States of Jersey
States Assembly

États de Jersey
Assemblée des États

Corporate Services Scrutiny Panel

Future Hospital Funding Strategy

Presented to the States on 13th April 2017

S.R.4/2017

Executive Summary

The Future Hospital Funding Strategy (P.130/2016) sets out the proposals of the Minister for Treasury and Resources for funding Jersey's new hospital. In summary, the proposition sets out the maximum expenditure of £466 million, to be funded through the issue of a bond of up to £400 million and the balance from the Strategic Reserve Fund.

The Funding Strategy was originally lodged on 30th November 2016 and scheduled for debate on 17th January 2017. The debate went ahead, despite a number of requests by the Panel for a delay to enable it to complete a review. However following a proposal by the Deputy of St Ouen, the States Assembly agreed to refer the Funding Strategy to the Panel for a detailed review.

The Panel's review, informed by the work of its advisors, *Concerto Partners LLP* and *Opus Corporate Finance*, has followed the structure of the proposition and in particular has looked at the proposed budget and the proposal to fund the hospital through a bond and the Strategic Reserve. It has also considered questions surrounding the legal capacity of the States to borrow, following questions raised during the debate in January.

In summary, the review has found that:

- The cost to deliver the hospital should be a maximum of £392 million, excluding contingency.
- The processes used to develop the budget are robust and it has been rated as Amber-Green by *Concerto*. (For explanation of this term, please see the advisor's report in Annex B).
- The benchmarking work undertaken by the advisors to the Hospital Project Team shows that the hospital budget is at the upper end of the benchmark range
- There are important items excluded from the hospital budget which will need to be funded separately (such as the car park extension and demolition of some of the existing buildings)
- Control of contingency amounts needs to be clarified
- The Bond proposals are reasonable, if borrowing is considered the best way forward
- The sensitivity analysis completed on the proposals indicates that structural changes to States Revenue <u>could</u> have serious implications on the affordability of the bond interest without other measures being taken
- The possible implications of Brexit should be taken into consideration when looking at the funding options for the hospital
- An alternative option to borrowing £400 million would be to use the Strategic Reserve initially and recapitalise it over a 40 year period

Whilst the method used to arrive at the funding model appears sound, the Panel is concerned about the control of contingency and the possibility that the figure of £466 million will become a self-fulfilling prophecy. The amendments to the proposition lodged by the Treasury Department, in relation to contingency control, are welcomed by the Panel and address some of the concerns raised by the Panel during the review.

The sensitivity of the funding model for the bond interest (i.e. relying on the investment returns of the Strategic Reserve) particularly concerned the Panel. If there was a structural change to the Island's finances (for example as a result of Brexit), the Strategic Reserve could be seriously impacted.

This led the Panel to lodge an amendment to Treasury's proposals, which would use the Strategic Reserve to fund the hospital construction, with a recapitalisation mechanism put in place so that by 2060, the Strategic Reserve would be at the same level as if the bond had been taken out without the Island being required to take out further debt in a period of uncertainty.

The Panel considers that this gives States Members a realistic alternative during the debate on 18th April. If States Members consider that borrowing is the best option, then the proposals from Treasury are reasonable. However, if there is concern about the level of debt being taken on and the associated risks, there is an alternative option available.

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Chairman's Foreword

P.130/2016 proposes to borrow £400 million as soon as possible, and for that money to be placed into the Strategic Reserve ("SRF")[1]. It is likely that the bond will be for 40 years, and therefore £400 million will have to be repaid at the end of that period. From day 1, interest of around £10 - £12 million a year will be paid out of the SRF[2]. The proposition from Treasury is that the average historic returns on the SRF will be such, that the annual interest payments and the capital amount repayable will be comfortably met by the average returns arising on the SRF during the life of the bond.

These statements are not in themselves unreasonable, when solely looking at the historic performance of the SRF.

The Panel considers it essential that Members are cognisant of the following points:

1) This will exhaust our ability to borrow (under present Law).
2) The States are already committed to a significant level of liabilities. With the proposed bond, such liabilities (all of which will have to be repaid) would be increased to £1.1 billion and with future interest payments taken into account, this would increase to just under £2 billion.
3) The Treasury model indicates that minimal structural changes in our finances wipes out the SRF within 25 years. However, the debt and the annual interest repayments would still be due to be repaid for another 15 years.
4) In the context of Brexit, our advisers have commented that "*the future for the States of Jersey must be considered more uncertain now than at any time in the last seventy years…"*

Taking all of this into account, the Panel considered that it was important that States Members had a realistic funding alternative. This option enables the project to go ahead without delay, but does not commit the States (and future generations) to the largest single borrowing it has envisaged in a lifetime.

We therefore asked a question of Treasury:

'How much would we have to pay <u>into</u> the SRF for it to arrive at the same balance at the end of a 40 year period as is presently projected will be the case for the bond scenario?'

The response? £4.2 million per year (uplifted annually by RPI)[3]

Given that, in the context of the overall States budget, this is a relatively de minimis amount, we believe that this is a realistic and prudent option. It builds in flexibility for the future, and most importantly does not impinge upon the States' ability to borrow in the future should the

[1] Money will then be transferred into a Hospital Construction Fund, as and when required, and that Fund will be used to settle any expenses. At the conclusion of the hospital project, the fund will be closed and any outstanding balances transferred to the Strategic Reserve.
[2] Assumes an annual interest rate of between 2.5% and 3% on the bond.
[3] Provided via email to the Panel on the 3rd April 2017.

necessity arise. It still leaves a sizeable proportion of the SRF available for future use, and commits the States to recapitalising the SRF on an annual basis moving forward.

We note that in 2013 it was proposed that the hospital project would cost approximately £300million[4]. This was going to be funded without recourse to public debt. Since then (for the years 2013-2015) we have made approximately £165 million on the SRF and we understand that 2016 will also show good returns.

We consider the Panel's Amendment to be consistent with the prudent, financial management good practices for which Jersey is well renowned, and recommend it to members as a preferable option during the forthcoming debate.

This has been a technically challenging review to perform within the time available. We trust that Members will find it a useful aide in their deliberations for the continuation of the debate.

We thank the Treasury, Health and Department for Infrastructure teams for their assistance in providing us with information, and for co-operating where it has been possible, for example in the strengthening of controls over contingency.

We would also like to place on record our sincere thanks to our Scrutiny Officers who have worked tirelessly and for many many hours, in order to meet the very tight deadlines for the debate.

We find ourselves in a period of high levels of uncertainty both on the European and Global stages, unprecedented in the last 70 years. How this will resolve itself, and how this will impact on the Island and its ability to continue to service debt out of reserves, without depleting those reserves entirely, remains to be seen.

States Members need to be completely comfortable with the inherent risks associated with the type and level of borrowing being proposed by Treasury.

If however, like this Panel, States Members consider that a more prudent and risk averse funding approach needs to be taken at this moment in time, then the Panel's amendment should be supported.

This is ultimately a political decision; one which will have repercussions on many generations to come.

Deputy John Le Fondré

Chairman, Corporate Services Scrutiny Panel.

[49] Taken from the Draft Budget Statement 2014, https://www.gov.je/SiteCollectionDocuments/Tax%20and%20your%20money/ID%20Draft%20Budget%20Statement%202013%20Sections%20E%20and%20F%20JB%2020131007.pdf [Last Accessed: 210th April 2017]

Key Findings

Budget

1. The Panel's advisors, *Concerto*, have analysed the various components of the budget and have rated it as Amber-Green under the UK Government Gateway review process. This means that "successful delivery appears probable. However, constant attention will be needed to ensure risks do not materialise into major issues threatening delivery." (p15)

2. The hospital cost estimation is approximately £392 million excluding the allowance for "risk" (i.e. contingency). The risk allowance is £74 million. (p18)

3. Out of the 9 projects reviewed by *Gleeds* for benchmarking, Jersey's proposed new hospital was the third most expensive. (p20)

4. Outpatient services will be permanently located at Westaway Court under the Future Hospital proposals and not on the main hospital site. (p22)

5. With the permanent relocation of outpatient services to Westaway Court, this represents a two-site solution. (p22)

6. There are a number of important items excluded from the hospital cost estimation which are directly relevant to the project and the costs for which have not been quantified publicly. These include the extension to Patriotic Street Car Park, the demolition of the 1960s and 1980s blocks and the ongoing costs for the new off-site catering facility and the relocated staff accommodation. (p24)

7. In choosing the existing site, one of the advantages put forward by the Minister for Health and Social Services and was the option to develop a health campus. No plans have been produced to support this proposal and the costings have not been provisioned for within the budget. (p24)

Control of expenditure

8. At this early stage of the project there is scope for savings to be made within the current cost estimation, for example tenders coming in cheaper than originally budgeted for, efficiencies being found or certain elements of the project not being required. If these savings are banked, the project can be delivered below the current cost estimation. (p27)

9. P.130/2016 states that the Treasury Department is responsible for control of contingency, however the exact governance structure around contingency control is still under discussion. (p29)

10. A recent change in inflation assumptions was reallocated to fund additions to the hospital project. (p30)

Funding Options

11. The Panel's advisor, *Opus*, has examined the options considered by the Treasury Department and has assessed that borrowing *"would appear to be a pragmatic way forward".* (p38)

12. Third-party involvement in the hospital project, would provide oversight of decision-making structures and provide an element of risk reduction. (p39)

13. The option of funding the future hospital project solely from the returns on the Strategic Reserve was considered viable in 2014 for a project cost of £297 million but has been ruled out as an option for funding the higher cost of £466 million. (p42)

14. If it is considered that borrowing is the best way to fund the future hospital project then the proposals lodged by Treasury are reasonable. However, an alternative option proposed by the Panel is to use the Strategic Reserve initially and recapitalise it from internal sources. (p44)

15. Recent modelling by Treasury shows that if an amount of £4.2 million (increased annually by inflation) was paid into the Strategic Reserve each year until 2060, it would bring the Strategic Reserve back to the same level of £4.2 billion in 2060 as if the bond option had been followed, without taking on any debt. (p44)

16. The Panel considers that finding an amount of £4.2 million annually from internal sources to recapitalise the Strategic Reserve should be achievable. On this basis, the Panel has lodged an amendment to P.130/2016 in order to give States Members a choice between funding the hospital from internal measures or through the proposed Bond issue. (p44)

Strategic Reserve

17. The Investment Strategy for the Strategic Reserve will be important in ensuring that the interest on the proposed Bond can be serviced. (p54)

18. In order to ensure the Bond interest can be serviced, the Strategic Reserve cannot be used for other purposes for at least 10 years. (at the Panel's suggestion, this has been increased to 15 years in the recent amendment to the proposition lodged by the Minister for Treasury and Resources) (p55)

19. A permanent reduction in annual income of the States of £42 million (approximately 5%) over a long-term period would lead to the Strategic Reserve being overdrawn without other measures being taken. (p58)

20. The stress testing undertaken by Treasury shows that one off shocks can be coped with in the proposed funding strategy. However, permanent structural changes would require changes to the strategy. (p58)

21. The Panel's advisor has commented that the uncertainty presented by Brexit presents a choice to either take advantage of today's low interest rates or to be more cautious and allow time to see how and when the costs of the project pan out and to tailor the borrowing accordingly. (p59)

Borrowing Limit and capacity to borrow

22. When the Hospital Funding Strategy was initially debated in January 2017, the proposed level of borrowing (£400 million) was marginally below the permitted headroom under the Public Finances Law (£402 million). (p64)

23. The headroom for borrowing has increased to approximately £25 million. (p65)

24. Issuing a bond of £400 million would severely restrict the future borrowing ability of the States without changing the current restrictions imposed by the Public Finances Law. (p66)

25. Jersey's debt to GDP ratio is small, however comparisons of this ratio with sovereign nations is of limited value. Jersey is not a sovereign nation and the self-imposed borrowing limit as set out in the Public Finances Law is more relevant. (p67)

26. On a strict legal basis, the borrowing condition in the Public Finances Law has been met. However, it is important to be aware of all liabilities of the States when considering the further borrowing now being contemplated. The Panel estimates that total current and future liabilities would be just under £2 billion if the bond proposal is accepted. (p69)

27. For the purposes of the borrowing condition set out in Article 21(3) of the Public Finances Law, the Long-Term Care Charge is considered a tax. (p70)

28. It is clear from the schedule presented to States Members during the debate in January 2017 that if the Long-Term Care Charge had not been considered a tax, the proposed borrowing would have exceeded the available headroom at that time. The option that had been considered in this scenario was to change the borrowing limit in the Public Finances Law. (p71)

Recommendations

1. The maximum budget that the Hospital Project Team work to should exclude the "risk" elements of the budget (i.e. contingency) and should therefore be £392 million. Control of the majority of the "risk" part of the budget of £74 million should be external to the project team so that it is only used for genuine unforeseen costs. It should be recognised that both elements of the budget envelope are estimates and could reduce as actual costs are established. (p18)

2. Both elements of the budget envelope (i.e. capital cost and contingency) are estimates and could reduce as actual costs are established. The principle of external control should apply to all savings, (irrespective of whether they occur within contingency or within the capital cost element), and which should not be spent. (p18)

3. Any savings achieved from the hospital cost estimate of £392 million should not be reallocated to be spent elsewhere. Such savings should be retained by Treasury separate from Contingency, as a saving. (p18)

4. The benchmarking work undertaken at the request of *Concerto* should be developed further to ensure the relative cost of Jersey's project is fully understood. (p21)

5. There needs to be a considered decision made regarding the Health Campus and Westaway Court. The long-term future usage of both sites needs clarification, justification and full costing. (p22)

6. Plans for developing a health campus on the existing hospital site, the estimated costs and the proposed funding sources should be clearly set out by Ministers by July 2017 when the detailed funding proposals for the hospital are brought before the States. (p25)

7. The finance costs associated with the construction period should be clearly set out when the detailed funding proposals for the hospital are brought before the States. (p25)

8. The Minister for Treasury and Resources should publish by Ministerial Decision any significant changes to the composition of the cost estimate outlined in P.130/2016 where savings or changes in assumptions are proposed to be reallocated within the project. This should cover both the period up to July 2017 when the detailed budget is brought to the States and subsequently as the project develops. (p34)

9. Contingency controls should be finalised as soon as possible and included in the detail of the final budget when it is brought back to the States in July. This should include reference to material savings arising from changes in assumptions or where costs turn out to be lower than budgeted for. (p34)

10. Third-party oversight of the hospital project should be explored in greater detail, before the project progresses further. (p39)

11. The Panel's advisors have made a number of recommendations in their reports about the detail of the Future Hospital Project. Ministers should ensure that these recommendations are all acted upon. (p50)

12. Irrespective of the outcome of the debate on the Future Hospital Funding Strategy, the Minister for Treasury and Resources should bring forward proposals for an annual capitalisation of the Strategic Reserve. (p51)

