"I have spoken to our cash managers, who in turn are talking to their economist in London this afternoon. Their advice at the moment seems to be not to transfer in the whole sum but to deposit either half or enough for the initial payments. By my reckoning the euro sum due is 27.2 million for December and January . . .*
>
> *In terms of when to make the payment it would seem logical to leave the money in our account as long as possible so 28 days from delivery would be 5th January."*

Tuesday, 9 December 2008

204. RLAM responded to HODST&R:

> *"As we discussed yesterday, forecasting for an exchange level is very difficult, mainly because of the huge number of influences which go to evaluating a countries currency and then comparing it to that of another country. However our in-house view is that sterling will continue to struggle against the major currencies in 2009 although the pace of devaluation will slow. As mentioned yesterday everything is set up and ready to go with HSBC."*

Thursday, 11 December 2008

205. At 0928 hours IMT&R alerted HODST&R to the fact that the application for payments 1 and 2 had arrived. She asked:

> *"What is your decision. Do we process it through Royal London or are you still sorting something with HSBC".*

206. HODST&R responded to IMT&R in the following way:

> *"We will still go through Royal London. I have spoken to [RLAM] this week for his advice on how much we should transfer now. He wasn't able to offer any as the markets are so volatile right now – the pound at an all time low against the euro yesterday. . . . My feel is that we should deposit c.€30 million – enough for the first two tranches payments – and wait until the rate is better before depositing the rest. I have advised TTS that we should always make payments at the latest possible dates. If the applications were received yesterday this would mean something like 5th or 6th January."*

207. HODST&R made the Treasurer aware that the States' exposure to the euro payments under the contract continued and that, in view of the rapid decline in the Euro/Sterling exchange rate, it appeared that the States were facing considerably increased costs. It was agreed that Hewitt should be contacted to seek his advice.

208. At 1511 hours, HODST&R sent the following e-mail to Hewitt:

> *"Our Position.*
>
> *We have signed a contract for an Energy From Waste Plant where €75 million of the cost is payable in euros over a period up to June 2012 (payment schedule attached).*
>
> *We consider the following options for dealing with these payments based on the criteria of certainty, lack of risk and cost:*
>
> *(1) Fix the exchange rates as at the date of signing contracts for a one off payment to the contractor of c. £1.28 million.*
>
> *(2) Deposit the full sum in an euro account and make payments when due.*
>
> *(3) Make payments at the exchange rate prevailing at due dates.*
>
> *(4) Purchase a series of forward contracts for the due dates at the date of signing contracts.*
>
> *(5) Purchase a series of participating forward contracts for the due dates at the date of signing contracts (50% would be at an agreed rate, 50% at a capped rate).*
>
> *Based on our criteria option 2 resulted in the lowest option which gave us maximum certainty.*
>
> *Based on this decision we have instructed Royal London to set up a bank account denominated in euros – this is now done.*
>
> *Since we made our decision the exchange rate has worsened considerably and the relative base rates for sterling and the Eurozone have moved. As a result revised forward contracts quotes were requested. The result of our evaluation (minus option 1 which has now gone), still produce the same results.*
>
> *We have just received the first payment request – payment is now due within 28 days.*

Our request

I would be grateful for your earliest possible advice in relation to whether we should:

(1) Translate the full €75 million from sterling now (this will be our preferred rate if the rate was not so poor as we do not want to get into "playing the market" with the risk, uncertainty and administration that would involve).

(2) Translate half the €75 million now and half when (if?) the rate improves.

(3) Translate only enough for the first two months' payments (c. €27.2 million) and the remainder when (if?) the risk rate improves and for each of these whether we should purchase a forward contract now for translation in, say a week's time."

209. At 1513 hours, HODST&R sent an e-mail to T&TR, DTT&R and RAT&R:

"For information – have now spoken to RLAM and Hewitt neither of whom were able to offer definitive advice. . Hewitt is back from holiday on Monday."

15 December 2008

210. At 1212, Hewitt sent an e-mail to HODST&R responding to his urgent request for assistance. The e-mail read as follows:

"I refer to our conversation this morning and to [my assistant's] previous emails. As [my assistant] has already indicated to you we do not provide professional advice on short term currency transactions and hence any comments we give at the present time are on the basis of suggesting a way forward to you and having some regard for some commercial and political judgement. However, it is on the basis that you would not take any legal action against us in respect of these comments whatever the outcome.

Clearly the pound has been very weak against the dollar and the yen over the last three or four months, but for a good part of that period the euro only strengthened slightly against sterling. In the last month of so the euro has been much stronger and there has even been talk of moving to parity for the euro with sterling. It seems to me that it is very hard to justify the current euro/pound exchange rate of even parity on a purchasing power basis and the adverse currency move reflects the low interest rate on sterling and overseas investors lack of confidence in the UK economy. Foreign exchange rates markets have a habit of reacting and the euro rate has already fallen a long way. Hence my inclination would be to take a chance on the exchange rate and not translate all the necessary future payments from sterling into euros at this time. My suggestion would be to action the December 2008 payment at current levels and to be in a position to action the payment for January if the exchange rate strengthens in the very short term. Clearly this introduces some risk but given protection not taken out at any higher levels it may not be much of a risk from current exchange rate levels.

If you do go down this route then I think it is also worth deciding at what exchange rate you would be prepared to make the move from sterling into euros for the remainder of the sums. Having decided this I then think there should be a strategy in place which executes as soon as the exchange rate hardens to that level. This could be a stepped series of rates so that for example you could decide that you would do 25% of any outstanding payments at 1.15, 25% at 1.20 etc., according to your tolerance risk and any political pressures. You do not of course need to actually make the change from a sterling bank account to a euro bank account in that you can buy forward contracts for euro delivery at the required rate from many reputable financial institutions".

Tuesday, 16 December 2008

211. At 1127 hours, HODST&R sent to Hewitt a paper setting out proposals for stepped transfer of euros on the basis of the ideas set out in Hewitt's e-mail dated 15 December 2008. The suggested solution was as follows:

"(1) All deposits in euros to be made at least two weeks before payments fall due.

(2) In addition to the above, in relation to the 2009 payments due of c. €16.4 million

- 25% to be deposited when the rate hits 1.15.

- a further 25% to be deposited when the rate hits 1.20.

- the remaining 50% to be deposited when the rate hits 1.25.

(3) As each trigger rate is reached a formal decision to be taken on whether to deposit any or all of the additional payments of €35 million beyond 2009.

(4) Should the rate fall below 1.05 immediate advice to be taken on whether to lock in any funds at that rate to prevent further losses".

212. These proposals were then discussed between Hewitt, HODST&R, and DTT&R. As a result of these discussions it was agreed that Hewitt would draft a policy which, in principle, at least, would be followed by T&R when dealing with euro payments under the contract. The policy in this paper read as follows:

"In the light of the currently low exchange rate for the euro the proposed policy is to meet payments as they fall due using the spot exchange rate approximately one week ahead of the actual payment date. However, if the exchange rate improves in favour of sterling, euro cash balances will be built up as and when the exchange rate passes certain trigger points. The trigger points are designed so that if all are achieved, then the financial impact would be to fund the contract at an average Sterling/Euro rate of around 1.20 compared with the current spot rate of €1.11 = £1.

If rate changes are such that sufficient euros have not been purchased at the time specific payments fall due, euros should be purchased using the spot exchange rate approximately one week ahead of the actual payment date.

Trigger Points

If the Sterling/Euro exchange rate appreciates to €1.15 = £1 then €5 million future payments will be pre funded by means of a bank account (or forward foreign exchange contracts). If the rate appreciates to 1.20, then a further €5 million will be pre funded. If the rate appreciates to 1.25 then all the remaining future payment values will be pre funded (c. €38.5 million).

It is intended that the trigger points will be reviewed by the department at each time they are triggered; however this does not mean that the intention is to make changes on each occasion. As an example of when a change could take place, if the first point is reached very quickly it may be decided to increase the exchange rates for future triggers. Similarly, if it takes a long time to reach the first trigger, the future triggers may be reduces as the chances of reaching future triggers may have reduced. The department may also consider the use of currency options in the review process but there is no current intention to include these in the trigger process".

Thursday, 18 December 2008

213. Having concluded discussions Hewitt responded to a request from DTT&R that he should confirm that the proposed approach appeared appropriate in the following way:

> *"As I mentioned in our telephone conversation, we are in currency markets, and indeed stock markets, where fear and panic can result in major movements in a short space of time. Whilst I accept it is painful to watch the euro going down sharply, I really do think that starting from the present position there is merit in the proposed policy. Yes, there is the risk of downside but locking in all the payments at the current rate just brings the certainty of a high sterling price. I accept that moving forward without cover brings a chance of a worse outcome but it does seem to me that on the balance of probabilities that is a risk worth taking (providing of course that you can afford to take that risk)".*

SECTION FIVE ~ 14 NOVEMBER 2008

Introduction

214. In this section of the report I will review the decisions made in respect of euro risk on 14 November 2008: the day on which the contract was signed under the following principal headings:

(1) What was done to manage the States' currency exposure?

(2) Was this action appropriate?

(3) Why was any inappropriate action taken?

(4) What other action could have been taken?

What was done?

215. In effect, no action was taken on 14 November 2008 to fix the exchange rate at which euros would be acquired to meet the States obligations under the EPC contract.

216. On the afternoon of 6 November 2008, the TT&R and DTT&R decided to accept the recommendation of an internal paper which was that an interest bearing euro account should be opened and sufficient funds deposited in that account to meet the obligations to make payments in euros. The precise terms of the recommendation were as follows:

> *"It is recommended that RLAM be requested to open an interest-bearing euro account and that the full contract sum is deposited at a time of favourable exchange rate prior to the first payment date."*[35]

[35] The full text of the paper is set out in Appendix Five.

