STATES OF JERSEY

PROPOSED BUDGET (GOVERNMENT PLAN) 2025-2028 (P.51/2024): SIXTEENTH AMENDMENT (P.51/2024 AMD.(16)) – COMMENTS

Presented to the States on 22nd November 2024
by the Council of Ministers

STATES GREFFE

COMMENTS

Background

The new Government Headquarters was constructed on land owned by the Public of the Island and the agreement in place with the building's Developer commits the Government to leasing the premises on completion and to providing a 99-year lease over the public land to the Developer. However, the Government has the option to purchase the building from the Developer and the Budget 2025-28 proposes that the Government of Jersey exercises this option.

There is a sound financial case for exercising the option to purchase, which is estimated to provide a financial return of more than £3.5 million in present value terms (£58 million in nominal terms) over the initial 25-year lease period compared to renting from the developer. An acquisition would also provide:

- security of tenure if, as is likely, the Government wishes to occupy the building at the end of the 25 year rental period

- greater flexibility for the Government to make modifications to suit its business needs

- a potential upside on valuation if the residual value of the building exceeds the conservative estimate used when calculating the financial return referred to above.

Investment by the Social Security (Reserve) Fund

The Social Security (Reserve) Fund (SSRF) maintains an internationally diversified investment portfolio to ensure it is able to fulfil its role to support the financial sustainability of the Social Security Fund.

When exploring the options to finance the purchase of the new Government Headquarters, officials responsible for managing the Fund's investments identified the purchase of the office, and its subsequent leaseback by the Government of Jersey, as a potential investment for the Fund. This led to a more detailed review by the independent Treasury Advisory Panel (TAP).

<u>Investment due diligence</u>

The SSRF has over £2 billion worth of assets held in its highly diversified investment portfolio. The proposed investment has been through the same governance process that is in place to direct the Fund's other investments.

Treasury officials have reviewed the proposal and sought external advice as necessary on key variables including the likely residual value of the building at the end of the initial lease period. The proposal was then reviewed by the TAP, an independent panel of investment experts that advises on the management of States Funds such as the SSRF. On analysis of the investment proposals, projected cash flows and proposed lease heads of terms, TAP was satisfied the investment would complement the existing allocation well and recommended approval of the investment on that basis.

<u>Benefits of the investment for the Fund</u>

The Council of Ministers shares Deputy Ozouf's concerns with respect to the need to protect the Social Security Funds given their critical role in the Island's social safety net. This is why the terms of the purchase have been carefully structured to reduce potential risks to the Fund and serve to improve its ability to meet its long-term objectives. This is includes:

- mirroring the commercial terms offered by the building's developer;
- transferring the building to the Fund for the purchase price of £91 million rather than then the higher market value estimated at more than £100 million given its occupation by the Government of Jersey, an AA-rated tenant, under an inflation linked lease;
- assuming a conservative residual value for the property at the end of the rental agreement.

The purchase of the building by the SSRF does not blur the lines between Fund investment and operational financing. It seeks to seize the opportunity for the Fund to take on an attractive investment with the follow-on benefit that the rental payments made by the Government of Jersey are retained in the public sector rather than being paid either to the developer or a third-party finance provider.

Reflecting the above, the Council of Ministers is keen to ensure the investment process is not politicised and that investment decisions continue to be taken in line with the independent expert advice from the TAP.

The TAP recommendation recognises the merits of the purchase and its ability to support the SSRF's investment strategy:

- **Rate of return** – the purchase is estimated to generate a rate of return equivalent to Jersey Retail Prices Index (RPI) plus 3% over the 25-year life of the initial Government of Jersey lease period. The Fiscal Policy Panel estimates the long-term trend rate of RPI at 2.4% so the anticipated internal rate of return for the Fund is 5.4%.

  There are a number of factors that could cause the actual rate of return to be higher. The return would materially improve if, as is likely, the Government chose to extend its lease after that period. As rental payments are linked to RPI, subject to a cap and collar arrangement, the rate of return would also increase if inflation was higher than anticipated.

  The Amendment suggests that only a 4.1% return would be achieved. It is not clear how this was calculated, but it appears to be generated by a simple extrapolation of the initial rental payment over the 25-year life of the agreement. This does not produce an accurate estimate of the rate of the return as it neither takes into account the cumulative effect of RPI linked rental payments nor the impact of the time value of money on the associated cashflows.

- **Marketability and liquidity -**

The investment represents 25 years of RPI linked cash flow from a government, backed by a commercial contract will all the protections an external commercial investor would expect.

Although expected to be held until the end of the lease, the characteristics of long term inflation linked cash flows makes the investment an attractive proposition, especially for pension funds looking to match their long-term inflation linked liabilities. Accordingly, we anticipate that there would be a ready market should the Fund wish to dispose of the asset. This has also been informally tested with external agencies who commonly trade similar assets.

The legal structuring of the investment has been designed to support the potential for SSRF to sell the investment to other buyers, subject to appropriate approvals. Equally, the inflation linked cashflows linked to the investment will increase in value if interest rates fall. These factors would further increase the marketability of the investment.

Regardless of whether SSRF decides to sell the investment before the end of the expected lease term, the investment generates significant cash flow through the annual rental payments. In the first 10 years of the lease agreement, around 50% of the initial outlay is projected to be returned in rental payments. This return would be faster if inflation over the period exceeds the 2.4% average projected.

Ultimately, at a little under 4% of the portfolio, the investment will have a negligible impact on the overall liquidity profile of the portfolio, though this will continue to be carefully monitored by TAP and the Actuary during the life of the investment.

- **Risk-adjusted return -** the investment in the office is estimated to allow the Fund to achieve its target return of RPI+3% while reducing risk. The investment represents a good risk-adjusted return.

  While the Amendment claims that the investment is not consistent with 'maximising returns for the Fund', the selection of investments is a balance between risk and reward and, like any well-constructed investment portfolio, the SSRF's investment portfolio is made up of assets with different risk-return ratios. Not all assets are intended to generate high returns. The portfolio deliberately contains a range of return seeking and lower risk, protective assets, which, in combination, are designed to achieve the Fund's target return over time.

  Although the asset is only a very small part of the portfolio, the characteristics are aligned with the protective assets in the portfolio. Cash flows are based on contractual rent, paid regardless of market conditions, and it is these guaranteed, low risk and inflation linked cash flows that will have a stabilising impact on the portfolio.

Conclusion

The decision for the SSRF to purchase the new Government Headquarters as an investment has been subject to the same rigorous investment decision-making process as that is in place for wider management the Fund's £2 billion portfolio. There is a sound financial rationale for the investment as has been confirmed by the Treasury Advisory Panel.

In line with the management arrangements for the wider SSRF portfolio, the investment remains under the oversight of the Treasury Advisory Panel. Leaving portfolio construction within the remit of an independent and expert panel allows the Fund to pursue a long-term strategy for the benefit of the ultimate beneficiaries of the Fund. Accordingly, the Council of Ministers urges members to reject the Amendment.