13. The articles of the Public Finances law in relation to borrowing and lending should be reviewed to ensure clarity of definitions, particularly in relation to the definition of "borrowing". (p72)

14. The Public Finances Law sets the parameters around which the States considers its financing options. The self-imposed borrowing limit set out in the Public Finances Law should be considered as prudent financial management and not subject to change if additional borrowing is considered in the future. (p72)

1. Hospital Budget

1. The budget for Jersey's new hospital is outlined in the Future Hospital Funding Strategy (P.130/2016).

2. The Proposition asks the States to agree:

> *"…expenditure up to a maximum of £466 million for the main construction project and all associated costs including relocation (and including contingencies) of a new Jersey General Hospital".*[5]

3. This figure is broken down into the following elements:

Provisional cost estimation	**Total £**
Works Cost after location factor	213,004,188
Fees	31,950,628
Non-Works Costs	15,419,921
Equipment	18,650,035
Risk	74,108,981
Inflation	68,751,737
Main project costs	**421,885,490**
Relocation Costs	39,932,329
Inflation	4,092,597
TOTAL COST	**465,910,416**

Source: P.130/2016[6]

4. The proposition highlights that this is a cost *estimation* and the figures will therefore be subject to change.

[5] P.130/2016 "*Future Hospital Funding Strategy*" (*http://www.statesassembly.gov.je/AssemblyPropositions/2016/P.130-2016.pdf*) *[Last Accessed: 4 April 2017]*
[6] P.130/2016, p6

5. The Panel's advisors, *Concerto*, have analysed the various components of the budget and have rated it as **Amber-Green** under the UK Government Gateway review process. This means that **"successful delivery appears probable. However, constant attention will be needed to ensure risks do not materialise into major issues threatening delivery."**

6. *Concerto* also commented that,

> *"Our view is that the processes used by the project team to develop and validate the budget are robust and that the amount of contingency funding within the declared budget looks sufficient in relation to the risks".*[7]

Key Finding - The Panel's advisors, *Concerto,* have analysed the various components of the budget and have rated it as **Amber-Green** under the UK Government Gateway review process. This means that **"successful delivery appears probable. However, constant attention will be needed to ensure risks do not materialise into major issues threatening delivery."**

Works cost after location factor - £213 million

7. This is the estimated cost of constructing the new hospital. It is based on standard UK hospital cost guides known as Health Premises Cost Guides (HPCG).

8. The standard HPCG allowances have been reduced by 15% in the case of this particular project, which the Panel understands is not unusual in hospital construction projects.

9. The works costs also include a "location factor", which is a percentage increase applied to the standard UK building costs to take account of the additional costs of building in Jersey. The exact amount is confidential, but is based on the *Royal Institute of Chartered Surveyors* Building Cost Information Service (BCIS) indices. *Concerto* note that the BCIS data is limited for projects of a similar nature and size in Jersey and therefore the allowance is difficult to assess accurately at this stage[8].

10. The cost estimation will be refined in July 2017, however a more realistic quantification of the costs for the project will only be known once the tendering process has been completed.

[7] *Concerto*. *Cost Assurance Report, Future Hospital Funding*. p2
[8] *Concerto.* p4

11. Whilst the cost estimations will be brought back to the States in detail later this year, the advisors to the Panel have assessed that the current estimations are *"at the upper end of the expected range".* The Panel notes that it should therefore be possible for some of the costs to come in below the amounts included in the current cost estimation.

Fees - £31.9 million

12. *Concerto* confirm that this is a standard industry allowance of 15%. The main advisor on the project is *Gleeds Management Services*, a UK property and construction consultancy firm with extensive experience of NHS hospital construction.

Non Works costs - £15.4 million

13. Non Works costs includes an allowance for the Percentage for Art scheme, other ancillary costs and an allowance of £9.5 million for acquisition of neighbouring properties on Kensington Place.

Equipment - £18.6 million

14. *Concerto* confirm that a 15% industry standard allowance has been included and a detailed strategy is now being prepared. This is based on an assumption of mostly new equipment in the new hospital.

Risk - £74.1 million

15. The Risk part of the budget is split into two main sections: Contingency; and Optimism Bias. The Contingency allowance of 12% is intended to cover unforeseen changes during design and construction.

16. The Optimism Bias allowance of 13% is based on UK Government standards. The explanation of Optimism Bias contained in the guidance published by HM Treasury is:

> *"Project appraisers have the tendency to be over optimistic. Explicit adjustments should therefore be made to the estimates of a project's costs, benefits and duration, which should be based on data from past or similar projects, and adjusted for the unique characteristics of the project in hand."*[9]

17. In their high level comments on the budget, *Concerto* have commented that:

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[9] HM Treasury Green Book Supplementary Guidance, (https://www.gov.uk/government/publications/green-book-supplementary-guidance-optimism-bias) [Last Accessed: 4 April 2017]

"Construction allowance on low side for project of this type and nature at such an early stage but taken with Optimism Bias seems reasonable".

18. Control of Contingency spend in projects such as this is critical in ensuring that expenditure remains under control. In particular, contingency should be set aside to fund both the weighted costs of the known risks listed on the risk register and the costs of the unforeseen risks that often develop and should not be viewed as an additional source of funding for the project.

19. Section 6 of this reports explores control of contingency in more detail.

Inflation - £68.7 million

20. An allowance has been made for inflation based on BCIS indices. *Concerto* have commented that inflation predictions can be subject to fluctuations. This is borne out in recent changes to the inflation index suggesting that inflation will be lower than previous forecast. This has resulted in a £13 million reduction in the inflation allowance for the hospital project.

21. The Future Hospital Project Board were informed by the Accounting Officer, of a decision to reallocate £11 million of these potential savings to fund various changes to the scope of the project. [10] The principal of these concerns was the new outpatient facility to be built at Westaway Court. The existing buildings will now be demolished and rebuilt instead of the original plan to refurbish them.

Relocation Costs - £39.9 million + inflation of £4 million

22. The Relocation Costs relate to work required to enable the existing hospital to continue to function whilst the new one is being constructed. These are costs that are specific to this site. In particular, this takes into account the need to relocate services located in parts of the hospital which will need to be demolished (i.e. the Gwyneth Huelin Wing), in order to create a clear site for the new building to be constructed on.

23. The costs include relocating the catering facility to an external site (but not the ongoing leasing costs of the facility), constructing a temporary block in the current car park of the General Hospital and relocating outpatient services to Westaway Court[11].

[10] This was identified at the end of the review process and the Panel are now seeking confirmation.
[11] *Gleeds* Capital Cost Report

24. Some of the relocations will be temporary. However the relocation of the catering facility and outpatients services will be permanent.

Total Cost - £465.9 million

25. The total cost, including all the above elements, is approximately £466 million. As this includes a contingency allocation for unforeseen items, the Panel considers that the actual budget the Hospital Project Team works to should **exclude** the risk elements of the budget and therefore should be approximately **£392 million**.

26. The Panel firmly considers that a significant part of the "risk" part of the budget should be subject to separate tight controls. This should be external to the Hospital Project Team, so that it is only utilised for genuine unforeseen costs. This will help ensure budgetary discipline and help to control expenditure.

Key Finding – The hospital cost estimation is approximately £392 million excluding the allowance for "risk" (i.e. contingency). The risk allowance is £74 million.

Recommendation – The maximum budget that the Hospital Project Team work to should exclude the "risk" elements of the budget (i.e. contingency) and should therefore be £392 million. Control of the majority of the "risk" part of the budget of £74 million should be external to the project team so that it is only used for genuine unforeseen costs. It should be recognised that both elements of the budget envelope are estimates and could reduce as actual costs are established.

Recommendation- Both elements of the budget envelope (i.e. capital cost and contingency) are estimates and could reduce as actual costs are established. The principle of external control should apply to all savings, (irrespective of whether they occur within contingency or within the capital cost element), and which should not be spent.

Recommendation – Any savings achieved from the hospital cost estimate of £392 million should not be reallocated to be spent elsewhere. Such savings should be retained by Treasury separate from Contingency, as a saving.

Benchmarking

27. A number of questions have been raised about the cost of Jersey's new hospital in comparison with hospitals situated elsewhere.

28. The Future Hospital website contains a broad explanation of the difficulties of making comparisons with other hospitals:

> *"It is difficult to compare costs to other hospitals in the UK as each Hospital Trust belongs to a network of other hospitals nearby which provide different services. Being on an Island, we provide a general hospital service to ensure we can treat the emergency admissions we have each year as well as providing services that prevent off-island trips for small procedures for Islanders. This is no longer the model adopted in the majority of Trusts in the UK. Therefore, there is no equivalent to compare with on a true like-for-like basis."*[12]

29. In a Public Hearing with the Minister for Infrastructure, the advisers to the Hospital Project Team explained the difficulties,

> ***Lead Technical Adviser, Gleeds:***
>
> *"It is very commonplace for people to quote figures, so people to say: "Well, I spoke to someone and they said that their hospital cost £3,000 a metre squared" and that appears a lot. The danger of that is that it may well have cost £3,000 a metre squared but it may have been built 15 years ago and it may be a very different type of hospital or they may not have accounted for all the things…"*[13]

30. Some strategic benchmarking had been carried out by *Gleeds* against two similar projects in the UK. At the request of the Panel's advisers, this work was expanded to include a further seven relevant hospitals. The resulting report was compiled over a weekend in order to meet the timescales for the review and contained the raw data, but no accompanying commentary or analysis.

31. The Panel's advisors requested that *Gleeds* conduct further benchmarking than was originally produced. Following this, the sample size *Gleeds* used for benchmarking

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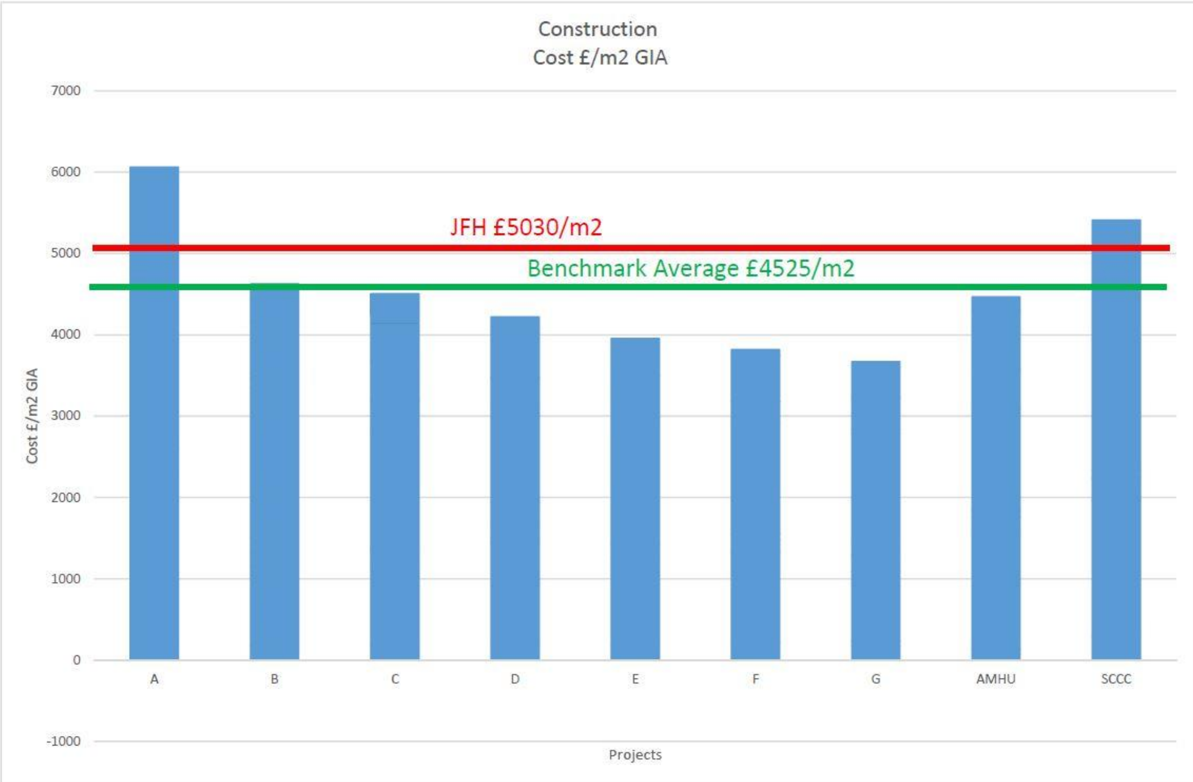
[12] Future Hospital Website *FAQ* (https://www.futurehospital.je/faq/) [Last Accessed: 4 April 2017]
[13] Public Hearing Transcript. *Corporate Services Scrutiny Panel Future Hospital Funding Strategy Review* (17th March) p29 http://www.statesassembly.gov.je/ScrutinyReviewTranscripts/2017/Transcript%20-%20Future%20Hospital%20Funding%20Strategy%20-%20Ministers%20for%20Infrastructure%20and%20Health%20-%2017%20March%202017.pdf [Last Accessed: 12 April 2017]

purposes was increased from 2 to 9 projects. The cost per square metre of these 9 projects positions Jersey at the upper end of the range of benchmarking. This is shown in the graph provided by the Hospital Project Team, as below:



Source: Hospital Project Team.[14]

32. *Concerto* have commented that:

> *"…While it is prudent at this relatively early stage in such a complex project to have a conservative budget, further work should be undertaken to mature the benchmarking report…"*

33. The Panel agrees that it is important to develop the benchmarking work further before the final budget is brought to the States for approval.

Key Finding – Out of the 9 projects reviewed by *Gleeds* for benchmarking, Jersey's proposed new hospital was the third most expensive.

[14] Provided to the Panel, following anonymisation, on the 11 April 2017. Found here: http://www.statesassembly.gov.je/ScrutinyReviewSubmissions/Submissions%20-%20Future%20Hospital%20Funding%20Strategy%20-%20Future%20Hospital%20Project%20Team%20-%2011%20April%202017.pdf [Last Accessed: 11 April 2017]

Recommendation – The benchmarking work undertaken at the request of *Concerto* should be developed further to ensure the relative cost of Jersey's project is fully understood.

Project scope and excluded items

34. The Panel was told that the new hospital will broadly be a like-for-like replacement for the existing hospital,

> ***Hospital Managing Director:***
>
> *"It is broadly like for like. It will be up to today's standards, so that automatically makes it bigger. It will have more beds, more theatres and more space for today's activity moving forward with the ageing population."*[15]

35. The current hospital has approximately 250 beds and the new hospital will provide 287 beds. Within this total, the number of adult beds will increase from 132 beds to 192 beds.[16]

36. The construction project will be concentrated towards the southern end of the existing site. Additional work will also be undertaken at Westaway Court and at another location for the provision of an off-site catering facility.

37. The relocation of outpatient services to Westaway Court will be permanent. For comparison, the work required to demolish the existing buildings and construct a new purpose built facility on this site will be similar in scale and cost to the recently completed Police Station at Green Street.