Was this action appropriate?

Introduction

217. I believe that the absence of effective action to fix the exchange rate on 14 November 2008 was inappropriate for five reasons:

(1) Rather than limiting the States' risk, the action taken exposed the States to an extension of the period during which there was a risk of loss through variations in currency exchange rates. The States do not have the skilled resource necessary to manage such risks;

(2) The approach was inconsistent with the States' planning for the contract;

(3) The recommendation that was accepted by the TT&R was based on a flawed analysis of the relative costs of different approaches to fixing the exchange rate;

(4) The approach was inconsistent with the normal approach of T&R;

(5) The approach was inconsistent with the statements made in P73/2008 about the management of currency exchange risk.

218. I will explain each of these matters below:

States' capacity to manage currency exchange risk

219. The recommendation accepted by the TT&R and DTT&R envisaged that the euros necessary for the EFW procurement would be bought "at a time of favourable exchange rate prior to the first payment date". Significantly, the recommendation did not propose that the euros which were required should be bought as at the date on which the contract was signed.

220. Implementation of this recommendation would necessarily require a judgement of when 'a time of favourable exchange rate' had arrived. In the final analysis, this judgement would have to be made by T&R. Thus, implementation of this recommendation would have required T&R to have within its resources staff with appropriate experience to make such a judgement.

221. The States do not normally become involved in substantial transactions denominated in foreign currencies. Apart from income in euros received by Jersey Airport in respect of its air

traffic control activities[36], I have not been able to identify any substantial flows of income in euros.. Moreover, there are no regular substantial payments in euros. The EFW procurement is exceptional in this respect.

222. In consequence, the States have not been obliged to manage substantial flows of cash in euros and do not have people with the skill necessary to do this on a day to day basis.

223. Where such income and payments occur, States' Departments appear to manage these matters for themselves without the involvement of the Treasury & Resources Department. Euros that are received (e.g. by Jersey Airport) are immediately converted into sterling. If payments are to be made, euros are purchased as and when they are required.

224. In the case of the EFW procurement, the total amount payable in euros is material and is due to be paid over an extended period. Thus the procurement exposed the States to a material risk from movements in the exchange rate over that period. To avoid this significant risk, action was required to fix the rate of exchange, as indeed was well appreciated by the group hat managed the project.[37]

225. As a consequence of the States' approach to managing transactions in foreign currencies, the fact is that the States do not have the resources to manage currency risks other than by eliminating the risk by immediate conversion. The evidence for this is that the record of the conversations about the alternative means by which the euro payments should be arranged and exchange risk managed (e.g. forward currency purchases and currency options) provides evidence that the staff of T&R were not familiar with the features of such instruments and disinclined to use them.[38]

226. It has been suggested to me that even though T&R may not have had staff with appropriate expertise, the recommendation might still have been acceptable because T&R could have relied upon its normal external advisers. The flaw in this suggestion is the

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36 I understand that Jersey Airport's annual income from this source is of the order of €6.8 million annually. Since there is no co-ordination of such matters with in the States, the normal practice of the Airport's Finance Director is to instruct the bank to sell the euros immediately they are received. There is no attempt to use the euros received to meet other euro liabilities of the States so that duplication of commission payments on conversion may be avoided.

37 This group included staff from T&R: including ADFIT&R and IMT&R.

38 See e-mails exchanged between HODST&R and ADFIT&R and IMT&R on 24 October 2008. The narrowness of the resource available within T&R was mentioned in a report entitled 'Emerging Issues' which I published in May 2008 in respect of the States' Spending review.

assumption that external advisers would have been prepared to advise in this way. As is very clear from the correspondence quoted in Section Four of this report, it was not the normal practice of either Hewitt or RLAM (the States' advisers) to advise on short term movements in currency exchange rates.

227. The recommendation which was accepted by TT&R and DTT&R necessarily required that T&R should have the resource to judge when 'a time of favourable exchange rate' had arrived although in fact there was no such resource.

Inconsistent with planning

228. It is clear that the possible exchange rate exposure was a matter of considerable concern to senior officers in both T&TS and T&R.[39]

229. Their original approach was that the contract would be denominated in sterling: i.e. all payments to contractors would be made in sterling so that any currency exchange risk would fall on contractors and not on the States. This was indeed specified in the Invitation To Tender.

230. It later became apparent that prospective bidders would not submit bids completely denominated in sterling but would undertake to fix the exchange rate at the date of signing (at a cost to be notified).[40]

231. Thus, the States had accepted that, during negotiation, the contract price would vary as a result of changes in the Euro/Sterling exchange rate; but intended that either the contract price would be fixed in sterling when the contract was signed, or all of the euros necessary for the required payments would be bought when the contract was signed, and which would be an alternative means of fixing the sterling cost of the contract.

232. As far as I can establish, until late October there was no serious consideration of any other possibility.[41]

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[39] See e-mails dated 24 January 2008; 8 and 13 February 2008; and a Briefing Paper submitted to the T&R Minister on 18 May 2008. Extracts from these documents are set out in Section Four of this report.

[40] See e-mail received from CNIM, one of the bidders for the contract, on 24 January 2008 (Section Four of this report).

[41] Officials had given consideration to the possibility of hedging the currency exchange risk between the date on which the States approved the procurement until the date on which the contract was signed but had discarded this possibility on the grounds of cost (see the Briefing paper submitted to the Minister on 18 May 2008)(Appendix Five). That Briefing Paper suggested that, once the States had approved the

233. The action that was in fact taken on 14 November 2008 was inconsistent with the way in which the procurement had been planned.

Flawed analysis and recommendations

234. The action taken on 14 November 2008 resulted from a decision of TT&R on 6 November 2008 to accept the recommendation of a paper entitled "EFW Funding Options", prepared by HODST&R.

235. This paper considered five options:

(1) Fix the exchange rate as at the date of signing contracts for one off payment to the contractor (c. £1.28 million);

(2) Deposit the full sum in an euro account and make payments when due;

(3) Make payments at the exchange rate prevailing at due dates;

(4) Purchase a series of forward contracts for the due dates at the date of signing contracts;

(5) Purchase a series of participating forward contracts for the due dates at the date of signing contracts (50% will be at an agreed rate, 50% at "capped rate").

236. The full text of the paper is set out in Appendix Five.

237. The concluding paragraph of the paper reads as follows:

> *"Recommendation: It is recommended that RLAM be requested to open an interest bearing euro account and that the full contract sum is deposited at a time of favourable exchange rates prior to the first payment date."*

238. The paper and the analysis that underpins the paper are flawed in a number of respects.

239. Firstly, the paper recommended that the necessary euros should be bought at 'a time of favourable exchange rate prior to the first payment date' and stated that this option would provide complete certainty for the States. This was self-evidently not the case.

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procurement, officials would submit a further briefing on ways of managing the currency exchange risk. No such paper was ever prepared or submitted.

240. As at 6 November 2008, there could be no certainty that 'a time of favourable exchange rate' would arrive 'prior to the first payment date' (i.e. by early January 2009) and that it would be recognised as such.

241. Buying the necessary euros and depositing them in an euro account could only have achieved 'complete certainty' if it had been done immediately, i.e. on 6 November 2008, or at least on 14 November 2008, the date of signing the contract. If there were to be any delay, there was a risk that the exchange rate would move unfavourably.

242. Secondly, the paper's recommendation that funds should be deposited in an euro account was based on the alleged relative cost to the States of buying euros immediately and buying euros forward. This was only appropriate on the assumption that all of the options considered (apart from buying euros at the rates ruling on the scheduled payment dates) would provide complete certainty for the States. As the option recommended did not provide complete certainty, reliance on the cost comparison was illegitimate.

243. Thirdly, even if a comparison of costs of adopting the various options considered had been a legitimate basis for a recommendation, the comparison was flawed.

244. The paper suggested that depositing euros in an interest-bearing account would cost less than forward purchases by an amount of about £250,000. The calculation of the euro deposit option assumed that the euros would not be bought until January 2009.[42] This is consistent with the suggestions made by RLAM in a note dated 5 November 2008. This created the possibility that the rate of exchange might vary between 6 November 2008 and early January 2009. If the variation had been unfavourable, the cost of buying euros would have risen and an additional cost would have been incurred which was not taken into account in the cost comparison.

245. Alternatively, if the exchange risk had been eliminated by assuming that the necessary euros would be bought in mid-November 2008 rather than in January 2009, the alleged cost benefit of £250,000 would have been largely eliminated by taking into account the interest income that would have been lost during that period (i.e. by holding deposits in euros rather than sterling at what would then have been a lower market rate of interest).

[42] This is clear from HODST&R's detailed calculations.

246. That the cost of these two alternative approaches would then have been virtually similar should not have been a surprise to HODST&R in the light of the advice of Hewitt[43] in an e-mail dated 24 October 2008:

> *". . . Since the pricing of forward foreign exchange contracts mentioned in the previous paragraph has regard to the levels of interest which are paid on balances in sterling and euros,, you should not find a dramatic difference between the financial cost of this method [immediate purchase of euros] and the method in the previous paragraphs [forward purchases of euros] . . ."*

247. In other words, even if cost comparisons had been a legitimate basis for a recommendation, the alleged cost saving arose largely from mistaken analysis.

248. Fourthly, the exchange rate assumed for the fourth option (participating forward contracts) was incorrect, although this did not affect the overall conclusion of the paper.