38. The use of Westaway Court temporarily during the construction period is understandable from a logistical point of view, in order to create a clear site for the new hospital to be constructed on. However, as the facility is intended to be permanent, it is not clear to what extent the move is driven by long-term strategic considerations rather than short-term practical ones.

39. In an email to the Panel on the 7 April 2017, the Hospital Project Team confirmed that the "proof of concept" proposed a permanent relocation of outpatients to a refurbished

[15] Public Hearing Transcript (17 March 2017) p14
[16] Public Hearing Transcript (17 March 2017) pp.57-58

building. The change made since the proof of concept, has been the decision to rebuild the site rather than merely refurbish it.

40. The possibility of the current hospital site being used as a “Health Campus” in the future has been put forward as one of the advantages of rebuilding on the existing site. This would see a number of different health services located on a single site. It would seem reasonable, therefore, to ask whether the long-term location for the outpatient facility should in fact be within the Health Campus on the existing hospital site.

Key Finding – Outpatient services will be permanently located at Westaway Court under the Future Hospital proposals and not on the main hospital site.

Key Finding – With the permanent relocation of outpatient services to Westaway Court, this represents a two-site solution.

Recommendation – There needs to be a considered decision made regarding the Health Campus and Westaway Court. The long-term future usage of both sites needs clarification, justification and full costing.

41. The impact of Westaway Court on the critical path of the project was expanded upon by the Chief Officer of the Department for Infrastructure:

> ***Chief Officer, Department for Infrastructure:***
> *“We are at the point where we are trying to move this forward quickly in a very politicalised environment. That was one of the options. The challenge we face is not that decision to knock it down or rebuild it. The challenge is its effect on the critical path of the programme. Now, what my job is and the team’s job is how do we shorten that critical path element and get this so we can take away that risk in terms of critical path? Now, the initial thinking was: “Let us repurpose it and that will shorten some time.” That is a very quick decision and it is a decision made in the position we are in. Looking at it, once you have got a bit more time, a bit more detail, you think: “The added value you will get from this, we will then try and mitigate that by delivering it in a different way and perhaps a quicker way, in a way which means the outcome is better.”*

42. The initial decision to repurpose the existing buildings at Westaway Court was clearly taken in the context of needing to quickly develop the overall proposals for this site option. Further consideration has now been given to the best technical option on that

site which has resulted in the decision to demolish the buildings and build a new facility[17]. However this is not the same as considered strategic planning for the location of the outpatient facility, despite prior decisions to relocate outpatient services there.

43. *Concerto* have highlighted that the timings of the project over the next 12 months are extremely tight and this change will add 3 months to the project programme[18]. It would therefore be difficult at this stage to reassess the plans for Westaway Court without causing serious knock on delays later in the project. However, there is a danger that a costly new facility will be developed as a by-product of the hospital project, without sufficient long-term strategic planning having been undertaken.

44. There are a number of important items which are excluded from the total estimated cost of £466 million. These include:

Extension to Patriotic Street Car Park	It has not yet been decided whether an extension to the car park will be required. It had previously been suggested that any extension to Patriotic Street Car Park would be funded from other sources, although in the Public Hearing with the Minister for Infrastructure, the Panel was told that it was now hoped that part of the funding would come from the Hospital budget.
Demolition costs of 1960s and 1980s blocks	No allowance has been made for the costs of demolishing the redundant existing hospital buildings once the new hospital is completed. In particular, this relates to the 1960s and 1980s blocks facing The Parade.
	Plans for possible future uses for the site will be brought forward as part of the planning application for the overall scheme, but it is important to note that this is not funded at present.
Leasing costs for the new off-site catering facility	Although the catering facility is currently located in the existing hospital, its operating model means that there is no need for it to be located within the hospital. This will free up space within the hospital, although it means that an ongoing leasing cost will be incurred.

[17] *Gleeds*, Westaway Feasibility Report, October 2016
[18] *Concerto*. pp.8-9

The cost of financing the debt	The total interest payable on the bond is estimated to be between £393.6 million and £450 million (depending on the interest rate achieved)[19] The Panel's advisor, *Opus*, has commented that it would be usual for the interest during the construction period to be included in the overall project cost, but it has not been in this case.
Costs of rehousing Health staff accommodated in Westaway Court	Staff accommodation will be outsourced to a third party provider which, as with the catering facility, will free up space but will have an ongoing rental cost attached.

45. *Concerto* have commented that the exclusions *"are logical and sensible but the States will need to make sure these costs are budgeted for somewhere within the overall system of Government."*[20]

46. In proposing the redevelopment of the existing hospital site, Ministers made reference to use of the existing hospital site as a "Health Campus". Whilst this might appear an attractive proposition, it is important to note that there is no provision for the costs of developing the Health Campus at this time.

Key Finding – There are a number of important items excluded from the hospital cost estimation which are directly relevant to the project and the costs for which have not been quantified publicly. These include the extension to Patriotic Street Car Park, the demolition of the 1960s and 1980s blocks and the ongoing costs for the new off-site catering facility and the relocated staff accommodation.

Key Finding - In choosing the existing site, one of the advantages put forward by the Minister for Health and Social Services was the option to develop a health campus. No plans have been produced to support this proposal and the costings have not been provisioned for within the budget.

[19] Internal forecasts undertaken by the Treasury Department
[20] Concerto. p6

Recommendation – Plans for developing a health campus on the existing hospital site, the estimated costs and the proposed funding sources should be clearly set out by Ministers by July 2017 when the detailed funding proposals for the hospital are brought before the States.

Recommendation – The finance costs associated with the construction period should be clearly set out when the detailed funding proposals for the hospital are brought before the States.

2. Control of expenditure

Contingency

47. P.130/2016 sets out the cost estimate for the project of £466 million. This includes a contingency allowance.

48. The contingency allowance is £74 million and includes two elements. This was explained by the Project Director during a Public Hearing:

> *"There is about £70 million plus of risk costs set out in P.130/2016 and that includes 2 types of contingency, what we would call project contingency, which you might be familiar with from some other projects, and a separate contingency, which is a risk-based contingency called optimism bias, which is required under good practice for very large projects".*[21]

49. The Proposition (P.130/2016) notes that there is a high level of contingency within the budget and that the more detailed budget due in July 2017 will provide a firmer estimate,

> *"This is an estimate based on current information; however, it carries a high level of contingency. The proof of concept will provide a firmer feasibility estimate. It is proposed that at this stage, to provide more certainty to the funding strategy, the budget is set by the States Assembly at a maximum of £466 million".* [22]

50. The Project Director explained

> ***Project Director, Jersey Property Holdings:***
>
> *"…the contingency is calculated from a percentage. There are then risk allocations made as we develop greater information through the feasibility study process, so whereas we might have needed greater contingency at an earlier stage, as we work through feasibility, we are able to define some of those costs and include them in the core objectives".*[23]

[21] Public Hearing Transcript (17 March) p9
[22] P.130/2016 p6
[23] Public Hearing Transcript (17 March) p11

51. The Chief Officer for the Department of Infrastructure told the Panel that the Contingency could reduce as the project progresses,

> ***Chief Officer, Department for Infrastructure:***
>
> *"Just to clarify, the aim is to start with an envelope which is adequate and then as you mitigate those risks going through the project, you then can make it certain and hopefully less. It is a thing we have just done with our S.T.W, (sewerage treatment works) project. It is a process, but your start point has got to assume not the worst, but you have got to assume if you do not know, then you assume a risk and a value to that risk.* ***If you mitigate that, then that hopefully lowers the cost of the project****."* [our emphasis][24]

52. With a start point of assuming the worst, then savings should materialise over the course of the project. In the Panel's opinion, it is important that these savings are then banked in order to achieve an overall reduction in cost.

Key Finding - At this early stage of the project. there is scope for savings to be made within the current cost estimation, for example tenders coming in cheaper than originally budgeted for, efficiencies being found or certain elements of the project not being required. If these savings are banked, the project can be delivered below the current cost estimation.

Controls over Contingency

53. The Report accompanying P.130/2016 states that control of contingency rests with the Treasury,

> *"This budget will be managed in 2 ways: the high levels of contingency will be managed by the Treasury, leaving the delivery team to manage the remaining estimated project costs. The contingency sums, if and when required, will be accessed through a process of challenge and agreement between the delivery team and the States Treasury".*[25]

54. The Minister for Treasury and Resources also confirmed that he considered that Treasury own the Contingency,

> ***The Connétable of St. John:***
> *"Who owns the contingency?*

[24] Ibid p12
[25] P.130/2016 pp.6-7

The Minister for Treasury and Resources:
Contingencies are managed from within Treasury".[26]

55. However, the Chief Officer of the Department for Infrastructure suggested that the contingency figures are currently controlled by the project team whilst the detailed budget is being worked up,

Deputy J.A.N. Le Fondré:
"…who controls the various contingency elements and are they allocated to specific risks"?

Chief Officer, Department for Infrastructure:
At the moment, they are controlled within the project because we are working on the basic figure of £466 million, and as we progress with the project, then we will crystallise those risks and change which box they are being put in.[27]

56. The Chief Officer also recognised that further work needed to be done to agree how contingency amounts will be controlled in the future,

Deputy J.A.N. Le Fondré:
"…who is the person who signs off on the uses of certain contingency elements?"

Chief Officer, Department for Infrastructure:
"That is something we need to discuss. We had a recent discussion with the Audit Committee and it is something we are discussing with the Treasurer and setting up a review of this in terms of what structure this project needs moving forward…"[28]

57. *Concerto* have recommended that ownership of contingency within the project should be clarified, as can be seen in the following extract from their report:

- *"A simple approach, but effective, is to determine which body within the governance structure owns the contingency sums (or relative proportions of them). For example the Treasury could hold a defined amount of the contingency, not to be accessed without sanction. The Project Board could hold the rest.*
- *A more insightful approach is to allocate contingency money to specific risks and similarly decide which body in the governance structure can best manage those risks and should hold the relevant contingency funds.*

[26] Public Hearing Transcript (20 March) p3
[27] Public Hearing Transcript (17 March) p12
[28] Ibid. p13

- *Under both management approaches, rules are needed for the "return" of contingency that is no longer needed (e.g. does it go to the Treasury contingency pot or to the one held by the Project Board?). Similarly rules are needed for unforeseen risks – who holds the pot for unknown risks? Clarity is essential."*[29]

58. It would be helpful if the further work on the governance structure around contingency currently being discussed between the project board and the Treasury Department could be completed by the time the detailed budget is brought to the States for approval in July of this year.

Finding – P.130/2016 states that the Treasury Department is responsible for control of contingency, however the exact governance structure around contingency control is still under discussion.

Inflation

59. In addition to the "risk" aspect of the budget of **£74 million**, there is an inflation allowance of **£69 million** (supplemented by an inflation allowance of £4 million for the relocation works).

60. The hospital cost has been calculated based on today's prices. An allowance is therefore made to cover for increases in those prices due to inflation, over the 8 year life of the project. If the inflation allowance is accurate, then it will be consumed as the project develops and prices increase in line with inflation.

61. *Concerto* have commented that inflation data can change significantly based on future economic trends.[30]

62. *Concerto* have highlighted a recent favourable change in the inflation assumptions of £13 million. Out of this potential saving for the project, £11 million was reallocated to other items within the project.

> *"As a result of favourable changes in the index, an additional £13M of headroom has recently been identified against the originally budgeted figure and the Project Board in January 2017 took a decision to reallocate £11M these*

[29] *Concerto*. p12
[30] *Concerto*. p5

> *potential savings towards funding some value-enhancing changes. The main change approved by the Board was the demolition and reconstruction of Westaway Court, rather than its refurbishment.'*[31]

63. Whilst *Concerto* note that the correct procedures were followed to authorise this change, they also note that inflation predictions could move the other way and once the reconstruction of Westaway Court is underway, the Project Team would have to find compensating savings from other parts of the budget or resort to contingency.

64. In the Panel's view, in light of the uncertain nature of inflation forecasts, at this early stage of the project, it is arguable that changes to the inflation predictions should not be "spent", particularly when it is considered that no additional money is available to fund adverse movements in inflation.

Key Finding – A recent change in inflation assumptions was reallocated to fund additions to the hospital project.

Expenditure control

65. To provide reassurance that effective controls over expenditure are in place, there are some additional measures that could be implemented in relation to the governance of contingency, the role played by advisors and safeguards in the proposition itself.

1. Improvement to governance structure

66. As already highlighted, the Project Board is already considering how contingency might best be controlled going forward. This might involve changes to the governance structure around the release of contingency. *Concerto's* suggestions are relevant in this regard.

2. Incentivisation of advisers

67. *Concerto* recommend that consideration be given to incentivising the advisers to the project team,

> *"Looking ahead it might be worthwhile aligning Gleeds' fee remuneration model to that of the main contractor once appointed. For example if there is a cost incentive mechanism on the main contractor to achieve savings and efficiencies (sometimes called a "pain/gain" mechanism) it might be worth*

[31] *Concerto*. p9

> *structuring Gleeds' fees accordingly. This would align behaviours across the professional and delivery teams.'*[32]

The Panel endorses this recommendation.

3. Changes to the Proposition

68. Expenditure control can be achieved to some extent through tightening the wording of the proposition. This will help to lay a marker at the outset in relation to certain types of expenditure.

- The amendment of the Connétable of St John approved by the States Assembly at the time of the original debate in January 2017 requires any contingency expenditure over £36 million to be notified to States Members in a report. The level was set at £36 million as this represents approximately 10% of the original project budget, which is a standard contingency allowance for a construction project.

- Following discussions with the Panel, the Minister for Treasury and Resources has lodged an amendment requiring that contingency monies be retained in the Strategic Reserve and only released to the Hospital Construction Fund on a Ministerial Decision.

- The first section of this report identified that, in the Panel's opinion, the actual budget for the hospital should be considered to be £392 million (being the total cost estimate of £466 million less the "risk" element of £74 million). The contingency, or "risk", allowance of £74 million should be viewed as separate from the construction budget and subject to tight controls. Following discussion with the Minister for Treasury and Resources, the Minister has lodged an amendment to make it clear that the main construction project will provisionally cost £392 million, with a separate contingency allowance of £74 million.