249. In short, the recommendation contained in the paper prepared by HODST&R was inadequate and flawed.

250. This flaw was however manifest. The fact that the recommendation spoke of buying euros at 'a time of favourable exchange rate' indicates that there was no certainty about when that time may come: which was clearly inconsistent with the paper's suggestion that the option offered 'complete certainty'.

251. HODST&R has told me that, however the recommendation may have been expressed in his paper, he was clear that what he meant by his recommendation was that the euros should be bought and deposited as at the date the contract was signed, if not before. He accepts that the words that were used in his paper do not reflect what he has told me was his intention.

252. DTT&R recollects that the decision made at the meeting was that all of the euros required to meet future payments should be purchased to be placed in a bank account and that this should happen on the contract date. He accepts however that this is not what the report recommended.

253. There is no formal record of the decision made by the TT&R at the meeting on 6 November 2008. Had a note been prepared it might have confirmed HODST&R's (and the

43 Of Hewitt, the States' strategic investment adviser.

DTT&R's) recollection. As both he and the Deputy Treasurer accept, the decision which they recall being made was not consistent with the paper HODST&R had written.

254. In the event, HODST&R used his paper to inform others of what had been decided. The first occasion on which this was done was at 1703 hours on 6 November 2008 (i.e. immediately following the meeting with the TT&R when the decision made must have been very clear in HODST&R's memory). If the decision made were as HODST&R and the DTT&R recall, it is somewhat surprising that HODST&R informed others of that decision by circulating a document whose recommendation was inconsistent with the decision that he says was made.

255. Again, on 7 November 2008, HODST&R sent an e-mail to IMT&R to which his paper was attached and said:

> *"[TT&R] has agreed to go with the euro account managed by RLAM on the basis of the attached. Could you please find out what sort of instruction they need from us (e.g. letter from [T&TR])."*

256. It was on the basis of the HODST&R's written recommendation words that IMT&R proceeded. I note that these words were in any case consistent with RLAM's note of advice dated 5 November 2008 which envisaged that for ease of administration the necessary euros should not be bought until January 2009.

257. In summary, therefore, the paper considered on 6 November 2008 was flawed.

Inconsistent with T & R's normal approach

258. As far as I have been able to establish, T&R does not have formal policies concerning the management of exchange risk.[44]

259. I therefore asked the TT&R about the approach which he would normally advise his staff to adopt in respect of the management of risks in the absence of a formal policy.

[44] Article 34 of the Public Finances Law (Jersey) 2005 empowers the TT&R, with the approval of the Minister, to issue such financial directions as appear necessary for the proper administration of the public finances of Jersey. No direction has been issued in respect of currency management. The absence of a formal policy in respect of foreign currency exchange risk reflects the fact that the States do not normally make substantial payments in foreign currencies and only limited amounts of income are received in foreign currencies.

260. He told me that there were two approaches which he would consistently encourage his staff to adopt:

(1) That the States should be risk adverse; and

(2) That T & R should wherever possible act on the basis of advice.

261. In this particular case, application of the principle of "risk aversion" should have led TT&R and his staff to ensure that the exchange rate was fixed (by whatever means) when the obligation to make payments in euros became probable and, in any event, no later than the date of signing the contract when the obligation became certain. However, if expert advice to the contrary had been received, then another course of action might have been considered.

262. In this case, the rate of exchange was not fixed by or at the time of signing the contract so the approach was not risk averse and could only have been justified on the basis that it was based on advice that had been received. I have therefore examined closely the advice that was received.

263. During the exercise carried out by HODST&R, advice was offered by three parties:

(1) The States' strategic investments adviser: Hewitt;

(2) RLAM: the States' cash manager; and

(3) HSBC: the States' bankers.

264. I will consider the advice given by each of these parties below.

265. Hewitt, the States' strategic investments adviser, has provided advice to the States for some years. The relationship is one in which Hewitt reacts to requests for advice from the States. On 24 October 2008, Hewitt responded to a request for advice from HODST&R and RAT&R:

> *"I understand [RAT&R] spoke to you yesterday regarding a contract we have where payments are to be made in euros. We have the option to fix the exchange rate as at the date of signing (assume 31/10/08) for £1.28 million. Other options we are considering are to deposit the full sum in a euro account or take a chance on the prevailing rates on the payment due dates. No doubt there are others. I attach a payment schedule and would be grateful if you could advise me on what would appear to be our best approach".*

266. Hewitt's response commented:

> *"There is no single obvious way forward here which is necessarily better than the other alternatives, and much depends on your requirements, certainty of price in sterling, and how much you wish to be dependent on the future vagaries of the foreign exchange market . . . In summary therefore, most UK Treasurers would, I think, buy a series of forward foreign exchange contracts to fix the sterling costs at this time and to remove exchange rate uncertainty".*

267. In dealing with the possibility of making no advance provision for the euro payments and to fund them as they come through, Hewitt said:

> *"This may cause some concerns for budgeting in that you do not have control over the sterling cost of the project but it does give an opportunity for perhaps gaining or losing from a change in the fortunes of sterling. Since 35% of the total cost is payable within six months, there is more of a short-term chance affect on exchange rate movements and little time for any long-term macro affects to come through".*

268. In essence, therefore, Hewitt's advice at the end of October 2008 consisted of two elements:

(1) The States would be ill advised to expose themselves to the chance of short-term currency exchange rate movements; and

(2) The purchase of forward currency contracts would be the normal way of achieving certainty[45].

269. The actions chosen by the States at the contract signing date on 14 November 2008 did not comply with this advice in either particular.

270. Secondly, HODST&R sought advice from RLAM from which I have already quoted.

> *As far as I can establish, the only briefing given to RLAM concerning the circumstances was based on a brief e-mail sent by HODST&R to IOT&R and IMT&R on 28 October 2008:"Can we please contact the bank asap to find out:*
>
> - *If we can get an interest bearing euro account,*
> - *If so, what rate will we pay and what charges will there be,*

[45] In Hewitt's words: '. . . most UK Treasurers would, I think, buy a series of forward exchange contracts to fix the sterling cost at this time and to remove exchange rate uncertainty.'

- *If they can arrange fixing forward contracts for euros should be choose to go down that route.*

As you know we are talking about either:

- *Depositing 75 million in euros with 16 payments over 2.5 years*
- *16 forward contracts for euros spread over 2.5 years.*

Please give me a call if you have any questions".[46]

271. The advice eventually provided by RLAM on 5 November 2008 appears to be more concerned with the mechanics of managing the transactions than with the consequences in terms of fixing the exchange rates. The concluding paragraph reads as follows:

> *"I hope that the above is of some use in your decision process in terms of cost effectiveness. I am sorry that I cannot offer a more definitive answer. However, with regards to administration it is our opinion that option 3, purchasing all of the euros in January 09 is the preferred option. It provides a known cost in sterling, ensures the euros are available when required and that the return on the euros is maximised in the intervening period".*

272. The effect of this analysis is that:

(1) RLAM do not appear to have been told that fixing the exchange rate at the earliest opportunity or at the date of signing the contract at the latest was an important objective for the States;

(2) Consequently, RLAM's advice did not take account of all of the States' objectives;

(3) Indeed, RLAM's advice was principally concerned with administrative convenience rather than with the management of a risk exposure[47]; and

(3) Consequently, the advice provided by RLAM could not be regarded as relevant to the States' principal objectives and, indeed, was not.

273. Thirdly, advice was offered to the States by HSBC, the States' bankers. The advice arose from conversations between members of T&R staff and HSBC's Relationship Manager for the States. HSBC were aware of the proposed procurement and of the need to purchase euros and

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[46] The request for advice was subsequently communicated to RLAM in a telephone conversation and appears to have been couched in terms similar to the e-mail.

[47] This is consistent with an exchange of e-mails between IMT&R, RAT&R and HODST&R on 11 and 12 November 2008 (see Section Four of this report).

was attempting to assist the States by providing support at a time when the States were deciding how the euros should be acquired. The advice which was provided is set out in an e-mail to HODST&R dated 5 November 2008 which concluded:

> *"For complete certainty and ability to budget, the forward contract is the simplest and easiest way to project against adverse movements. However, with the current volatility in the foreign exchange market, the ability to benefit from GBP strength may be important to you while maintaining a degree of certainty".*

274. I understand that T&R were inclined to be cautious about such advice offered by HSBC (rather than requested by the States from HSBC) as T&R regarded HSBC as a provider of services rather than as a provider of advice. However, I note that the advice offered by HSBC was similar to that provided by Hewitt.

275. In short, the action taken by the States on 14 November 2008 was not consistent with the advice provided by the States' strategic investment adviser which was supported by HSBC. Although the action taken was based on advice provided by RLAM, I cannot find evidence that RLAM was provided with a balanced view of the States' objectives on which to advise.

276. The outcome of this analysis is that the action taken on 14 November 2008 was not consistent with the approach that the TT&R would normally expect his staff to adopt in the absence of a formal policy in that:

(1) The action was not risk averse in that it extended the period during which the States were exposed to currency exchange risk; and

(2) The action was inconsistent with the advice that T&R had received.

P73/2008

277. P73/2008 stated that:

> *"The exchange risk will be eliminated upon the signing of the contract with the preferred bidder at which time the Euro/Sterling rate will be deemed to freeze for the purposes of the contract payments. All contract payments will be in sterling."*

278. Manifestly this did not happen.

279. A failure to implement a statement of this kind should not necessarily be a matter for criticism. If in November 2008 T&R officials formed the view that the statement in P73/2008 did not represent the best value for the States, they would be open to criticism for not proposing a different approach. However, as I have shown, the approach that was adopted in November 2008 involved deserting the risk aversion promised in P73/2008 on the basis of a flawed analysis.