Expenditure philosophy

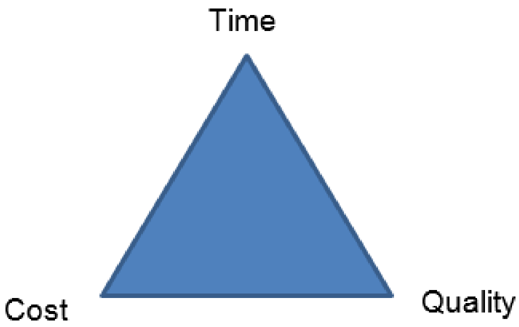
69. *Concerto* commented in their report that on the evidence of the project development to date, the aim has been to maximise what is delivered within the cost envelope of £466 million rather than aiming to come in under budget,

> *"Recognising that this is a once-in-a-generation project, the team's aim is to maximise quality of the delivered solution, staying within the total budget envelope. This philosophy reduces the chances of the project coming in under budget – more the aim is to come in on budget having maximised the delivered functionality / performance. If, however, risks reveal themselves late-on in the*

[32] Ibid. p8

project, with the budget fully committed, there may not be headroom to find solutions at that stage within the budget envelope."[33]

70. *Concerto* have made reference to a time, quality and cost triangle.



71. The Panel asked the Minister for Health and Social Services what, in his view, took precedence,

Senator S.C. Ferguson:

"Given your political responsibility, what, in your view, is the balance between time, cost and quality? Which takes precedence?"

The Minister for Health and Social Services:

"I do not think you could separate any of those. What we do know is the longer we take, the more it is going to cost. The longer it takes, the more our patients are at risk because our infrastructure health-wise is deteriorating, so we need to be getting on with this."[34]

72. In a separate Public Hearing, the Assistant Minister for Treasury and Resources, who is also an Assistant Minister for Health and Social Services, was asked the same question,

The Connétable of St. John:

"Given this is the largest capital spend on any project to date what, in your view, is the balance between time, cost and quality? The sort of famous triangle; time, quality, cost.

[33] Ibid. p11
[34] Public Hearing Transcript (17th March) p17

Assistant Minister for Treasury and Resources:

> *Well, equally from a customer point of view, with my Health and Social Services hat on, we want quality, the most important part because of the long term need for the public of Jersey but equally it has got to be done on time and at cost, at the right cost. That is a matter really for the project managers but certainly from a customer point of view quality is premium".*[35]

73. In relation to contingency expenditure, the Minister for Treasury and Resources told the Panel,

> *"…the mindset is not to spend the contingency unless it is absolutely needed. It is there for that purpose…"*[36]

74. *Concerto* have recommended reaffirming the balance and trade-off between time, cost and quality. In the Panel's view, it is important that the project team and the project Accounting Officer clarify this so that it is clear where the priority lies.

75. Whilst it is understandable that all involved want to deliver a quality hospital for the public of Jersey, the Panel is concerned that this could be at the expense of sufficient consideration being given to the control of costs.

76. Although the project is at an early stage, the reallocation of a "saving" in relation to inflation indices gives rise to concern that future savings across the project may also be reallocated rather than banked. The fact that the project is at the upper end of the benchmark may indicate an element of "hidden" contingency within the budget.

77. Where savings are identified in any parts of the budget, for example tenders coming in cheaper than originally budgeted for, efficiencies being found, or certain elements of the budget not being required, the Panel considers that these should be banked and not "spent".

78. Such an approach to savings over the course of the project will help ensure that the project can be delivered below the current allowance for the main construction project and that contingency is protected for genuine unforeseen needs.

[35] Public Hearing Transcript (20 March) p14
[36] Ibid. p12

Recommendation – The Minister for Treasury and Resources should publish any significant changes to the composition of the cost estimate outlined in P.130/2016 where savings or changes in assumptions are reallocated within the project. This should cover both the period up to July 2017 when the detailed budget is brought to the States and subsequently as the project develops.

Recommendation – Contingency controls should be finalised as soon as possible and included in the detail of the final budget when it is brought back to the States in July. This should include reference to material savings arising from changes in assumptions or where costs turn out to be lower than budgeted for.

3. Funding Options

Summary of the Bond proposal

79. In P.130/2016 it was confirmed that,

> *"After considering all the options and consulting with expert advisors, the Council of Ministers is proposing to raise the funding required through a Public Rated Sterling Bond, supplemented by existing reserves."*[37]

80. A Sterling Bond is "a bond issued by a country that is not the United Kingdom, but payable in British pounds",[38] whilst "Public Rated" refers to the quality of a bond. A sovereign government rated bond is regarded as the highest in terms of quality. This is due to it being largely risk-free in terms of meeting repayments, being backed by a nation's treasury.

81. The Proposition highlights that one of the key reasons for such a strategy is that there is a precedent for issuing a bond of this type. This refers to the £250 million bond for affordable housing, issued in 2014.

82. The issuance of a bond is deemed in the proposition to be especially prudent at this juncture, given the historically low interest rates that are currently being seen. The total cost for the repayment of the proposed bond, will therefore be significantly less than it might otherwise have been.

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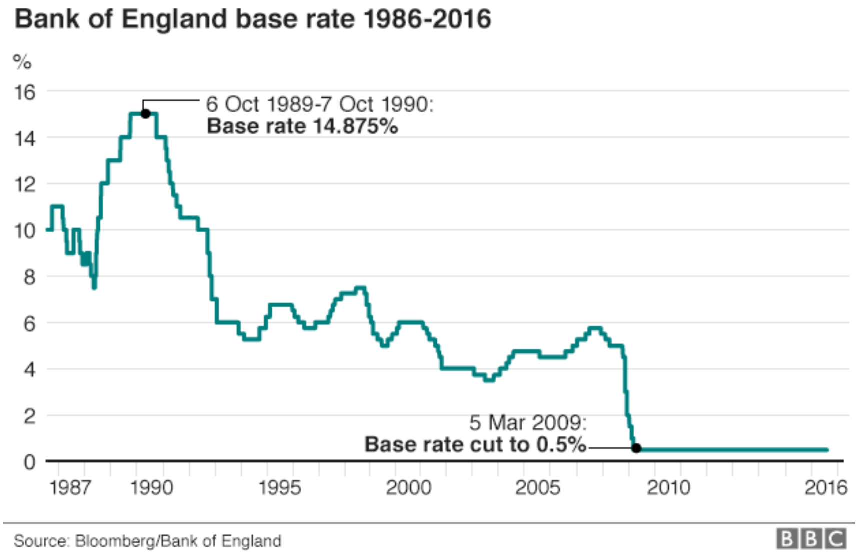
[37] P.130/2016. p3
[38] ft.com/lexicon. *"Sterling Bond"* http://lexicon.ft.com/Term?term=public [Last Accessed: 21 March 2017]



Source: BBC[39]

83. Repayment of both the interest and the capital of the bond is proposed to be met from the revenue produced by the investments in the Strategic Reserve. The Proposition states that the average return of these investments *"since 1986 has exceeded RPI by 4%.",* whilst *"From 2005-2015 the average return was 7%, which was 4.5% above RPI(Y)."*[40]

84. In light of these historic returns and on the basis of prudent forward projections of expected return, the Proposition highlights that it *"makes sense to borrow through a Bond, then repay the interest and, eventually, the capital, using excess returns on the Strategic Reserve."*[41] In other words, the average returns on the Strategic Reserve will be such, that the annual interest payments and the capital amount repayable will be comfortably met by the average returns arising on the SRF during the life of the bond.

85. During a Public Hearing it was confirmed by the Minister for Treasury and Resources, that whilst the average returns were indeed 4% over RPI,

> *"The proposal that we have presented is much more cautious and prudent, 2 per cent over R.P.I. over the issuance period, which is intended to be 40 years. So we believe there is ... over that extended period in an environment where*

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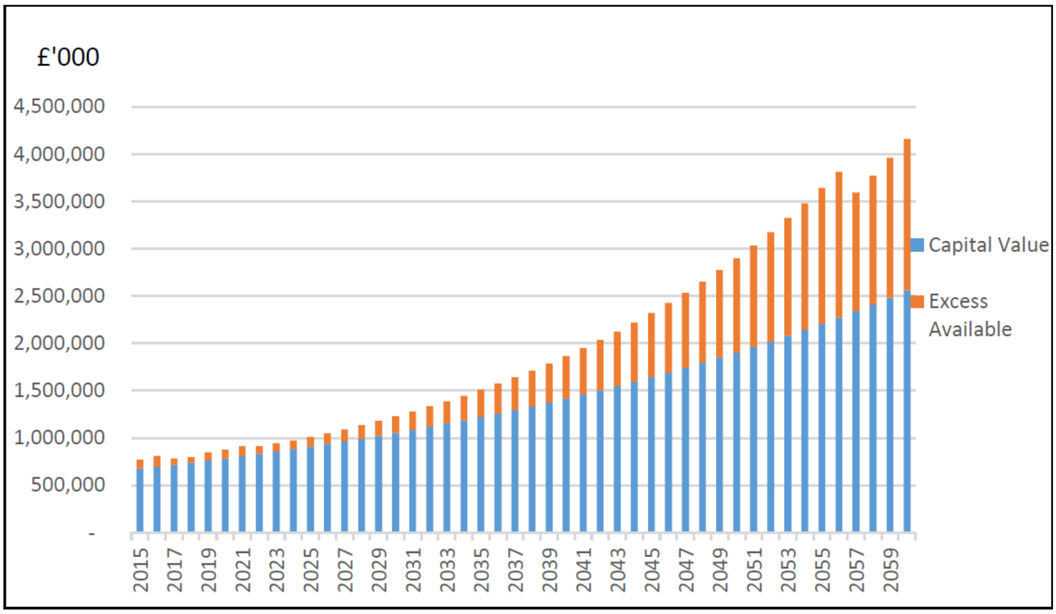
[39] Brand Power *"First UK Interest Rate Cut in Seven Years Expected"* *http://www.brandpowerng.com/first-uk-interest-rate-cut-in-seven-years-expected/ [Last accessed: 24 March 2017]*
[40] P.130/2016 pp.3-4
[41] Ibid. p4

we have historically low bond rates, we believe that gives enough flexibility and safety.”[42]

86. This is reflected in the graph below, which highlights the impact of the Future Hospital’s funding on the Strategic Reserve. The graph shows, that with the capital value of the Strategic Reserve protected in line with a growth of RPI (within the terms set in the Budget Statement P.129/2014), the excess returns available to fund the proposed bond are predicted to be more than sufficient.[43]



Source: P.130/2016[44]

87. P.130/2016 puts forwards a recommendation for a 30 or 40-year bond, borrowing up to a maximum of £400 million. It highlights that whilst this would increase the States of Jersey debt to GDP ratio from 6% to 16%, when compared to other national debts this is still fairly small. The proposition uses the examples of Australia and the United Kingdom, with ratios of 37% and 89% respectively. The Panel would note however, that given these are examples of sovereign nations in charge of their own monetary policies, this has only limited comparative value.

[42] Public Hearing Transcript (20 March) p14
[43] Addendum and Budget Statement 2015 (September 2014) http://www.statesassembly.gov.je/AssemblyPropositions/2014/Budget%20Statement%202015%20(as%20amended).pdf [Last Accessed: 21 March 2017]
[44] Ibid. p16

Other Options Considered

88. The Panel engaged *Opus Corporate Finance ("Opus"*) to review the proposed financing strategy as outlined above. *Opus* were also asked to examine in detail other mechanisms that could be considered, whether variations to the bond structure, or entirely separate strategies.

89. The underlying message from *Opus* (report included as an appendix) is that the proposed funding mechanism *"would appear to be a pragmatic way forward"*.[45] *Opus* do highlight however, that there are options that could be considered.

90. What is clear, is that options presented by *Opus* and the strategy laid-out in the Proposition, need to be appraised within the context of what would be appropriate for a public sector project. This means, that decision-making is obliged to factor in a certain level of rigour or caution, avoiding risks and options which the private-sector may have been able to exploit. In relation to a question about whether to draw the Bond down in tranches, the Treasurer of the States explained that,

> *"…we looked at the alternatives and believed that the States generally has a view preferring certainty over market risk*."[46]

Key Finding – The Panel's advisor, *Opus*, has examined the options considered by the Treasury Department and has assessed that borrowing *"would appear to be a pragmatic way forward".*

Private Finance Mechanism

91. *Opus* examined the feasibility of the future hospital being funded through a private or project finance mechanism. This is also known as a Private Finance Initiative (PFI). Such a strategy, in principle, would mean that a private body would take ownership of designing and building the hospital, including all costs, and in return is paid a regular fee over the agreed lifespan of the project.

92. *Opus* determined that because the hospital does not produce any form of significant revenue generating income, this was deemed as being unattractive to investors. When

[45] Opus Corporate Finance. *"Corporate Services Scrutiny Panel- Future Hospital funding Strategy" p3*
[46] Public Hearing Transcript (20 March) p36

asked by the Panel whether a private finance mechanism had been considered, the Treasurer of the States commented,

> *"At the end of the day the advice we had was for greater complexity, including complexities relating to not owning the hospital and having to work with the landlord for the hospital, provider of the service. The pricing was not going to be cheaper than the pricing we could get through a bond, yet involved greater complexity. The one area where it would reduce some of the complexity would be perhaps through the construction phase, the first construction phase. There are plenty of examples of they do not necessarily do the work that the customer thinks they are going to do."*[47]

93. This is in line with the finding of *Opus*. They highlight largely similar reasons for their conclusion that such a strategy is inappropriate. They underline however, that whilst a PFI solution would be more expensive, it would provide a third-party, external to the States of Jersey, to share in both risk and decision-making structures. Such third party support, with both monetary and reputational investment, would provide a measure of protection, which in the present proposal, does not exist.

Key Finding – Third-party involvement in the hospital project, would provide oversight of decision-making structures and provide an element of risk reduction.

Recommendation – Third-party oversight of the hospital project should be explored in greater detail, before the project progresses further.

94. *Opus* underlines that the hospital does not charge for its services (beyond a small percentage of private patients). As such, the debt derived from the bond is distinctly separate from the purposes it is being created for. Without a change in fundamental principles regarding private investment and the hospital generating revenue, *Opus* states, that the consequence of such constraints is,

> *"…traditional PFI/PPP approaches, which involve the private capital, and traditional project finance, which is typically secured on the project cash-flows, can be ruled out. This essentially leave state-funded solutions."*[48]

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[47] Public Hearing Transcript (20 March) p37
[48] *Opus*. p6.

95. The options for state-funded solutions for Jersey can be seen to rest with either the capital in the Strategic Reserve Fund or through a capacity for government borrowing.

Tax-Based Mechanism

96. A tax-based mechanism to fund the hospital construction was previously raised as an option by the Minister for Treasury and Resources, but was seemingly ruled out during the development of the Funding Strategy. In a comment to the States Assembly in January 2017, the Minister for Treasury and Resources stated that,

> *"…we estimate that over the long term, the differences between the investment returns and the cost of that borrowing is such that the cost of our borrowing can be funded from the excess returns on the reserve. These are the returns that over and above the capital amount the States Assembly agree to protect…and it does this without requiring direct contributions from Islanders through any additional charges or taxes…"*[49]

97. None of the evidence provided to the Panel includes consideration of a specific hospital charge, so it would appear that Treasury's advisors were not asked to consider this as a possible funding option.

98. Given the reasons above, the proposal does not make reference to a funding mechanism derived from a new tax. However, the Proposal does make a caveat for the longer-term,

> *"The coupon cost for a Bond of up to £400 million is likely to be an amount that can be financed over the long term without the need for further taxes or charges; although there is always the possibility that things may change in the medium or longer term."*[50]

Strategic Reserve Funded

99. Within the 2014 Budget Statement, it was suggested that the hospital could be funded out of the returns on the Strategic Reserve (above the Capital figure plus RPI) alone.

> *"This Report proposes that the funding for the hospital scheme of an estimated £297 million to be spent over the years 2014 to 2024 is drawn down from the Strategic Reserve Fund thereby meeting the cost of the hospital from the investment returns on the Fund.*[51]

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[49] *Hansard, States of Jersey Official Report* (18 January 2017) p24 http://www.statesassembly.gov.je/AssemblyHansard/2017/2017.01.18%20States%20-%20Edited%20Transcript.pdf [Last Accessed: 22 March 2017]
[50] P.130/2016 p17
[51] Draft Budget Statement 2014, (Section E.) p112 https://www.gov.je/SiteCollectionDocuments/Tax%20and%20your%20money/ID%20Draft%20Budget%20Statement%202013%20Sections%20E%20and%20F%20JB%2020131007.pdf [Last Accessed: 22 March 2017]

100. As can be seen, this proposal was based on a total hospital build (or refurbishment) budget of up to £297 million, rather than the £466 million in P.130/2016.

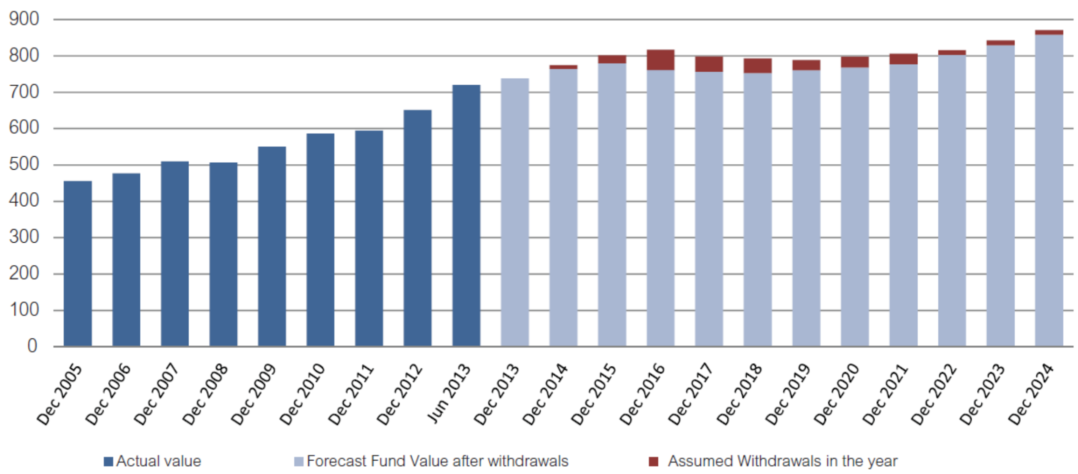
101. The advantages of such a strategy were highlighted in the 2014 Budget as being that,

> *"…the Hospital project can be met with no new cost to the tax payer and without incurring debt. The hospital would be paid for in full by the time it was completed. The advantages of this are that by the time the hospital is built, the scheme can be fully funded with no new cost to the taxpayer and without the need for borrowing."*[52]

102. The Panel note that based on these assumptions, between 2014 and today, if such a strategy had been implemented, a substantial proportion of the funding for the hospital could have already been secured through gains generated by the Strategic Reserve[53].

103. Whilst this might have been possible within the confines of a lower budget, this is held out as not being possible with a potential spend of £466 million (with no recapitalisation mechanism) as currently envisaged. The graph below, shows the returns on the Strategic Reserve when used for a 10-year phased drawdown of £297 million as a strategy.

FIGURE 52 – PROJECTED STRATEGIC RESERVE FUND BALANCE (£'M) ASSUMING 5% INVESTMENT RETURN AND DRAWN DOWN OF £297M FOR THE HOSPITAL



Source: Draft Budget Statement 2014[54]

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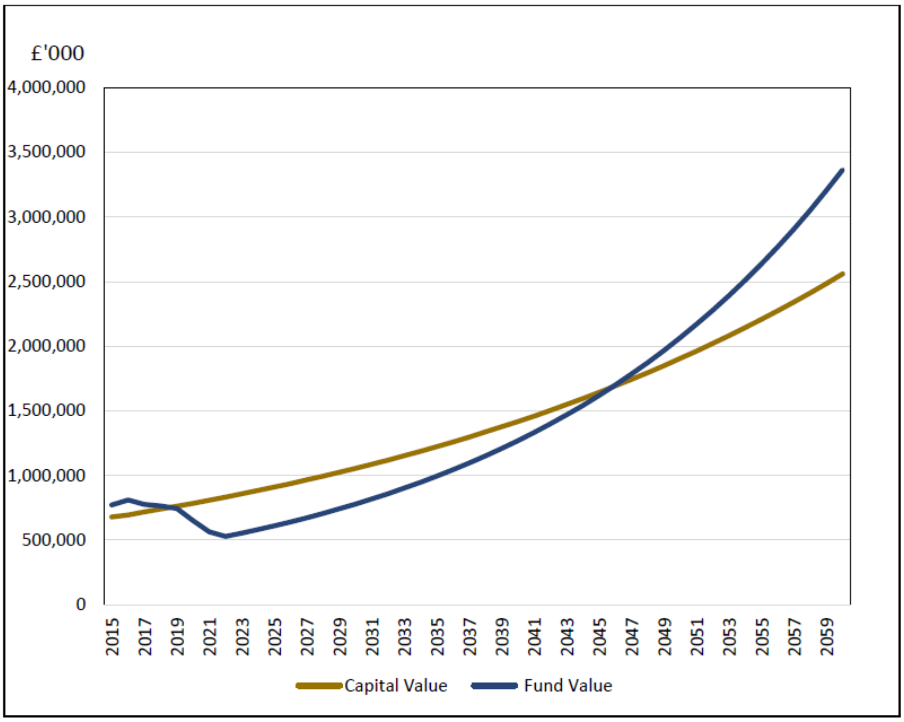
[52] Ibid.
[53] For example the gains on the Strategic Reserve in 2014, 2015 and 2016 were 7.2%, 2.7% (as detailed in the States accounts) and 13.6% (quoted in a Public Hearing on 20 March 2017)
[54] Ibid. p113

104. When compared to the graph from P.130/2016 below, showing a drawdown of the proposed £466 million, there is a distinct difference. Protecting the capital value of the Strategic Reserve is not achievable without some form of recapitalisation mechanism put in place.



Source: P.130/2016[55]

Key Finding – the option of funding the future hospital project solely from the returns on the Strategic Reserve was considered viable in 2014 for a project cost of £297 million but has been ruled out as an option for funding the higher cost of £466 million.

105. P.130/2016 also sets out several other reasons as to why funding the entire project from the Strategic Reserve is not appropriate. Firstly, whilst the Strategic Reserve's returns are a potential source of funding, certain amounts are already assigned elsewhere, these being,

> *"£56.7 million in 2016, net £50.3 million in 2017, and a further £16 million in 2018. A repayment of £20 million is currently planned in 2019. The remaining excess return at that point is estimated at £85 million."*[56]

106. P.130/2016 also emphasises, as previously discussed, that with current levels of borrowing being at historic low levels, the returns being made on the Strategic Reserve

[55] P.130/2016 p10
[56] Ibid. p9

are significantly higher than the costs of servicing the bond. The Proposition underlines this point, that,

> *"In these uncertain times, making a decision now to use the Strategic Reserve to fund the hospital construction would compromise the Government's flexibility."*[57]

The Panel would also highlight that a bond would just as effectively constrain the States of Jersey, given that a bond of £400 million would almost reach the ceiling for borrowing.

107. One option that appears not to have been considered is a scenario whereby the Strategic Reserve is used initially to fund the construction costs of the hospital but is replenished from other funding sources. The Panel therefore asked the Treasury Department to model two possible scenarios

a) *Assuming the hospital is built and funded from the Strategic Reserve, Calculate approximately what annual amount would be needed to be paid into the Strategic Reserve Fund in order to achieve the same balance in 2060 as the balance that arises with the bond being proposed.*

The answer was that an amount of £4.2 million (increased annually by inflation) would need to be paid into the Strategic Reserve each year until 2060 to bring it back to the same level of £4.2 billion in 2016 as if the bond option had been followed[58].

b) *Assuming the hospital is built and funded form the Strategic Reserve, calculate the balance of the Strategic Reserve Fund in 2060 with an annual addition of £15m from revenue raising measures (increased annually by cost of living) – commencing in 2018.*

The answer was that a revenue raising measure of £15 million per year would mean that the Strategic Reserve balance would be £6.9 billion in 2060, significantly more than would be necessary to return it to the total of £4.2 billion in Treasury's proposals.

Given the responses provided, the Panel considers that finding an amount of £4.2 million annually from internal sources to recapitalise the Strategic Reserve should be achievable. On this basis, the Panel has lodged an amendment to P.130/2016 in order to give States Members

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[57] Ibid. p10
[58] Figures provided to the Panel by the Treasury Department in an email dated 03/04/2017

a choice between funding the hospital from internal measures or through the proposed Bond issue.

Key Finding – If it is considered that borrowing is the best way to fund the future hospital project then the proposals lodged by Treasury are reasonable. However, an alternative option proposed by the Panel is to use the Strategic Reserve initially and recapitalise it from internal sources.

Key Finding – Recent modelling by Treasury shows that if an amount of £4.2 million (increased annually by inflation) was paid into the Strategic Reserve each year until 2060, it would bring the Strategic Reserve back to the same level of £4.2 billion in 2016 as if the bond option had been followed, without taking on any debt.

Key Finding - The Panel considers that finding an amount of £4.2 million annually from internal sources to recapitalise the Strategic Reserve should be achievable. On this basis, the Panel has lodged an amendment to P.130/2016 in order to give States Members a choice between funding the hospital from internal measures or through the proposed Bond issue.

Balance of Funding

108. The Proposition proposes borrowing up to £400 million through a bond and funding the remainder from the Strategic Reserve (some of which has already been agreed). As part of its review, the Panel explored whether a larger percentage could be utilised from the Strategic Reserve.

109. The balance between the two sources of revenue clearly needs to reflect the most cost-effective approach. However, this needs to be balanced with the appropriate level of caution, in terms of risk, when using public money.

110. In P.130/2016, the rationale given for a strategy of issuing a bond up to £400 million, is that the returns on the Strategic Reserve are greater than the negative impact of borrowing though a bond issuance. As such, the maximum amount that can be borrowed through a bond is the most desirable. P.130/2016 states that,

> *"With the cost of raising debt at such historically low levels, it seems sensible to borrow the majority of the funding needed, leaving reserves to finance the cost of the debt and maintain flexibility in such uncertain times."*[59]

[59] Ibid. p17

111. The Proposition outlines that £400 million is a figure that would be realistically the maximum that could be borrowed, without a negative impact on the Island's credit rating and in terms of affordability of the annual interest payments.[60]

112. Given the presumption being made that the Strategic Reserve will bring in a higher revenue than the cost of servicing the bond (as well as the initial administrative costs), this could be considered a reasonable course of action to take. In a Public Hearing, the Treasurer of the States confirmed the strategy, stating,

> *"We played with a number of different scenarios. At the end of the day where we were, and mostly still are, the historical lower cost of debt made it preferential to maximise the debt, at the same time as going through all the uncertainty we are going through out there in the world maintaining the size of the strategic reserve."*[61]

113. The uncertainties in the current financial markets, given the current political, financial and social upheavals, also need to be considered. An argument could be made that just using the Strategic Reserve in the initial years, would protect the Island's credit rating and borrowing capacity whilst this period of uncertainty lasts.

114. This question was put to the Treasurer at a Public Hearing,

> **Senator S.C. Ferguson:**
>
> *"Given the current uncertainty as a result of Brexit, would it be an opportunity to use the income from the strategic reserve in the first few years and then to issue a bond to cover the bulk of the capital cost from 2019 onwards?"*
>
> **Treasurer of the States:**
> *"Then what you are doing there is you are taking the view that you are willing to carry the risk of the market moving against you … the States Government or the States generally like to see certainty rather than uncertainty.*[62]*"*

115. While utilising debt to fund the hospital project appears attractive given the historically low interest rates, *Opus* highlight the risk of Brexit and the issue of timing in assessing the Bond proposals:

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[60] P.130/2016 p19
[61] Public Hearing Transcript (20 March) p37
[62] Public Hearing Transcript (20 March) pp.37-38

"Market conditions: is it a good time to borrow, given historically low yields and margins, or would it be better to wait bearing in mind the uncertainty associated with Brexit and the US political scene? Certainly, bond yields and spreads are historically attractive, which argues in favour of borrowing now (notwithstanding the carrying cost). But given the level of contingency in the hospital budget, there is some risk of overfunding, if the full amount is borrowed early."[63]

Variations on the Bond Model

116. In relation to the detail of the Bond, *Opus* examined several aspects of the bond proposal, including:

- Tenor (Length)
- Profile of the bond
- Drawdown options
- Index-linking
- Hedging

117. The current borrowing strategy, set out in the Proposal is,

> *"At this time, accepting all the risks described above, the expected way forward would be to issue debt of £350 – £400 million in the first half of 2017, and to hold those proceeds in a newly constituted Special Fund as set up to facilitate the funding requirements around the new General Hospital construction."*[64]

118. As such, these current proposals can be tested against the advisors recommendations, as well as the risk associated with each strategy.

Tenor

119. The Proposition makes reference to a borrowing period of 40 years, although the exact Tenor will be dependent on the demands of investors:

> *"Decisions such as the length of the borrowing period (tenor) need to be made after the potential investors have been visited and their preferred tenor considered…"*[65]

[63] *Opus*. p4
[64] P.130/2016 p21
[65] P.130/2016 p21

120. *Opus* commented that,

> *"...Tenor: the tenor advocated by EY is 40 years. This period is not particularly linked to the useful economic life of the hospital but driven by a combination of the desire for certainty over the life of the financing and optimal market pricing given the shape of the yield curve and market appetite."*[66]

121. Although the expected lifespan of the hospital is aligned with the tenor of the bond[67], the statement above shows that the determining factor for the duration of the bond is the ability of the Strategic Reserve to pay the capital cost of the bond at its maturity date.

122. A very short bond, whilst obviously cheaper in terms of total repayment costs, would not give the Strategic Reserve sufficient time to grow to a size where repayments of the capital of the bond could be met.

123. *Opus* highlights this, explaining that the length of bond needs to reflect the returns on the Strategic Reserve.