Why did this happen?

Introduction

280. There appear to be three principal reasons why T&R failed to adopt an appropriate approach to managing exchange rate exposure on 14 November 2008:

(1) T&R's staff had limited experience of foreign currency management;

(2) T&R's staff resources are limited;

(3) HODST&R's recommendations were flawed; and

(4) HODST&R's recommendations were not properly reviewed.

Inappropriate experience

281. T&R's decision on 6 November 2008 and the failure to act on 14 November 2008 were based on the recommendations of HODST&R, a member of T&R's staff who, in common with other members of T&R's staff, had no significant experience of the management of exchange rate risk.

1. On 22 October 2008, ADFIT&R alerted DTT&R to the need to make some decisions about "fixing the exchange rate" in anticipation that the contract would be signed on 31 October 2008, nine days later. DTT&R in turn asked HODST&R to undertake a "straightforward option appraisal and costing".

282. I understand that DTT&R considered HODST&R to be appropriate for this task because:

(1) He is a senior accountant within T&R with approximately 20 years' post qualification experience of which 10 years have been spent with the States of Jersey.

(2) He was, for a considerable time Acting Chief Internal Auditor with responsibility for the Audit and Risk Management Division of T&R.

(3) He has considerable experience of preparing analyses and reports for presentation to the TT&R and Ministers.

283. Without doubting the value of this experience, it is evident that the task which DTT&R assigned to HODST&R ideally required specific knowledge and skill which HODST&R either did not have or did not display: a knowledge of foreign currency management and the skill of balancing quantifiable costs against unquantifiable risks.[48]

284. As far as the former is concerned, the fact that HODST&R did not have the experience of foreign currency management necessary to undertake this work is clear from an e-mail that he sent on 27 October 2008 to IMT&R and IOT&R in response to Hewitt's advice:

> *"Please see advice below. I have no idea how difficult it is to set up forward contracts or who would do it. If it's complicated it might be better to deposit the whole €75 million but get an interest bearing account. Should we discuss this with the bank? . . ."*

285. As I have shown, HODST&R also appears to misinterpreted the differences between the advice provided by Hewitt and RLAM.

286. As far as the latter is concerned, I note that HODST&R's recommendation was based on a projected cost saving of approximately £250,000 without any recognition of the fact that his calculations were based on the assumption that the required euros would not be acquired until January 2009, so that the States' risk would continue for a further two months. In other words, HODST&R failed to balance the unquantifiable risk against the quantified cost saving.

287. The effect of HODST&R's lack of knowledge and skill was exacerbated by his failure to include in his options paper any reference to the assumptions which underpinned his recommendations (i.e. the assumption that the euros would not be acquired until January 2009).

288. HODST&R's difficulty was also exacerbated by:

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[48] It was clear from the beginning that this balance was critical to the appraisal that HODST&R was asked to prepare: see the initial e-mails quoted under 23 October 2008 in Section Four of this report.

(1) The failure of T&R's management to ensure that when the former SIMT&R left T&R on 3 October 2008 there was a proper handover of his responsibilities to continuing members of staff and of his knowledge of what needed to be done in respect of each area for which he had been responsible. There were some brief handover discussions and I have inspected the manuscript notes of those conversations. There appear to have been only limited references to the EFW procurement and the issues surrounding the purchase of euros.

(2) The failure of T&R's management to ensure that HODST&R was aware of P73/2008 (i.e. he was not aware of the public statement that the rate of exchange would be fixed when the contract was signed).

Limited staff resources

289. Issues relating to currency exposures had previously fallen within the responsibility of the former SIMT&R who had represented T&R in the EFW Project Funding Working Group but had left the States' employment on 3 October 2008, having resigned on 11 July 2008. Although attempts had been made to recruit a suitably experienced replacement, these had not met with success by the end of October 2008.

290. A number of consequences flowed from departure of the former SIMT&R:

(1) Although there was an attempt to hand over his knowledge of the state of the projects for which he was responsible, a great deal of knowledge was lost. Information about the EFW project was not handed over to HODST&R with the result that when he was asked (on 24 October 2008) to look at the euros matter, he was unaware of the discussions which had taken place within the Funding Group and the Group's attitude towards currency exchange risk.

(2) There was no one within T&R's remaining staff who had experience of currency issues and cash management.[49]

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[49] I note that the former SIMT&R returned to T&R in December for what was understood to be a handover. I understand that this was agreed by the DTT&R. The planned leaving date was 10 October 2008. By that time no replacement had been appointed, although it was hoped that an appointment was imminent. It was therefore agreed that the former SIMT&R would leave on 3 October 2008, a week early, and return in December 2008 for a week to hand over to the replacement who it was hoped would by then have been appointed. In the event, no replacement was appointed.

291. I have commented before on the narrowness of the resources available to T&R and the department's inability to recruit people with appropriate skill and experience.[50]

Flawed approach and recommendations

292. I have already dealt with the flaws in HODST&R's recommendations. To a large extent these flowed from a failure to follow rigorously the approach that I believe would have been wise in the circumstances.

293. As I have suggested, HODST&R was not alone in his inexperience in these matters: T&R staff generally did not have such experience and generally such experience has not been required because the States do not generally become involved in material transactions involving foreign currency. In these circumstances, the appropriate approach is to:

(1) Define the requirement, identifying all of the conditions that must be satisfied to meet the States' objectives;

(2) Seek appropriate advice, making sure that the adviser understands the requirement;

(3) Test the advice to ensure that it is appropriate and has taken full account of the States' objectives; and

(4) Follow the advice.

294. In this case, this approach was not adopted rigorously in that:

(1) The requirement and the related conditions were not fully defined (e.g. the commitment in P73/2008 to fix the exchange rate as at the date of signing the contract was not recognised);

(2) Although advice was sought, the advisers were not informed of all of the conditions that must be satisfied to meet the States' objectives (e.g. RLAM were not informed of the commitment to fix the exchange rate as at the date of signing the contract); and

(3) The advice that was received was not adequately tested to ensure that if took full account of the States' objectives.

[50] See my report 'Emerging Issues' published in May 2008.

Review of HODST&R's recommendations

295. As far as I have been able to establish, HODST&R's paper and his recommendations were not subjected to a searching review by the TT&R and the DTT&R when they met at 1630 hours on 6 November 2008 to consider his recommendations. A number of factors would have strongly suggested that such a searching review was necessary:

(1) The EFW procurement was unprecedented in terms of its size and of the currency exchange risk that it presented;

(2) Management of currency exchange risks fell outside HODST&R's experience;

(3) The departure of the former SIMT&R had denied T&R the benefit of his accumulated knowledge of the planning of the EFW procurement[51]; and

(4) The cost increases that had resulted already from the exchange risk were significant enough for COT&TS to be concerned about the adequacy of the budget for the project.[52]

296. The effect of all of these factors was that the TT&R and the DTT&R had to be sure that the decision which they eventually reached was unquestionably risk averse and thus that the recommendations on which a decision was invited were properly prepared and resulted from a proper process.

297. There were two further practical factors that should also have been borne in mind. Firstly, the need to make a decision was becoming urgent as the deadline for signing the contract was 14 November (eight days later) and it was necessary to decide whether the contract should provide that the Contractor would be paid in sterling or in euros. Secondly, although there was pressure to reach a conclusion on the currency issue, HODST&R's paper and recommendations were not available to the TT&R before his meeting with HODST&R and the DTT&R.

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[51] I acknowledge that ADFIT&R who was also present at the early morning meeting on 6 November 2008, had also been a member of the Project Funding Working Group and that he had some knowledge of the financial aspects of the procurement. However, the funding of the project and management of the Euro risk had been largely dealt with by the former SIMT&R.

[52] This was evident (at least to the Treasurer) from discussion at the meeting which took place that morning to discuss issues that might affect the signing of the EPC contract: see under 6 November 2008 in Section Four of this report.

298. In spite of the urgency of the matter, there can be no doubt that it would have been wise to check carefully that the approach recommended by HODST&R was appropriately risk averse and consistent with the advice that had been received.

299. Had this been done, the flaws in HODST&R's process, analysis and recommendations would have been appreciated. For example, a simple check of the written advice provided by RLAM would have demonstrated that the approach recommended by HODST&R would not provide immediate certainty by eliminating further exposure to exchange rate risk.

300. It has been suggested to me that the TT&R was entitled to rely, without searching review, upon the advice of staff, including the DTT&R, especially in view of the pressure of business with which the TT&R must deal. I do not share this view:

(1) The EFW procurement was exceptional in terms of its scale and the attendant currency exchange risks and deserved special attention.

(2) The TT&R must have been aware of the limitations of HODST&R's experience and should have taken appropriate steps[53] to ensure that any recommendations were founded on a satisfactory analysis and consistent with advice, where relevant. He should also have been aware of the pressure under which HODST&R had been working.

(3) The TT&R should have been aware that statements had been made to the States about the management of currency exchange risk (in P73/2008) and thus sought to ensure that HODST&R's recommendations were consistent with them. Alternatively, in view of the public attention that would inevitably be drawn to such a major procurement, the Treasurer should have enquired whether any such statements had been made and whether the recommendations were consistent with them.[54]

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[53] These steps might have included, for example, asking someone else to check HODST&R's analysis and Hewitt's confirmatory advice.

[54] The drafting of P73/2008 had been the responsibility of the former SIMT&R who left the employment of the States on 3 October 2008. There was a handover between him and RAT&R at the end of September but, whilst this did include some mention of the issues which are the subject of this report, it was somewhat limited in scope. Certainly, when I first asked HODST&R and RAT&R about the references to exchange risk in P73/2008, they both appeared unaware that there were any.