> *"This judgement goes to the heart of the financing strategy which is to lock in today's favourable borrowing rates (yields and spreads) to optimise the chance that the SRF [Strategic Reserve Fund] income will be sufficient to meet the debt service on the bond."*[68]

Profile of the Bond/ Drawdown Options

124. *Opus* draws attention to whether it is most appropriate to borrow the revenue required in one process at the start of the build. As the hospital project will take numerous years to reach completion, it will mean there will be a requirement to invest the revenue raised through the bond. Given administrative costs and the less attractive rate of borrowing achieved, revenue raised through several issuance may actually be better value.

125. *Opus* highlights,

> *"Bond market yields and spreads are close to historic lows. This makes early drawing of the bond attractive, since there is clearly more upside than downside risk in interest rates and spreads. However, the bulk of the capital costs of the hospital construction project are spread over five to six years from 2019*

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[66] *Opus*. p10
[67] As confirmed in a Public Hearing with the Minister for Treasury and Resources
[68] *Opus*. p10

> *onwards (and that assumes no delays in the planning or preparatory processes between now and then)."*[69]

126. *Opus* suggest however, that whilst the overall project cost is high enough to warrant a Bond that will not incur penalties on issuance, it is not significant enough to allow for numerous bonds to be issued as and when they are required to fund the project. As such, *"…even a delayed drawdown strategy will only approximate a matching of the funding to the expenditure."*[70]

127. After further work requested by *Opus*, the advisors to the Hospital Project Team agreed that potentially such a strategy could lead to initial savings, but that this would be subject to numerous risks.

128. Firstly, the costs of hedging the Bond, (paying a fee or penalty to protect the market against negative fluctuations) would erode any profit that you would encounter. Secondly, if the borrowing was not hedged, given the uncertain financial climate, there would be risk of markets shifting, resulting in a higher cost of borrowing overall.

129. Given that the savings that could be made are relatively small, the advisors to the Hospital Project Team conclude that the risks involved in such a strategy do not warrant the potential savings made.

130. Deferring the Bond was also examined. This is a strategy that is based on the argument laid out above, but where the bond for £400 million would be agreed in principle at the start of the project, but not drawn down in one tranche. During a Public Hearing, the Treasurer of the States explained that,

> *"What we have deemed is that the States would rather have certainty. With a bond that you draw down in tranches you leave yourself open to further market risk."*[71]

131. The conclusions reached were that, whilst not deferring the bond may have a small financial penalty, but this was *"a price you pay for certainty…we looked at the alternatives and believed that the States generally has a view preferring certainty over market risk."*[72]

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[69] Ibid. p7
[70] Ibid.
[71] Public Hearing Transcript (20 March) p35
[72] Ibid.

132. The conclusion as to whether a deferred bond or a bond in tranches is more cost effective than issuing a standard bond at the start of the project, lies largely in terms of risk. It seems that the risks involved in such a process do not justify the small saving made. If hedging is used to counter this risk, the savings made become unworthy of the administrative and associated costs that the process must entail.

133. *Opus* do, however, recommend that the position is checked before finalising the bond*:*

> *"Our view remains that this issue ought to be re-considered when the time for financing is actually live and that is well worth testing the options available in the market at the time, rather than plumping now for a single option funding strategy."*[73]

Index Linking

134. An index linked bond differs from a standard Bond in that *"both the semi-annual coupon payments and the principal payment are adjusted in line with movements in the General Index of Retail Prices in the UK (also known as the RPI)."*[74]

135. *Opus* highlights that index linking *"offers lower debt service costs in the short run, but creates a larger (and potentially uncapped) repayment requirement on maturity".*[75] ,

136. This would mean that the deficit would be reduced in the short-term, but both the coupon and capital payment would move depending on movement of the RPI over the life of the bond.

137. The advisors to the Hospital Project Team conducted an evaluation at the request of *Opus*, of issuing one bond based on RPI and one ordinary fixed bond. Their conclusion was that such a strategy would not be as cost-effective as an ordinary fixed-rate bond, as the overall repayments would be higher[76].

138. *Opus* agreed with this finding, but stated that despite such predictions,

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[73] *Opus*. p8
[74] United Kingdom Debt Management Office, *Gilt Market* (http://www.dmo.gov.uk/index.aspx?page=Gilts/Indexlinked) [Last Accessed: 23 March 2017]
[75] *Opus*. p4
[76] EY Advice paper dated 13 March 2017

> *"As with the deferred drawdown arguments, we would recommend that these issues are considered again by Treasury and the Bookrunner again at the time of going live with the bond issuance"*[77]

Pre-Hedging

139. The use of hedging against changes in interest rate rises is one way of reducing the risk of changes in interest rates between the time the States approve the Funding Strategy and the date of issue of the Bond.

140. In principle, this would mean paying a penalty or fee in return for guaranteeing the bond at fixed rate of return for the investor. This protects against unforeseen rises in interest rates.

141. In the advice provided to *Opus*, two key variables were highlighted. Firstly, that the cost of hedging would vary depending on the details agreed and second, that as hedging locks into a future yield, this could be higher than the current level.

142. At the time of going to market, the rate offered to pre-hedge would have to be judged as to whether it would impact too greatly on the Strategic Reserve in the initial years of borrowing.

143. In financial advice provided to the Hospital Project Team in January, it was emphasised that pre-hedging was not about trying to beat the markets, rather it was about gaining security over a known repayment value. Clearly, when discussing government debt repayments, high levels of certainty are desirable.

144. In order to maximise caution, it is agreed by both *Opus* and the financial advisors to the Hospital Project Team that hedging a percentage of the total amount borrowed is the best strategy. This means that you are protected to some extent, whether interest rates go up or down.

Recommendation – The Panel's advisors have made a number of recommendations in their reports about the detail of the Future Hospital Project. Ministers should ensure that these recommendations are all acted upon.

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[77] *Opus*. p9

Recommendation – Irrespective of the outcome of the debate on the Future Hospital Funding Strategy, the Minister for Treasury and Resources should bring forward proposals for an annual capitalisation of the Strategic Reserve.

4. Strategic Reserve

145. The Future Hospital Funding Strategy relies on using the Strategic Reserve in two ways,

- To fund the interest payments on the proposed Bond and the eventual capital repayment of the Bond
- To fund any additional amount, over and above the amount borrowed, up to the cost estimation of £466 million. In the event that the Bond is £400 million, an additional £42.4 million will be required from the Strategic Reserve on top of amounts already allocated to the project.

146. The value of the Strategic Reserve is stated in the Proposition as being £866 million as of October 2016. The capital part is protected following a decision of the States in the 2015 budget to maintain it in real terms in line with RPI. The protected capital value as at 31 December 2015 was £679 million[78]:

Strategic Reserve - MTFP Addition (September 2016)	2015 Actual £'000	2016 Forecast £'000	2017 Forecast £'000	2018 Forecast £'000	2019 Forecast £'000
Strategic Reserve - Protected Capital Value [2]	*678,917*	694,532	718,147	739,691	761,882
Strategic Reserve - Accumulated Excess Return [1]	*92,465*	87,732	47,159	47,479	85,147
Strategic Reserve - Estimated Fund balance	**771,382**	**782,265**	**765,305**	**787,170**	**847,029**

Source: Fourth Addendum to MTFP Addition.[79]

147. The original policy for the Strategic Reserve agreed by the States in 2006 was,

> *"…a permanent reserve, where the capital value is only to be used in exceptional circumstances to insulate the Island's economy from severe structural decline such as the sudden collapse of a major Island industry or from major natural disaster."*[80]

148. Although the capital is only to be used in exceptional circumstances, the States agreed in 2009[81] to use up to £100 million of the Strategic Reserve to provide up-front funding for the *Bank Depositors Compensation Scheme*. The full amount should be considered as a potential future call on the Strategic Reserve, although there are mechanisms under the *Bank Depositors Compensation Scheme* for any monies advanced by the States to be repaid.

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[78] Figures included in Fourth Addendum to MTFP Addition, lodged by Minister for Treasury and Resources on 22nd September 2016. The value of £866 million as at October 2016 included in the proposition is an updated estimate of the value of the Strategic Reserve
[79] Draft Medium Term Financial Plan Addition for 2017-2019 (P.68/2016) – Fourth Addendum – Interim Update on States Income Forecasts. (http://www.statesassembly.gov.je/AssemblyPropositions/2016/P.68-2016Add(4).pdf?_ga=1.203606544.1223286821.1490090738) [Last Accessed: 11 April 2017]
[80] P.133/2006
[81] P.84/2009

149. Following the decision in the 2015 budget to define the protected capital element of the Strategic Reserve, the accumulated returns generated by the fund can be used for other purposes, subject to approval by the States Assembly.]

150. In recent years, the returns on the Strategic Reserve have been used to supplement the expenditure of the States through transfers into the Consolidated Fund. Actual and forecast amounts are as follows[82]:

Year	Total transfer from Strategic Reserve	Breakdown and reason	
2014	£10.2 million *actual*		Future Hospital Project
2015	£36.7 million *actual*	£10 million	Independent Jersey Care Inquiry
		£22.7 million	Future Hospital Project
		£4 million	redundancy provisions
2016	£56.7 million *forecast*	£4million	Independent Jersey Care Inquiry
		£5 million	EPGDP
		£16 million	redundancy provision
		£5 million	consolidated fund working balance
		£1 million	Les Quennevais School
		£25.7 million	Annual Capital programme
2017	£50.2 million *forecast*	(£5 million)	EPGDP
		£39 million	Les Quennevais School
		£16.2 million	Annual Capital programme
2018	£16 million *forecast*		Consolidated fund working balance
2019	(£20 million) *forecast*		Predicted £20 million repayment from the consolidated fund

[82] Compiled from Annual Financial Statements 2014 and 2015, MTFP Addition and 4th Addendum to MTFP Addition

151. As outlined in an earlier chapter, in approving the Budget 2014, the States agreed that the returns on the Strategic Reserve could be used to fund the construction of a new hospital. At this time, it was envisaged that the entire cost of the hospital could be paid for out of the returns alone.

152. To date, £32.9 million has been allocated to the Future Hospital Project. £23.6 million of this allocation has not been spent and is proposed to form part of the total cost envelope of £466 million[83].

153. P.130/2016 states that the previous funding model is no longer appropriate in light of the increased cost estimate for the chosen site, and therefore asks States Members to agree to amend their previous decision and use the Strategic Reserve in the two ways highlighted above.

Investment Strategy

154. The Funding Strategy is based upon using the predicted returns from the Strategic Reserve to fund the costs of the Bond. Opus have noted that this is a "…*critical part of the overall funding plan*"[84].

155. There are two particular risks in relying on the Strategic Reserve in this way. Firstly, that the investment returns are not sufficient to fund the interest on the bond and eventual capital repayment on the bond. Secondly, that an exceptional circumstance occurs which requires the capital of the Strategic Reserve to be used.

156. These risks are highlighted by Opus,

> *"…The risk that income from the Strategic Reserve Fund is inadequate to service the new debt, either because the capital in the fund needs to be deployed for some other purpose; or because investment returns fall/become more volatile, so as to prove an unreliable or inadequate source of debt service. We consider these risks to be strategic and hence worthy of a clearer and more explicit combined strategy bringing together the investment strategy for the Strategic Reserve Fund in the context of the management of debt service risk."*[85]

Key Finding – The Investment Strategy for the Strategic Reserve will be important in ensuring that the interest on the proposed Bond can be serviced.

[83] P.130/2016. p20
[84] *Opus*. p10
[85] Ibid. p4

157. *Opus* go on to say,

> *"More fundamentally, the Strategic Reserve Fund's capital will need to be fully reserved to servicing the Hospital Bond, at least in the initial years when the risk of an overall mismatch is greatest.* ***This means that the capital in the Strategic Reserve Fund cannot be used for any other purpose until it is clear that the returns from the fund are more than adequate to service the Hospital bond****, in which case it might be possible to envisage using pre-defined criteria to enable a release of capital."*[86] *[Our emphasis]*

158. The amendment to the proposition approved by the States Assembly in January 2017 deals with the point raised by *Opus*, by locking up the Strategic Reserve for a period of 10 years.

159. This means that in the event of the sudden collapse of the island's finance industry or some other unexpected emergency, the Strategic Reserve could not be used, unless some other funding source for the bond interest was found.

Key Finding – In order to ensure the Bond interest can be serviced, the Strategic Reserve cannot be used for other purposes for at least 10 years. (At the Panel's suggestion, this has been increased to 15 years in the recent amendment to the proposition lodged by the Minister for Treasury and Resources)

160. The Treasurer of the States told the Panel during a Public Hearing, that in such a scenario, it is likely that a whole new strategy would be required in any event:

> *"…therefore my take on this position if something changed in the future then the States would probably have to change, if we are talking about significant draw downs on the strategic reserve, to see… how it would be funded on an ongoing basis…it would probably be within a whole host of other numbers that you have to deal with and you would set your budget accordingly at that point.*[87]

161. *Opus* have also highlighted the risks inherent in relying on investment returns to fund the debt repayments which in turn requires an appropriate investment strategy,

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[86] Ibid. P10
[87] Public Hearing Transcript (20th March) p47

> *"it is apparent that returns from investments, even a broadly based fund of the size of the Strategic Reserve Fund, cannot be guaranteed. It is also apparent that returns from investments are not necessarily well correlated with borrowing costs. To take an extreme case, if the investments were all in companies or situations that benefited from reductions in the cost of borrowing, then the risk between the liability on the bond and the return from the investments would not be well correlated.*
>
> *It is therefore reasonable to ask whether the investment strategy for the Strategic Reserve Fund is being monitored and/or adjusted in order to provide as good a hedge as possible to the debt service of the bond, consistent with still providing the required returns. The documentation that we have seen is not particularly revealing about this point."*[88]

162. The proposition sets out the assumed rate of return on the Strategic Reserve over the long-term of 2% above inflation. With inflation currently at 3%, this equates to a return of 5% per annum. This compares with an average return on the fund since 1986 of 8.1% and recent returns of 8.3% in 2009 and 9.6% in 2012. These historic returns, if repeated in the future would be sufficient to cover the interest on the bond and capital repayment.

163. However, historic returns are no guarantee of future performance. *Opus* have highlighted the importance of appropriate investment management and oversight of the Strategic Reserve and that more work may need to be done in this area,

> *"It is therefore reasonable to ask whether the investment strategy for the Strategic Reserve Fund is being monitored and/or adjusted in order to provide as good a hedge as possible to the debt service of the bond, consistent with still providing the required returns. The documentation that we have seen is not particularly revealing about this point."*[89]

164. *Opus* go on to comment on the role of the Treasury Advisory Panel in this regard,

> *"We understand that the Treasury Advisory Panel is established to bring together the most critical stakeholders in the project to regularly review the investment strategy and disbursements in the context of progress on the hospital construction. It would make sense for this group (if it does not already) also to review the arrangements relating to the debt issuance and hedging, so that there was a natural forum to bring together all the financing issues."*[90]

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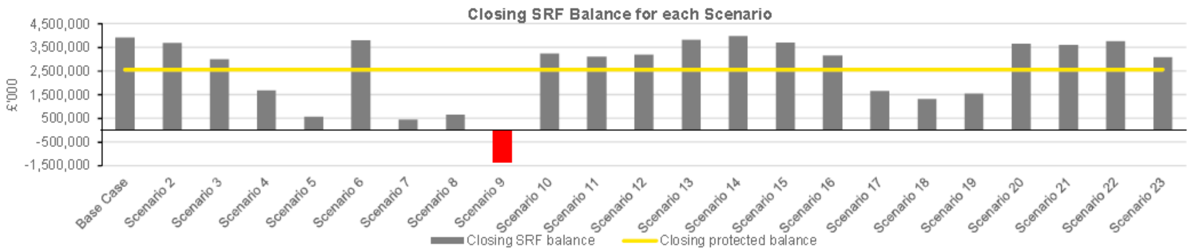
[88] *Opus*. p10
[89] Ibid.
[90] Ibid. p11

165. *Opus* also comment that the advice provided by EY does not extend to the investment strategy of the Strategic Reserve, and note that,

> *"This may be because it is not EY who are responsible for the investment strategy for the SRF. This dichotomy, while understandable in terms of the relevant skill sets of the relevant advisers, creates a fundamental risk which we believe ought to be addressed by pulling together the strategies that will determine the debt service obligations and the SRF returns in order to optimise the opportunity to lock in the arbitrage (as far as is possible) and to minimise the risk of each strategy creating more risk."*[91]

Sensitivity of the Strategic Reserve modelling

166. As part of the planning work for the Funding Strategy, the Treasury Department commissioned some scenario modelling for the Strategic Reserve from their advisors, EY. The results of this analysis are outlined in the following graph produced by EY.



Source: EY[92,93]

167. The scenarios include an increase in construction costs for the hospital, a one-off £100 million withdrawal from the Strategic Reserve, a decrease in investment returns and a decrease in tax receipts over a prolonged period (for example as an impact of Brexit).

168. The worst case scenario was a £42 million shortfall over a 35 year period (scenario 9 in the graph), as explained by Treasury Officers in a Public Hearing,

> ***Director, Financial Planning and Performance:***
> *Yes, 42 million between 2020 and 2055. A 42 million shortfall over 2020 to 2055 was one of the scenarios that we looked at.*

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[91] Ibid. p9
[92] Graph taken from Debt Capacity Analysis paper by EY, dated 3 November 2016
[93]Note: The SRF would be unable to go into deficit, as could be interepted from Scenario 9

> ***Treasurer of the States:***
> *In which case you would still have … that would entirely overdraw considerably the strategic reserve, and that I think would put you in a position of having to draw down £42 million every year, it was just to illustrate. It was not anything we ever thought would ever happen, it is to understand the limit of the …*[94]

For the purposes of understanding what a figure of £42 million would represent, the Panel calculates this to be only approximately a 5% reduction in current levels of States of Jersey income.

169. The results of this analysis indicate the sensitivity of the proposed strategy to relatively small changes in revenue or investment returns.

Key Finding – A permanent reduction in annual income of the States of £42 million (approximately 5%) over a long-term period would lead to the Strategic Reserve being overdrawn without other measures being taken.

170. A number of outcomes indicated that additional measures (such as raising new taxes) would be needed, as explained by the Treasurer of the States,

> ***Treasurer of the States:***
> *It is sufficient to take instances of shocks but under any scenario where you said significant deterioration in the fund, is obviously not, in that event you would have to be thinking about … we would have to be changing the strategy regardless of what you were paying on the bond.*[95]

Key Finding – The stress testing undertaken by Treasury shows that one off shocks can be coped with in the proposed funding strategy. However, permanent structural changes would require changes to the strategy.

171. The possible implications of Brexit are dealt with in a number of the scenarios in the sensitivity analysis. *Opus* draw attention to the risks of Brexit and say that "*the future for the States of Jersey must be considered more uncertain now than at any time in the last seventy years".* They go on to note that the impact on Jersey is hard to predict at present,

> *"… Nevertheless, it is clearly possible that Jersey's future will be affected by Brexit, either because the UK itself becomes more competitive as a relatively tax-light regime for certain activities; or because the EU – and indeed the world*

[94] Public Hearing Transcript (20 March) pp.47-48
[95] Public Hearing Transcript (20 March) p48

more generally – becomes more hostile towards such regimes. As of today, the impact on Jersey is hard to foresee and predict, including the longer term impact on Jersey's credit rating and borrowing capacity, but it points up the main choice to be made here, whether to take advantage of today's historically low spreads and yields or to adopt a more cautious approach in terms of allowing time to see how and when the costs of the project pan out and to tailor the borrowing more closely in terms of quantum and time (albeit in return for the risk of borrowing costs increasing in the intervening time)".[96]

Key Finding – The Panel's advisor has commented that the uncertainty presented by Brexit presents a choice to either take advantage of today's low interest rates or to be more cautious and allow time to see how and when the costs of the project pan out and to tailor the borrowing accordingly.

172. A strategy of issuing a bond and relying on investment returns to exceed the costs of borrowing could be considered to involve a reasonable degree of risk. *Opus* comment "*Indeed, if the strategy is so risk-free, it might be asked why this has not already happened.*"[97]

173. In response to a question on the risks of Brexit in a Public Hearing, the Treasurer of the States emphasised that the proposed option provides certainty to the States,

Senator S.C. Ferguson:
"Given the current uncertainty as a result of Brexit, would it be an opportunity to use the income from the strategic reserve in the first few years and then to issue a bond to cover the bulk of the capital cost from 2019 onwards?"

***Treasurer of the States**:*
"Then what you are doing there is you are taking the view that you are willing to carry the risk of the market moving against you and I come back to …, that the States Government or the States generally like to see certainty rather than Uncertainty."[98]

Hospital Construction Fund

174. The proposition asks States Members to approve the establishment of the Hospital Construction Fund as a Special Fund under the Public Finances Law in order to ring-fence the expenditure on the hospital construction project. The purposes of this proposed Fund are identified in the Proposition as being,

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[96] *Opus*. p8
[97] *Opus*. p8
[98] Public Hearing Transcript (20 March) pp.37-38

"…to facilitate –

(a) the construction and fitting out, and all associated costs, of a new General Hospital facility in Jersey (the "New Jersey General Hospital – JGH"); and

(b) the funding and all costs of arrangement, and financing and repayment of any external borrowing for the "New JGH".[99]

175. The proposition also highlights the importance of having a dedicated fund,

> *"As part of the process of marketing a Bond, investors are interested in the intended use of the funds. Having a specific Fund set up for the hospital construction, and transferring the money received from the Bond into that Fund helps to demonstrate the intended use and to ring-fence that money. It also assists in putting controls around the expenditure."*[100]

176. *Opus* confirm that the proposal of keeping the construction funds separate in a dedicated fund is appropriate, highlighting that it allows for proper management of calls on and payments for the project. They state in their report that this would *"help safeguard good governance of the project"*.[101]

177. The Panel understands that the current intention is to hold the monies raised by the Bond in the Strategic Reserve and transfer to the Hospital Construction Fund in line with expenditure requirements. The transfers will be backed by a Ministerial Decision. This is outlined in the 2nd Amendment to the proposition lodged by the Minster for Treasury and Resources on 3rd April 2017. This is a change to the proposals outlined in P.130/2016, which suggest that the bond monies will be placed directly into the Hospital Construction Fund. In the Panel's view, this is a positive move which provides additional transparency on the project spend as it progresses.

178. *Opus* identified that the management of the Strategic Reserve may have to be altered to take this into account, given the increased flexibility required with funds not allocated to long-term investments.

> *"It is not clear whether the management of the fund is going to be in any way tailored or altered in order to achieve the necessary flexibility, in terms of deploying funds to the Hospital Construction Fund and in terms of securing the necessary returns to service the debt; and whether this results in an increased or decreased risk of investment outcomes from the fund."*[102]

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[99] P.130/2016 p24
[100] P.130/2016 p20
[101] *Opus*. p11
[102] Ibid. p5

179. The Panel asked the Treasurer of the States about the investment strategy for the money raised by the Bond and were told that the money would be held in lower risk investments,

Senator S.C. Ferguson:

"…and where will the money raised in bond be held? In the strategic reserve?"

Treasurer of the States:

"The working assumption is it will be within the strategic reserve as part of the bigger investment portfolio and then release it as and when we need to for the hospital construction fund."

Senator S.C. Ferguson:

"You will be investing it?"

Treasurer of the States:

"The £400 million … this is conundrum which, I think, the Senator is talking about. If we put the £400 million into the wider investment portfolio then we will lose some of the capital, so this is part of the cost of wanting certainty that we will place that £400 million with the Treasury Advisory Panel's advice or listing their conclusions with their own investment advisers and lastly lower risk investments so as to minimise the risk of losing some of the capital."[103]

180. An important aspect that is also worth considering is what controls will be placed on expenditure of the proposed funds. *Opus* highlight the importance of such an action,

"*It would be sensible for the Terms of Reference for the Hospital Construction Fund to be clear about its remit in certain areas, such as:*

- *Validation of payment claims by contractors (including reach-out to principal sub-contractors)*
- *Agreement of variations in the main works and related contracts (subject to whatever wider governance is required for this)*
- *Calls for funding from the Strategic Reserve Fund*
- *Management of funds between receipt and on-payment to contractors*

In terms of management of the Hospital Construction Fund, we would assume that it should be closely tied to – and aligned with - the financial control of the project as a whole."[104]

[103] Public Hearing Transcript (20 March) p38
[104] *Opus*. pp.11-12

181. The terms of reference for the Fund, as set out in P.130/2016, outline the high level remit. In due course, at the same time as formally establishing the Fund, it would be helpful if the Treasury Department could clearly set out the more detailed controls over expenditure that will be in place.

182. The terms of reference contained in P.130/2016 require six-monthly reports on expenditure from the Hospital Construction Fund to be presented to the Council of Ministers and then to the States. This level of transparency is welcomed by the Panel and, together with the controls over money transferred into the HCF, will provide visibility to States Members and the public on project expenditure as it progresses.

N.B. After the above section of the report was drafted, the Minister for Treasury and Resources lodged an amendment to the Future Hospital Funding Strategy which included new terms of reference for the Hospital Construction Fund. The new terms of reference no longer include any reporting obligations. This is something that the Panel will follow up on. The remaining comments above are still relevant to the new terms of reference.

5. Borrowing Limit and the Capacity to Borrow

Overview

183. The States of Jersey has a self-imposed borrowing limit in place. This is set out in the *Public Finances Law* and highlights,

> *"The States shall not authorize any borrowing if it would permit the total amount borrowed by the States at that time to exceed an amount equal to the estimated income of the States derived from taxation during the previous financial year."*[105]

Borrowing is therefore only allowed up to the most recent forecast of the income arising from taxation of the States of Jersey, from the previous financial year.

184. Although the borrowing limit is set out in law, it is essentially a political decision for States Members as to what level of borrowing they feel is acceptable for the Island. If the will of the Assembly was towards a different limit, the Law could be changed. Equally, even if the strict legal limit of "borrowing" was being adhered to under the Law, Members may still consider that the overall exposure to liabilities (even if they were not presently defined as "borrowing") was too great.

Headroom

185. During the original debate of P.130/2016 in January 2017 the Treasury Department provided the following calculation to all States Members detailing the relevant figures at the point of lodging the Proposition:

[105] Public Finances (Jersey) Law 2005, *(Pt.3 Art. 21)* https://www.jerseylaw.je/laws/revised/PDFs/24.900.pdf [Last Accessed: 24 March 2017]

	2016 Quarter 3 Forecast £'000
Income Tax	471,000
GST	83,334
Island Rates	12,142
Impots	56,787
Stamp Duty and LTT	25,394
Long Term Care Charge	17,114
Total 'Income Derived from Taxation' per Article 21	**665,771**
2015 External Borrowing*	243,112
Total 'Borrowing' per Article 21	**243,112**
Balance to Borrowing limit set by Article 21(3)	422,659
Guarantees from 2015 Accounts	
Student Loans	2,700
Small Firms	400
JNWWC	14,900
Jersey Arts Trust	2,300
Total of SoJ Guaratees	**20,300**
Balance to Borrowing limit after Guarantees	**402,359**

Source: Treasury Department[106]

186. From these figures, it can be seen that the total estimated income from taxation was at the time £665 million. It can be also seen from the table above (and as discussed in more detail below), that the States of Jersey has "external borrowing" of £243 million (being the £250 million Andium Bond issued for social housing which is accounted for at £243 million due to the discount paid on the issuance of the bond). This meant that, after taking account of £20 million States of Jersey guarantees (which Treasury have treated as "borrowing" for the purposes of the calculation) the balance left available to borrow was £402 million.

187. This, clearly, is fractionally greater than the proposed £400 million bond issuance and therefore, using the figures provided by Treasury on the date of the debate, allowed under the Public Finances Law.

Key Finding – When the Hospital Funding Strategy was initially debated in January 2017, the proposed level of borrowing (£400 million) was marginally below the permitted headroom under the *Public Finances Law* (£402 million)

106 Copy of the Treasury Department table provided to States Members during the debate on 18/19 January. A version can be found here: (http://www.statesassembly.gov.je/ScrutinyReviewSubmissions/Submissions%20-%20Future%20Hospital%20Funding%20Strategy%20-%20Treasury%20Department%20-%2019%20January%202017.pdf) [Last Accessed: 11 April 2017]

188. Whilst this headroom is clearly acceptable within the legal framework, it is also very close to the limits imposed on borrowing. This margin however has increased since the debate and in a recent Public Hearing, it was identified as now being £25 million,

> **Deputy J.A.N. Le Fondré:**
> *"…You are saying the current expectation for the amount of headroom for borrowing under the Public Finances Law is now better than the £402 million that you gave to States Members on 19th January?"*
>
> **The Minister for Treasury and Resources:**
> *"Correct."*
>
> **Deputy J.A.N. Le Fondré:**
> *"Do you have a rough indication of how much by, like £10 million, £15 million?"*
>
> **The Minister for Treasury and Resources:**
> *"£25 million."*[107]

Key Finding – The headroom for borrowing has increased to approximately £25 million

It should also be noted that had the debate on the Hospital Funding Strategy taken place in November 2016 alongside the debate on the Hospital site, if a bond of £400 million was intended, then the borrowing limit would have been breached and the Public Finances Law would have had to be amended.