(4) The existence of other pressures upon the TT&R's time does not diminish these considerations.

301. It would however have been reasonable for the TT&R to have taken into account the fact that the DTT&R was HODST&R's line manager, had requested him to undertake the work and appears to have had an opportunity to review the work before the meeting with the Treasurer at 1630 hours on 6 November 2008.

302. Above all of these matters, as I have shown, the recommendation set out in HODST&R's paper self-evidently did not offer an approach that guaranteed that the States' risk in this matter would be eliminated. In other words, taken at its face value, it was clear that the recommendation could not provide the complete certainty that was necessary.

303. These observations should be borne in mind when reflecting upon HODST&R's position. In this report, I have been critical of the recommendation which he made in his paper dated 6 November 2008. In my view, he was entitled to expect that those to whom his recommendations were presented would take his limited expertise into account when reviewing his paper.

304. It has been suggested to me that this analysis does not take adequate account of the fact that the responsibility for managing the risks attaching to capital projects normally lies with departmental Accounting Officers and not with the TT&R and DTT&R.

305. I agree that it is the normal practice for departmental Accounting Officers to be responsible for risks arising from capital projects. However, the EPC contract was exceptional in that it gave rise to a foreign currency exchange risk (i.e. most of the States' capital projects do not give rise to such a risk). Consequently, an exceptional approach was adopted as evidenced by P73/2008[55] which stated:

> *"The Treasury has conducted a sensitivity analysis of the currency exposure and obtained expert evidence on anticipated currency fluctuations. As with all States' capital projects the Treasury will monitor* ***and manage***[56] *the fluctuations risk.*

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55 P73/2008 was lodged au Greffe on 20 May 2008.
56 Emphasis added.

306. In other words, long before the TT&R and DTT&R met on 6 November, T&R had publicly accepted responsibility for managing the currency exchange risk in this case.[57]

Summary

307. In summary, inappropriate action was taken because reliance was placed upon the recommendations made by a member of T&R staff with limited experience of currency exchange questions, without appropriate review.

What should have been done?

308. In principle, action should have been taken that eliminated further currency exchange risk from the date of signing the contract if not before. There were a number of ways in which this could have been done:

(1) Agreement could have been reached with the contractor to fix the exchange rate so that all contract payments were made in sterling;

(2) The total amount due to be paid in euros could have been purchased as at the date of signing the contract and then placed in an account whence they could have been transferred when payment was due; or

(3) The necessary euros could have been purchased forward at the rates ruling as at the date of signing the contract or earlier.

309. I will review each of these options below.

310. Firstly, negotiations with the contractor had proceeded on the basis that the States had the option to choose that contract payments should be denominated in sterling in return for a variation of the contract price. The contractor had indicated that the necessary payment would be of the order of £1.28 million. This should be compared with the fact that movements in the exchange rate had already increased the Total Project Cost. The rate of exchange assumed in P73/2008 was 1. 2729. At the beginning of November 2008, the rate of exchange had moved

[57] I note that both the Treasurer and Deputy Treasurer were aware of P73/2008 as it was being drafted. The Treasurer attended the meeting at which the draft was considered and approved by the Minister.

to 1.2167 and by the date on which the contract was signed, the rate had moved again to 1.1693. These changes had increased the Total Project Cost over that shown in P73/2008 by an amount of £2.745 million by early November 2008 and by an amount of £5.268 million by the date on which the contract was signed.[58]

311. The advantage of this approach was that administration would have been easy once the Contract had been agreed. The disadvantage of this approach was that, apart from incurring the cost payable to the contractor, there was a fear that the States would have been fixing the rate of exchange at a low point without preserving the right to participate in any beneficial subsequent improvement in the exchange rate. However, preserving that right would only have been worthwhile if the States and T&R in particular had the resource necessary to monitor the position so that advantage could be taken of favourable exchange rate movements.

312. Secondly, the total amount required in euros could have been purchased immediately and deposited to be held until required. This also would have had the effect of fixing the exchange rate but would have denied the States any participation in favourable movements in the exchange rate.

313. The difficulty with this approach was that the States did not have an open interest-bearing euro account at the time and it would have taken time to open such an account.

314. This difficulty could have been overcome. Although the States had no interest-bearing euro account, there was at least one euro current account (held by T&R for use for tax transactions). It would have been possible for euros to be bought and deposited in that account pending the opening of an interest-bearing account. The advantage of this approach would have been immediate fixing of the exchange rate. The disadvantage would have been the loss of interest income during the hiatus.

315. Thirdly, the required euros could have been bought forward to match the planned payment timetable. This would also have fixed the exchange rate but would have denied the States the right to benefit from favourable movements in the exchange rate unless the forward

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58 A detailed analysis of these changes is set out in Section Eight of this report.

purchase contracts had been accompanied by matching options.[59] Some cost would have been incurred in this process.

316. The States' bankers. HSBC, have confirmed to me that such forward purchases could have been made without significant delay.[60]

317. In summary,

(1) there were strong reasons for fixing the exchange rate;

(2) one of the means of fixing the rate should have been chosen;

(3) the most straightforward means of doing this would have been to reach agreement with the contractor.

Conclusions

318. The conclusions that I have reached in respect of the action taken on 14 November 2008 may be summarised in the following way:

What was done?

319. The exchange rate was not fixed.

320. The approach eventually arrived at envisaged that all of the euros required would be purchased at 'a time of favourable rate' prior to January 2009 when the first payments in euros would be made.

Was the action appropriate?

321. I believe that the action taken was not appropriate because:

(1) The States are not in a position to manage currency exchange rate exposures.

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59 The forward purchases would have been accompanied by options to sell the euros at the rate set in the forward purchases so that, in the event that the exchange rate had moved favourably, the euros which had been bought forward could have been sold at the rate applying to the purchases by exercising the options.

60 Normally, a bank asked by a customer to arrange substantial forward currency purchases for the first time would have required time to assess the credit risk attaching to such purchases (i.e. the bank would be liable to honour the forward purchases irrespective of whether the customer could meet his obligation to buy the currency when the forward purchase matured).

(2) Rather than limiting the States' risk, it exposed the States to an extension of the period during which there was a risk of loss through variations in currency exchange rates;

(3) The approach was inconsistent with the States' planning for the contracts;

(4) The recommendation that was accepted by the TT&R was based on a flawed analysis of the relative costs of different approaches to fixing the exchange rate;

(5) The approach was inconsistent with the normal approach of T&R; and

(6) The approach was inconsistent with the statements made in P73/2008 about the management of currency exchange risk.

Why was inappropriate action taken?

322. Inappropriate action was taken because reliance was placed upon flawed recommendations made by a member of T&R staff with limited experience of currency exchange questions, without appropriate review.

What action should have been taken?

323. As far as concerns the actions that should have been taken:

(1) there were strong reasons for fixing the exchange rate;

(2) one of the means of fixing the rate should have been chosen;

(3) the most straightforward means of doing this would have been to reach agreement with the contractor.

SECTION SIX ~ 17 DECEMBER 2008

Introduction

324. In this section of the report I will review the decisions made in respect of euro risk on or around 17 December 2008: the day on T&R adopted the policy which is now being implemented to provide the euros which will be necessary to meet the States' obligations under the EPC contract. I will set out my review under the following principal headings:

(1) What was done to manage the States' currency exposure?

(2) Was that action appropriate?

(3) Why did this happen?

(4) What should have been done?

What was done?

325. The EPC contract was signed on 14 November 2008. As I have described in Section Five, the States did not fix the euro exchange rate as at that date. By the beginning of December 2008, the States had still not taken action to fix the sterling equivalent cost of the euro liabilities, and the currency exchange rate had moved unfavourably. The effect was that the sterling equivalent cots of the euro liabilities was increasing rapidly.

326. After urgent discussions and consultations, it was decided to adopt the following policy:

> *"In the light of the currently low exchange rate for the euro the proposed policy is to meet payments as they fall due using the spot exchange rate approximately one week ahead of the actual payment dates. However, if the exchange rate improves in favour of sterling, euro cash balances will be built up as and when the exchange rate passes certain trigger points. The trigger points are designed so that if all are achieved, then the financial impact would be the fund the contract at an average Sterling/Euro rate of around 1.20 compared with the current spot rate of €1.11 = £1.*
>
> *If rates change such that sufficient euros have not been purchased at the time specific payments fall due, euros should be purchased using the spot exchange rate approximately one week ahead of the actual payment date."*[61]

[61] The full policy is set out in Section Three of this report: 17 December 2008.

Was this action appropriate?

327. In certain respects, the action that was taken was inappropriate. The effect of the policy that was adopted on 17 December 2008 was that the euro exchange rate would not be fixed for the purposes of the contract. Euros would be acquired for the contract either as they were required or as the exchange rate improved provided that it improved sufficiently to exceed pre-selected trigger rates. There was and remains no certainty either that the rate will improve or that the rate will not deteriorate further.

328. Thus the question is begged: what made this undesirable position appropriate as at 17 December 2008?

329. The answer is that it appeared to be the least unattractive of the choices that were available.

330. In principle, there were only two or three choices:

(1) All of the required euros could be purchased immediately (whether as spot purchases or forward purchases);

(2) The required euros could be bought as and when required to make payments; or

(3) The required euros could be bought as and when required subject to the possibility that advantage might be taken of changes in the exchange rate that created chances to buy earlier at or favourable rates.

331. The first of these three choices was unattractive because, following the serious fall in the exchange rate, immediate purchases would 'lock in' a substantial increase in the Total Project Cost. At the rate of exchange ruling on 17 December 2008, the Total Project Cost would have been £119.79 million; an increase over the Total Project Cost as at 14 November 2008 of £5.56 million, which would have been entirely attributable to the T&R's management of the euro exposure.

332. Furthermore, as the fall in the exchange rate had occurred quickly, so it became more likely that further moves would be more favourable from the point of view of the States. Immediate purchase of the required euros would have denied the States all chance of benefiting

from such favourable movements. This would have been the price of eliminating the currency exchange risk.

333. The second of these choices was unattractive because it would left the States at the mercy of the markets; precisely the position that T&R had consistently said it wished to avoid and there would have been no protection against unfavourable movements in the exchange rate.

334. The third of these choices is in reality merely a version of the second choice recognising that the States might be able to take opportunistic advantage of favourable movements in the exchange rate. This too was unattractive since there would have been no protection against unfavourable movements in the exchange rate and placed the States in a position analogous to a speculator which is inimical to their public position.

335. The unattractiveness of each of these choices is plain. In the end, the TT&R chose the approach which appeared to leave the States with a possibility that the States could improve their position by taking advantage of favourable exchange rate movements. This was done in recognition that there was no limit to the further losses that might be made, but in reliance on a calculation that such further losses were made less probable, by the speed of the recent fall in the exchange rate.

Why did this happen?

Policy mistakes made in November 2008

336. That T&R found itself in this position is directly attributable to the policy mistakes made on 14 November 2008.

Failure to heed warnings

337. The effect of the policy mistakes made in November 2008 was heightened by a failure to heed warnings that its approach was unwise.

338. These warnings came from two sources:

(1) Babtie Fichtner: the Consulting Engineers to the project. The consulting engineers' concern was expressed to COT&TS in an e-mail on 13 November 2008. The e-mail was passed to ADFIT&R on the same day by DWSPT&TS.[62]

(2) HSBC: the States' bankers. On two occasions HSBC explained to HODST&R the nature of the risks which were being taken.[63] On one further occasion, HSBC communicated with the Head of Shared Services (HOSST&R) to ensure that a more senior person within T&R was aware of the risks.[64]

339. These warnings were not passed to the TT&S and DTT&S who were unaware of them.

Alleged reliance on advice

340. I am aware that statements have been made to the effect that the course of action taken was chosen on the basis of advice. In my view these statements are misleading.

341. Firstly, as I have shown in Section Five, the approach adopted in November 2008 was chosen in disregard of the only advice that was based on a knowledge of the States' strategic position.

342. Secondly, when it came to the decisions made in December 2008, T&R found that it was impossible to obtain formal advice.

343. In December, advice was sought from two sources: RLAM and Hewitt.

344. RLAM's response was, in effect, to give no advice:

> *"As we discussed yesterday, forecasting of an exchange level is very difficult . . . our in-house view is that sterling will continue to struggle against the major currencies in*

[62] See Section Four of this report: 13 November 2008.

[63] See an e-mail sent by HSBC to HODST&R on 27 November 2008 (Section Four of this report) following a meeting or conversation on 26 November 2008. HSBC sent a further e-mail on 2 December 2008 in response to a request made by HODST&R for further information about prices (see Section Four of this report).

[64] E-mail sent by HSBC to HOSST&R on 27 November 2008 (see Section Four of this report). Before replying (on 1 December 2008) HOSST&R spoke to HODST&R on the matter and was told that the issue was under consideration. HOSST&R then replied to HSBC saying that the matter was under control.

> *2009 although the pace of devaluation will be slow. As mentioned yesterday, everything is set up and ready to go with HSBC."*[65]

345. HODST&R characterised this response in the following way:

> *"I have spoken to [RLAM] this week for his advice on how much we should transfer now. He wasn't able to offer any as the markets are so volatile right now – the pound at an all time low against the euro yesterday."*[66]

346. Hewitt's response was initially even less helpful. When first contacted by HODST&R,[67] the States' principal contact at Hewitt was absent from his office on holiday. A member of his staff responded by saying that Hewitt did not give advice on short term currency transactions.

347. On his return, and after a telephone conversation with the TT&S, the principal contact at Hewitt sent an e-mail which began:

> *"I refer to our conversation this morning and to [my assistant's]previous e-mails. As [my assistant] has already indicated to you we do not provide professional advice on short term currency transactions and hence any comments we give at the present time are on the basis of suggesting a way forward to you and having some regard for some commercial and political judgement. However it is on the basis that you would not take any legal action against us in respect of these comments whatever the outcome."*[68]

348. Hewitt then went on to suggest an approach similar to that eventually adopted on 17 December 2008 and then, on the basis of a draft first proposed by HODST&R to draft the statement of policy which was eventually adopted formally. As the document was adopted, DTT&R asked Hewitt to confirm that he still thought that the proposed approach was advisable and Hewitt responded:

> *"I accept that moving forward without cover brings a chance of a worse outcome but it does seem to me that on the balance of probabilities that is a risk worth taking (providing of course that you can afford to take that risk)."*[69]

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65 E-mail from RLAM to HODST&R dated 9 December 2008 (see Section Four of this report). A similar request to RLAM for advice on 13 November received a similar response (see Section Four of this report).

66 E-mail from HODST&R to IMT&R on 11 December 2008 (see Section Four of this report).

67 On 11 December 2008 (see Section Four of this report).

68 E-mail from Hewitt to HODST&R dated 15 December 2008 (see Section Four of this report).

69 E-mail from Hewitt to DTT&R dated 18 December 2008 (see Section Four of this report).

349. These responses are not surprising. Short term movements in exchange rates are notoriously difficult to foresee. Advising on such movements is so fraught with difficulty and risk that most houses are not prepared to offer such advice. As I have shown, Hewitt were only prepared to assist on the basis that any assistance would not be actionable.

350. This is an area in which the responsibility for making judgements cannot be out-sourced. This is precisely why T&R's normal risk aversion is well advised.

What should have been done?

351. The principal weakness in the approach that was adopted on 17 December 2008 was that it left the States exposed to further unfavourable exchange rate movements. To eliminate this weakness, the States might either have bought all of the require euros at once (which was unattractive as I have already explained) or have augmented the eventual policy by buying call options so that euros could at least be purchased at the rates prevailing in December 2008 even if the rate subsequently declined further. The disadvantage of this approach was that it would have incurred additional cost.

Conclusions

352. The conclusions that I have reached in respect of the action taken on 17 December 2008 may be summarised in the following way:

What was done?

353. A policy was agreed by which euros would be acquired as and when needed to meet payments under the EPC contract save that if the exchange rate passed various 'triggers' the opportunity would be taken to buy euros in advance of the contractual requirement.

Was the action appropriate?

354. I believe that the action taken was not inappropriate because:

(1) Although the approach adopted left the States exposed to further unfavourable exchange rate movements and placed the States in a position analogous to that of a speculator;

(2) The approach adopted was the least unattractive of the choices available.

355. However, T&R should also have considered purchasing call options to ensure that if the exchange rate moved unfavourably, euros could be acquired at the rate ruling on 17 December 2008, thus creating a floor for the States' exposure.

Why did this happen?

356. That T&R found itself in this position is directly attributable to the policy mistakes made on 14 November 2008 and the failure of T&R to heed the warnings that these mistakes were likely to prove costly.

What should have been done?

357. Although action could have been taken to eliminate down-side risk (i.e. to eliminate the States' exposure to further unfavourable movements in the exchange rate), it is not clear that the costs that would have been incurred would have been justifiable.

SECTION SEVEN ~ 10 JULY 2008

Introduction

358. In this section of the report, I will consider the actions that were taken on 10 July 2008, the day after the States approved the proposed procurement and the proposals for financing the procurement.

359. This stage of the review seemed appropriate because the States' exposure to movements in the euro rate of exchange commenced from the date of approval of the procurement. Before that date, there was some uncertainty over whether the States would decide to proceed with the proposal. After that date, it was likely that the procurement would proceed.[70]

360. I will review the action taken under the following headings:

(1) What action was taken?

(2) Was the action appropriate?

(3) Why was the action taken?

(4) What should have been done?

What action was taken?

361. No action was taken to fix the rate of exchange for the euros required to be paid under the contract.

362. Proposition P73/2008 said that:

> *". . . exchange risk will be eliminated upon the signing of the contract with the preferred bidder . . ."*[71]

363. This was how matters were left until November 2008.

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[70] It has been suggested to me that after 10 July 2008 there remained a possibility that the procurement would not proceed and that, in particular, the need to obtain planning approval represented a major uncertainty. I have discussed this issue with all of those involved. In my view, although there obviously remained a technical possibility that the project would not proceed, on the balance of probabilities, once the States' approval had been given, the project would have been expected to proceed to completion.

[71] The relevant extract from P73/2008 is set out in full in Section Four of this report (20 May 2008).

364. In the Briefing Paper submitted to the T&R Minister together with the draft of P73/2008, T&R said that when the States had approved the procurement a further briefing paper would be submitted:

> *". . . recommending how the risk should be managed between the approval date and the signing of the EPC contract."*[72]

365. No such paper was ever submitted.

Was this action appropriate?

366. In one sense, the action taken was entirely appropriate: T&R complied precisely with the statements that had been made to the States and on the basis of which the States had given approval to the procurement.

367. However, from the point of view of the management of the States' risks, the failure to submit a further briefing paper and thus to consider how the currency risk could best be managed was, in retrospect, unfortunate.

368. It has been suggested to me that it would have been illegitimate for T&R to have taken any steps to have manage the currency risk before the contract was signed. I understand the argument to be that, until the contract existed, the requirement for the euro payments was too uncertain for it to be defensible to incur expense in protecting the States against the currency risk.

369. On the one hand, there is evidence that the States' approval of the procurement on 9 July 2008 was not regarded as final at least by some members of the States. For example, on 28 August 2008, the Connétable of St Helier lodged a proposition inviting the States to agree that final planning permission should not be given until a public inquiry had been held. The commencement of such an inquiry would have had the effect of delaying planning approval so that the EPC contract could not be signed before the end of the period agreed with the preferred bidder. Had this happened, the bidder would have been entitled to re-visit and re-calculate the tender and it may have proved necessary to repeat the tendering process.

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[72] The relevant extract from the Briefing Paper is set out in full in Section Four of this report (18 May 2008).

370. Thus there were grounds for considering that it would be unwise to hedge the currency risk until the EPC contract had been signed.

371. Nonetheless, T&R is responsible for ensuring that the States' financial risks are managed effectively. In this case, that could have been done by transferring some of the States' liquid resources into euros immediately. Whilst this would have led to a cost in terms of interest foregone (because the interest in sterling happened to be higher than that in euros) the reduction in the States' exposure would have been considerable.

372. It has also been suggested to me that this was a responsibility of T&TS rather than T&R.

373. I do not share this view.

374. P73/2008 dealt with this matter in the following way:

> *"As with all States capital projects the Treasury will monitor and manage the fluctuations risk."*[73]

375. In short, as at 10 July 2008, T&R should have re-considered the currency exchange rate exposure (as promised) and should have taken appropriate steps to manage that exposure.

Why was this action taken?

376. The options for managing the euro exposure should have been considered in the briefing paper that was to have been prepared for the Minister once the States had approved the procurement.

377. The preparation of such a paper would have been the responsibility of SIMT&R who of course wrote the original Briefing Paper that proposed the preparation of a further paper in due course. I have not been able to establish why this further paper was not prepared.[74]

378. As I have indicated above, there was reason to be concerned that the States' approval on 9 July 2008 might not prove to have been final. This would suggest that, in the conditions of the

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[73] The full extract from P73/2008 is set out in Section Four of this report (20 May 2008).

[74] The former SIMT&R has told me that he was given to understand that it would not be appropriate to incur costs in hedging the Euro liability before the EPC contract was signed. Senior officers within T&R have denied that this was the case.

time, there may have been reason for avoiding what might have proved to be the pointless expense of hedging an euro liability that did not arise.

379. In retrospect, it may appear that if the States' risk had been hedged from the day on which the States approved the procurement (as SIMT&R had originally proposed) a substantial increase in the cost of the procurement would have been avoided. However this retrospective view does not necessarily mean that the failure to act was unreasonable.

What should have been done?

380. The straightforward action would have been to transfer some of the States' liquid resources from sterling into euros.

381. Alternatively, T&R could have made forward purchases of euros or to have bought an option as originally considered by SIMT&R.

382. It has been suggested to me that these steps would have been difficult because there was uncertainty about the total amount of euros that would be required and the precise payment programme.

383. I do not share this view.

384. Firstly, although there was some uncertainty about the design of the project most of that uncertainty related to other aspects of the project other than the EPC contract which gave rise to the commitment to make payments in euros. In fact, between 10 July 2008 (when the States approved the procurement) and 14 November 2008 (when the contract was signed) there was no change in the total amount of euros payable.

385. Secondly, although there was uncertainty over the precise payment timetable, this would have been irrelevant if the euros had simply been purchased in July 2008. If the States had decided to buy the euros forward, I understand that the terms could be varied inexpensively if the payment programme had changed in negotiation.[75]

386. In short, steps could have been taken in July 2008 which would have eliminated, or at least limited, the States' euro exposure.

75 Information given to me by HSBC.

Conclusions

387. The conclusions that I have reached in respect of the action taken on 10 July 2008 may be summarised in the following way:

What action was taken?

388. No action was taken to fix the exchange rate for the contract.

Was the action appropriate?

389. I believe that the action was not unreasonable in the sense that there remained some question whether the States' approval would prove to have been final and it was in any case consistent with the statements made to the States in P73/2008.

Why was this action taken?

390. The promised briefing paper was not prepared because there was thought to be material doubt whether the States' approval for the procurement would prove to have been final.

What action should have been taken?

391. The most straightforward approach would have been to transfer some of the States' liquid funds into euros.

SECTION EIGHT ~ COST OF THE PROCUREMENT

Introduction

392. In this section of the report, I will consider the overall cost of the procurement of the EFW plant and the effect on that cost of variations in the cost of acquiring euros.

Proposed cost

393. The report attached to Proposition P73/2008 indicated that the total cost of the procurement would be £106.31 million.[76]

394. However, that figure was merely an estimate of the probable cost of the procurement as the Engineering and Procurement Construction Contract (EPC) was partially subject to currency risk with certain agreed payments being quoted in euros. Inevitably, the rate of exchange used in P73/2008 was that which applied in May 2008 when the Proposition was lodged au Greffe. By 9 July 2008, the rate of exchange had changed.

395. It was intended that the Euro/Sterling rate would be deemed to freeze on signing of the contract. Consequently, the total cost of the procurement would not be known until the contract was signed.

[76] Paragraph 2.3.

396.

397. If the Euro/Sterling rate had indeed been frozen at the date of signing the contract, the total cost would have been as follows:

	As at 14 November 2008		*P73/2008*
	£million	*£ million*	*£million*
EPC price as reported in P73/2008		92.265	92.265
Add:			
(1) scope adjustments	-0.834		1.089
(2) architectural requirements	3.918		
(3) JEC interface clarifications	0.179		
(4) PI insurance			
(5) Advanced Payment Bond	0.094		
		3.357	
EPC price as at 14 November 2008		95.622	93.354
Enabling works		3.627	3.627
JEC agreement		0.397	0.397
JEC agreement variations		0.133	
Decommissioning		2.083	2.083
Project management		6.845	6.845
Project management – additional requirements		0.260	
Sub-total		108.967	106.306
Add: Exchange rate movement		5.263	
TOTAL PROJECT COST		**114.230**	**106.306**

398. This was the cost within the contemplation of the States when the procurement was approved on 9 July 2008 because P73/2008 indicated that the sterling equivalent cost of the agreed payments in euros would be fixed as at the date of signing the contract.

399. The costs shown above can be reconciled to each other in the following way:

	Million	*Million*
Total Project Cost per P73/2008		106.31
Additional costs through negotiation and design changes		
(1) Changes in EPC price	2.26	
(2) Changes in JEC agreement	0.13	
(3) Project management	0.26	
		2.65
Sub-total		108.96
Additional sterling cost equivalent to euros		
Euro payments translated at November rate (1.1693)	64.73	
Euro payments translated at P73/2008 rate (1.2729)	59.46	
		5.27
TOTAL PROJECT COST AT 14 NOVEMBER 2008		**114.23**

400. In assessing the effect of currency fluctuations on the total cost of the procurement, I have used the cost as at 14 November 2008 as a benchmark.

Cost of the approach being adopted by the States

401. The approach being adopted by T&R to the purchase of the necessary euros has been explained in foregoing sections of this report.

402. At the date of this report, the first payments have been made and, since the exchange rate has not reached the triggers, further euros have not been purchased. As no options have been purchased, it has been assumed for the purpose of this calculation that the remaining euros will be acquired at the rate ruling on the day of purchase and this has been assumed to be equal to the exchange rate at the date of this report.

403. On this basis, the total euro cost will be:

	Euros	*Exchange rate*	*Sterling cost*
Payments made to 23 February 2009	28,265,183	1.075	26,287,919
Euros acquired at trigger point and held to meet future claims	3,948,715	1.150	3,433,665
Sub-total	32,213,898		29,721,584
Payments remaining to be paid	43,476,773	1.143	38,070,729
	75,690,671		**67,792,313**

404. The calculation of the sterling equivalent cost of payments remaining to be paid is based on the rate ruling on 23 February 2009. On this basis, the sterling equivalent cost exceeds by £3.06 million the equivalent cost included in the Total Project Cost as at 14 November 2008.

405. Thus on this basis the Total Project Cost will be £117.29 million.

406. The TT&R and DTT&R have suggested that my approach is unrealistic and does not take account of the possibility that the exchange rate may move favourably with the result that the total cost of acquiring euros may be substantially less than the above table suggests. They also suggested that I might use published exchange rate forecasts as the basis for this calculation.

407. I acknowledge that actual exchange rates may prove to be more favourable than the rate I have used above. However, I do not think that it is good practice to take account of favourable exchange rate movements that have yet to occur. Moreover, during the past year (which admittedly was exceptionally turbulent) published forecasts were most unreliable.

Decision points: alternative strategies

408. I have made calculations of the effect of 'fixing' the rate of exchange at various other dates so that they may be compared with the current estimate of the cost of the approach to acquiring euros which is currently being followed. For this purpose, I have assumed that the States would adopt the simplest approach: i.e. that on each of the days chosen, the States would

have purchased the total amount of euros at the ruling exchange rate. I acknowledge that in practice a different approach might have been adopted, but calculations on this basis are straightforward. The dates I have chosen for comparison are:

(1) 14 November 2008: the date on which the contract was signed and on which the States would have expected the exchange rate to be fixed.

(2) 17 December 2008: This was the day on which the States settled on the approach to acquiring euros which is currently being applied. I have assumed that the States bought euros at this date to meet all of the payments that are to be made.

(3) 10 July 2008: This was the day following the States' approval of the procurement. I have assumed that the States bought euros at this date to meet all of the payments that are to be made.

Decision point: 14 November 2008

409. If euros had been purchased at the rate ruling on 14 November 2008 (1.1693[77]), the cost of the procurement would have been as shown in the table of Total Project Cost set out above.

Decision point: 17 December 2008

410. Had the total amount of euros required been purchased at the rate ruling on this day (1.0769), the sterling equivalent cost would have been £70,285,700.

411. This would have exceeded the sterling equivalent cost as at 14 November 2008 by £5.56 million and would have implied that the Total Project Cost would be £119.79 million.

Decision point: 10 July 2008

412. Finally, if the States had bought euros on 10 July 2008, the day after the States approved the procurement, the sterling equivalent cost of the euro payments would have been £60,431,673[78].

77 Per Bank of England database.
78 The rate of exchange on that day was 1.2525, per the Bank of England database.

413. This would have been £4.30 million less than the sterling equivalent cost included in the Total Project Cost as at 14 November 2008 and would have implied that the Total Project Cost would be £109.93 million.

Summary

414. The results of these calculations may be summarised in the following way:

	Sterling equivalent cost of Euros	*Total Project Cost*	*Variation in cost*
14 November 2008 – contract signing Assuming that all euros had been bought at rate ruling on the date on which the contract was signed	64.73 m	114.23 m	-
Current approach Actual approach now being used by T&R (estimated using rates ruling at the date of this report and thus still subject to currency fluctuations)	69.75 m	117.29 m	+£3.06 m
17 December 2008 – the date on which the current approach was adopted Assuming that all euros had been bought at the exchange rate ruling on this day	70.29 m	119.79 m	+£5.56 m
10 July 2008 – the day following the States' approval of the procurement Assuming that all euros had been bought immediately the States approved the procurement	60.43 m	109.93 m	-£4.30 m

APPENDIX ONE ~ TERMS OF REFERENCE

1. This review is commissioned in accordance with the powers of the Comptroller & Auditor General as set out in the Public Finance Jersey Law 2005 to take place in the light of:

(1) the States' approval of the procurement of an Energy from Waste (EFW) Plant;

(2) the agreed contractual arrangements surrounding that procurement;

(3) the fact that the contractual arrangements require that a significant element of the consideration payable by the States shall be paid in euros rather than in sterling;

(4) the fact that this requirement for payment in euros exposed the States to a risk of changes in the effective cost of the procurement as a result of exchange rate movements; and

(5) the public concern that the States should take, but may not have taken appropriate steps to manage their exposure to this risk.

2. The purpose of the review is to examine:

(1) the circumstances surrounding the issues which given rise to the public concern mentioned in paragraph 1 above;

(2) the steps that have been taken to manage the States' exposure in respect of the EFW procurement for the period from the States' approval of the procurement to the beginning of 2009 and the adequacy of those steps;

(3) the adequacy of the arrangements that are now in place to manage the States' future exposure to such risk in respect of the EFW procurement; and

(4) any other detailed matters that appear relevant to items (1) to (3) above and the issues to which paragraph 1 above refers.

3. After my initial enquiries, I will consider whether other matters should be added to paragraph 2.

4. The outcome of the review will be a report prepared and published in accordance with the provisions of the Public Finance Jersey Law 2005.

5. I intend that this report will be completed and published in the shortest time possible.

APPENDIX TWO ~ PEOPLE WHO PROVIDED INFORMATION FOR THIS REPORT

The list below sets out all of those people who provided information in the course of the review which led to this report.

People whose names are marked with a single asterisk ***** were interviewed for the purpose of this report. Those marked with a double asterisk ****** were interviewed by telephone.

Name	*Department/Organisation*	*Position*
Barratt, Jonathan*	HSBC	Relationship Manager
Black, Ian*	T&R	Treasurer of the States
Butler, George**	Formerly T&R	Strategic Investments Manager
Cohen, Senator FE**	States of Jersey	Planning and Environment Minister
Farrington, Nick**	Deloitte	Assistant Director
Foster, Ray*	T&R	Assistant Director, Finance and Investments
Gardiner, Will*	T&TS	Director, Waste Strategy Project
Hager, David*	Hewitt	
Heath, Jenny**	T&R	Investments Manager
Hemmings, Kevin*	T&R	Head, Decision Support
Lusby, Stuart**	T&TS	Head of Shared Services
Pope, Jonathan**	RLAM	
Richardson, John*	T&TS	Chief Officer
Turner, Jason*	T&R	Deputy Treasurer
Washington, Maria*	T&R	Regulatory Adviser

APPENDIX THREE ~ LIST OF ABBREVIATIONS USED IN THIS REPORT

Abbreviation	*Denotation*
ADFIT&R	Assistant Director Finance and Investment, T&R
ADSWSPT&TS	Assistant Director Solid Waste Strategy Projects, T&TS
BPS	Basis points
CMD	Chief Minister's Department
CNIM	The preferred bidder and subsequently contractor
COT&TS	Chief Officer, T&TS
CSBC	Jersey company established by CNIM, the preferred bidder
DTT&R	Deputy Treasurer
DWMT&TS	Director Waste Management, T&TS
DWSPT&TS	Director Waste Strategy Project, T&TS
EFW	Energy from Waste Plant
EPC	Engineering and Procurement Construction Contract
EUR	Euro
FDT&TS	Finance Director, T&TS
GBP	Pound Sterling
HODST&R	Head of Decision Support, T&R
HOSST&R	Head of Shared Services, T&R
IMT&R	Investment Manager, T&R
IOT&R	Investment Officer, T&R
JEC	Jersey Electricity Company
PI	Professional Indemnity
RLAM	Royal London Asset Management (Channel Islands)
SIMT&R	Strategic Investments Manager, T&R
TT&R	Treasurer of the States
T&R	Treasury & Resources Department
T&TS	Transport & Technical Services Department

APPENDIX FOUR ~ SCHEDULE OF PAYMENTS UNDER THE CONTRACT

Cost in Euros	*To be paid by*
16,986,675	December 2008
10,227,224	January 2009
1,052,285	February 2009
119,826	April 2009
675,826	June 2009
675,826	August 2009
10,227,224	October 2009
119,826	November 2009
3,519,835	December 2009
110,760	January 2010
3,409,075	February 2010
6,884,606	March 2010
88,608	April 2010
3,409,075	May 2010
88,342	July 2010
3,409,075	August 2010
2,270,720	September 2010
2,727.260	October 2010
3,484,167	November 2010
2,420,904	March 2011
2,079,996	June 2011
1,704,536	June 2012

€75,690,671

APPENDIX FIVE ~ EFW FUNDING OPTIONS PAPER (6 NOVEMBER 2008)

(This Appendix consists of the text of the paper prepared by HODST&R and submitted to the TT&S and DTT&S on 6 November 2008. The original paper was accompanied by a table which set out a brief description of each of the options considered)

Background

The contract for the main works in relation to the Energy from Waste Plant is to be signed imminently (target date is 14th November). The States agreed to fund the works internally. The contract sum is fixed in euros and is c. €75 Million. The States need to establish the most cost-effective and efficient approach to making euro payments, which are spread across two and a half years (see attached schedule). Managing exchange rate risk is paramount. There is an opportunity to fix the rate as at the date of signing the contract for a one-off payment of c£1.28 million.

Methodology

Five main options have been identified for making euro payments. These are:

(1) Fix the exchange rate as at the date of signing contracts for a one-off payment to the contractor of c£1.28 million.
(2) Deposit the full sum in a euro account and make payments when due.
(3) Make payments at the exchange rate prevailing at due dates.
(4) Purchase a series of forward contracts for the due dates at the date of signing contracts.
(5) Purchase a series of participating forward contracts for the due dates at the date of signing contracts. (50% would be at agreed rate, 50% at "capped" rate).

Each of these options was considered in terms of the following factors:

- Certainty
- Risk and
- Cost.

The results of this option appraisal are attached.

Other considerations

The airport receives approximately 7 million income in euros per annum. The Income Tax Office is also holding around €2 million in retention tax. There may be synergy in co-ordinating the States' approach to dealing in euros.

Conclusions

The most risky and potentially costliest option is to make payments at the exchange rate prevailing on the due dates. Whilst a favourable movement in exchange rates would benefit the States, the difference in the cost between the 52 week high and low rates would have been £7.8 million. This is considered to be too great a risk so the option has been discarded.

All of the other four options provide complete certainty for the States so cost is the deciding factor. The first option (paying c£1.28 million to fix the rate) would have essentially the same effect as depositing the full sum in a euro account although would involve commission payments. RLAM have confirmed there would be no additional charges for operating the euro account. The interest earned on euros would, however, be slightly less than sterling (differential c0.75% per RLAM) equating to c£440k.

Advice was sought from the States' Investment Advisers (Hewitt). Their recommendation was to purchase a series of forward contracts. HSBC could operate these straightforwardly and this would appear to be the second cheapest option (by c£245k). Participating forward contracts are another option. With these should the sterling rate against the euro improve dramatically, the States would benefit from these improved rates but be protected from adverse moves. This option appears to be only 4th cheapest.

Advice was also sought from RLAM. For ease of operation they recommend operating a euro account and depositing the full sum prior to first payment. With this option the States would retain flexibility e.g. could deposit other euros received but not currently earning interest.

In summary this would appear to be a straight choice between operating a euro account and purchasing forward contracts. The euro account appears to be c£245k cheaper, more flexible and simplest.

Recommendation

It is recommended that RLAM be requested to open an interest-bearing euro account and that the full contract sum is deposited at a time of favourable exchange rate prior to the first payment date.

Head of Decision Support
6th November 2008