189. Despite this increase, there are still risks associated with borrowing up to the practical limit. Opus comments that,

> *"…the scale of the resulting indebtedness is such that the proposed bond (taken in conjunction with the £250m bond already in issue) would utilise a very substantial proportion of Jersey's available borrowing capacity at its present credit rating, at least in the earlier years through construction, with little room to absorb capital cost increases and/or additional project funding. It would also require the capital in the Strategic Reserve Fund not to be used, at least in the early years, and subject to some constraints until the hospital debt was largely paid off, thus restricting (severely in the early years) the insurance value of that fund for other purposes."*[108]

190. Despite the small increase in headroom, a £400 million bond would still leave the Strategic Reserve as the only substantial funding source for unforeseen expenditure or

[107] Public Hearing Transcript (20 March) p23
[108] *Opus*. pp.3-4

for an emergency requirement. The only alternative would be to remove the current restrictions in the Public Finances Law to increase borrowing headroom.

Key Finding - issuing a bond of £400 million would severely restrict the future borrowing ability of the States without changing the current restrictions imposed by the *Public Finances Law*

191. At a Public Hearing, the Minister for Treasury and Resources confirmed there was no current discussion to change the Public Finances Law. However, he confirmed that any future increases to borrowing would require such a change.

> **The Minister for Treasury and Resources:**
> *"Sorry, just go back. Although there have been no discussions within Treasury or the Council of Ministers, of course there are those that are suggesting for student financing we should go out and borrow money, which would be an entirely different debate."*
>
> **Deputy J.A.N. Le Fondré:**
> *"Okay. In other words, if that came through you would have to change the Public Finances Law to increase the ability of the States to borrow money or if any other significant project came through you would have to change the Finances Law again to increase the capacity of the States to borrow money?"*
>
> **The Minister for Treasury and Resources:**
> *"Yes. We would not be able to do both."*[109]

192. The impact that such further borrowing would have on the Island's debt to GDP ratio was also emphasised by the Minister.

> **The Minister for Treasury and Resources:**
>
> *"…What we would be very conscious of would be any impact that borrowing would have on, for example, our credit rating and we are, based on advice, significantly away from that position but we would not want to see it rise very much from the current position."*[110]

193. However, the Minister pointed out that Jersey's debt to GDP ratio would still be relatively small, even with a £400 million bond.

> **The Minister for Treasury and Resources:**
>
> *"But I think it is fair to say that, upon advice, it is unlikely to concern, for example, the rating agencies if we were to need increase our debt to G.D.P. ratio, and I hasten to add again that is not a strategy that is being considered*

[109] Public Hearing Transcript (20th March) p24
[110] Ibid. p25

or is very likely, but there is therefore headroom if, in the future, somebody should decide that they wish to do so."[111]

194. Legally the headroom for borrowing is determined by the Public Finances Law rather than the debt to GDP ratio. However, the ratio would benefit from being examined in greater detail, given the length of time that an issuance of the bond in its present guise, would impact on Jersey's ability to borrow. Being aware of the likely ceiling at which ramifications to the Island's credit rating, or at which the cost of borrowing would become higher, would doubtlessly be useful. The advisors to the Hospital Project Team seem to have calculated a rough indication of such a ceiling.

"Advice from EY is that the States of Jersey could borrow about £850m at their present credit rating (i.e. £600m net of the £250m housing bond). This seems a reasonable estimate, in the present market, but would leave the States of Jersey with very little flexibility for other borrowings."[112]

Key Finding – Jersey's debt to GDP ratio is small, however comparisons of this ratio with other sovereign nations is of limited value. Jersey is not a sovereign nation and the self-imposed borrowing limit as set out in the Public Finances Law is more relevant.

Andium Bond

195. During the debate on P.130/2016 in January 2017, it was identified that in the figures used to justify the borrowing capacity available (presented in the table on p64 of this report), the Andium bond had been included in the calculation at the cash-value figure of £243 million rather than the £250 million bond issuance.

196. Given that the headroom in borrowing capacity at the point of debate was only £2 million (as shown in the table on p64 of this report), the £7 million difference between £243 and £250 million would have been too high under the *Public Finances Law's* borrowing limit, to allow the proposals in P.130/2016.

197. During the debate, the rationale for using the lower of the two figures was raised,

The Bailiff:
"… I think the first question which arises from that is one for the Minister for Treasury and Resources and that is why, Minister, in your figures you have put a detail of the borrowing figure at less than the amount which, according to Deputy Brée is the nominal amount which falls to be repaid?"

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[111] Public Hearing Transcript (20th March) p45
[112] *Opus*. p12

Senator A.J.H. Maclean:
"That is correct. ***the advice we have received is carrying this amount in this way and showing it in this way is correct, because that is the amount we received. We did not receive £250 million, we received the amount shown."***[113] *[Our emphasis]*

198. This was confirmed during the debate by the Solicitor General,

The Bailiff:
"… I think we are only dealing with a question of law at the moment. I wonder if I can just put a question to the Solicitor General. For the purposes of Article 21(3) [of the Public Finances Law], *are you able to say whether the word "borrowing" should include the nominal amount or the amount that was received, as an issue that this is a matter of construction of law?"*

The Solicitor General:
"As I understand it, it should be the amount that is received because the amount seems to me to be just a form of interest or deferred interest. I would say it is the amount received."

199. Therefore, under the Law, the Andium bond had been correctly stated as £243 million. However the Panel is of the opinion that when considering the wider context of the overall level of States debt and liabilities, the total of £250 million is the relevant figure.

Other financial obligations

200. During the course of the debate on P.130/2016, it was considered whether wider States financial obligations would be considered as either additional borrowing or lending, for the purposes of the calculation of headroom.

201. Other types of liabilities listed in the States' accounts include the pre-1987 pension liability and finance leases. These total approximately £383 million[114].

202. The narrow definition of "borrowing" for the purposes of the law would exclude these other liabilities. This is evidenced by advice provided by the Solicitor General during the debate in relation to finance leases,

Deputy J.A.N. Le Fondré:
"As I have asked earlier, would finance leases have been pulled-in to that and that type of idea?"

The Solicitor General:
"…borrowing is not something that is defined in the law. It is something that would ultimately have to be found by a court. In terms of the English case law, it gives it its ordinary natural meaning. Leases, finance leases, it really depends

[113] *Hansard, States of Jersey Official Report* (19 January 2017) p9
[114] Details set out in the Panel's amendment to P.130/2016

on the terms of the finance lease, but as I understand it, the particular finance leases in this case can be discounted for the purposes of the calculation."[115]

On a strict legal basis, therefore, the "borrowing" condition in the Public Finances Law has been met. The Panel note, however, that there are other liabilities detailed in the States Accounts which mean that the actual indebtedness of the States is substantially higher than the legal definition for the purposes of this particular clause in the Public Finances Law. States Members should be conscious of this in the context of further borrowing now being contemplated. In the Panel's amendment to P.130/2016, it is estimated that, if the bond proposal is accepted, the States of Jersey total liabilities would be just under £2 billion[116].

Key Finding - On a strict legal basis, the borrowing condition in the *Public Finances Law* has been met. However it is important to be aware of all liabilities of the States when considering the further borrowing now being contemplated. The Panel estimates that total current and future liabilities would be just under £2 billion if the bond proposal is accepted.

Current borrowing headroom

203. Ultimately, the consideration regarding the borrowing limit must take into account that since the original date of debate the headroom for borrowing has increased to £25 million, as identified earlier. As the Minister for Treasury and Resources outlined during the original debate,

Senator A.J.H. Maclean:

"These figures are based on estimates at Quarter 3, which was the time clearly that we were lodging the proposition or preparing the proposition for lodging. I mentioned earlier on that there had been a number of updates since then, hence the confusion yesterday. ***What I can tell Members is that the position has improved quite significantly in terms of our income****. That has not yet been finalised, but we can provide figures to Members later on which will show a significantly improved position with regard to our income, which ensures that this proposition is, without doubt, compliant."*[117] *[Our emphasis]*

204. Despite this, it must be reiterated that the borrowing headroom of £25 million, whilst technically allowed under the *Public Finances Law,* is still marginal. Furthermore, States Members should be aware that in agreeing to P.130/2016, there would be very little room for future borrowing for a significant period.

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[115] Hansard, (19th January 2017) pp.10-11
[116] P.130/2016 Amd 3
[117] Ibid. pp.12-13

Long-Term Care

205. During the debate on P.130/2016, it emerged that the income raised by the States from the Long-Term Care Charge was treated as taxable income for the purposes of the borrowing calculation. The figures provided to States Members during the debate showed the estimated income in 2016 to be £17 million. This had a significant impact on achieving the headroom within the borrowing limit.

206. The question was asked of the Solicitor General during the debate, whether the Long-Term Care Charge could be included in the calculation of taxable income, for the purposes of the Public Finances Law borrowing limit. He advised that this was able to be included.

Mr. M.H. Temple Q.C., H.M. Solicitor General:

"…I repeat, a hypothecated tax is still a tax and the expenditure it meets is still public expenditure. It changes nothing but appearances that the tax is being accumulated to meet future expenses, long-term care costs in this case. So for the purposes of Article 21(3) in my opinion in legal terms I view the long-term care contributions as a hypothecated tax and I do see it as income of the States for the purposes of the limit that is in Article 21(3) of the Law. That is my advice."[118]

Key Finding – For the purposes of the borrowing condition set out in Article 21(3) of the *Public Finances Law*, the *Long-Term Care Charge* is considered a tax.

207. During a Public Hearing, it was explained that the Treasury Department originally had not expected to include the Long-Term Care Charge in the calculation and had planned to change the Public Finances Law, to allow P.130/2016 to be debated.

Deputy J.A.N. Le Fondré:

"What we are exploring on is that there seems to be a very fine argument as to why it is a tax and not a charge…"

Treasurer of the States:

….in terms of the answer in respect of 21(3) it just goes back to we had not expected to confirm for the purposes of 21(3) that it [Long Term Care] would be deemed tax revenue and, therefore, that is another factor that said that we were looking at changing the Public Finances Law. However, once it was confirmed for the purposes of 21(3) it would be regarded that was another reason that we did not bring it forward against the Public Finances Law to change the borrowing. Obviously if it had not been included then we would not have been able to come forward with the proposition for £400 million…"

[118] Hansard, (19 January 2017) pp.4-5

Deputy J.A.N. Le Fondré:

"Initially you were approaching it that it was a charge not a tax and would not have been included?"

Treasurer of the States:

"Initially, yes, within the confines of how the law works and there were a number of other instances which for accountants feel like one thing but for lawyers feel like something entirely different."

Key Finding – It is clear from the schedule presented to States Members during the debate in January 2017 that if the Long-Term Care Charge had not been considered a tax, the proposed borrowing would have exceeded the available headroom at that time. The option that had been considered in this scenario was to change the borrowing limit in the Public Finances Law.

208. The improvement in headroom within the Public Finances Law to £25 million means that the inclusion of Long-Term Care in the calculation is no longer critical.

209. The potential need for a structural review of the Public Finances Law was raised in a Public Hearing, with the following response.

Deputy J.A.N. Le Fondré:

"Do you think that perhaps in future the Public Finances Law could warrant a bit of a review to clarify some of these errors?"

Treasurer of the States:

"I think the confusion that has arisen in the meantime and the comment probably demonstrates that that is the case."[119]

210. In light of the questions raised in relation to P.130/2016 and the borrowing limit, such a review in due course, would now seem appropriate. This will allow a careful, independent and objective review, with no imminent time pressures or connection to a particular funding need.

[119] Public Hearing Transcript (20 March) p27

Recommendation – The articles of the Public Finances law in relation to borrowing and lending should be reviewed to ensure clarity of definitions, particularly in relation to the definition of “borrowing”.

Recommendation – The Public Finances Law sets the parameters around which the States considers its financing options. The self-imposed borrowing limit set out in the Public Finances Law should be considered as prudent financial management and not subject to change if additional borrowing is considered in the future.

Appendix: PANEL MEMBERSHIP, TERMS OF REFERENCE AND EVIDENCE CONSIDERED

Panel Membership:

Deputy John Le Fondré (Chairman)

Deputy Simon Brée (Vice Chairman)

Senator Sarah Ferguson

Deputy Kevin Lewis

Connétable Christopher Taylor

Expert Advisors

The Panel appointed two advisors for the review. *Concerto Partners LLP* (to examine the cost modelling of the hospital) and *Opus Corporate Finance (to examine the proposed method of funding the hospital)*.

Concerto is a consultancy firm specialising in public and private sector programme delivery and strategy. *Concerto* has worked for the UK government at all levels, providing project review services under the Cabinet Office's Major Projects Review Group framework contract. They have reviewed over 100 health projects for the NHS, including new hospital construction projects and have helped other hospital trusts establish their own internal assurance functions.

The advisors from *Concerto* were:

Mr. M. Symes

Mr B. Yardley

Opus were formed in 2006. They are an independent, management-owned corporate finance advisory house, focusing on the UK and European markets. They specialise in providing advice in relation to financial transactions at a corporate level, having worked across most industries, including large infrastructure projects.

The advisor from *Opus* was:

Mr. R. Morse

Review Terms of Reference:

1. To assess the reliability of the level of identified expenditure on the future hospital capital project (£466 million) and the Minister's contingency plans should expenditure exceed the current estimate
2. To examine the appropriateness of funding the project through a Public Rated Sterling Bond (up to £400 million), supplemented by existing reserves level of borrowing
3. To examine the reliability of associated financial forecasts
4. To establish what other options have been considered and discounted by the Minister, and why
5. To identify any appropriate alternative funding options (i.e. not examined by the Minister) that merit further consideration
6. To assess the proposed use of the Strategic Reserve Fund as part of a "blended" funding strategy
7. To examine the purpose, terms of reference and operation of the 'Hospital Construction Fund'

Public Hearings:

The Panel conducted two public hearings on the 17th and 20th March. The first focused on the remits of the Minister for Health and Social Security and Minister for Infrastructure, whilst the second focused on the remit of the Minister for Treasury and Resources**.** Those attending are listed below.

17th March 2017- Public Hearing- Health and Social Security/Infrastructure

Attendees:

- Senator A. Green, The Minister for Health and Social Services
- Deputy E. Noel, The Minister for Infrastructure
- J. Rogers, Chief Officer, Department for Infrastructure
- M. Penny Director of *Gleeds Management Services*
- H. O'Shea, Hospital Managing Director
- J. Garbutt, Director of Health and Social Services
- W. Gardiner, Project Director, Jersey Property Holdings

20th March 2017- Public Hearing- Treasury and Resources

Attendees:

- Senator A. Maclean, The Minister for Treasury and Resources
- Connétable J. Refault, Assistant Minister for Treasury and Resources
- R. Bell, Treasurer of the States
- A. Rogers, Director, Financial Planning and Performance
- S. Hayward, Director, Treasury Operations and Investments

Briefings:

The Panel received several briefings from the Minister, Assistant Minister and officers of the Treasury Department.

Meetings:

The advisors held the following meetings with relevant stakeholders whilst on-Island:

***Concerto*:**

Thursday 23rd February: Hospital Project Team, Jersey Property Holdings and advisors from *Gleeds*

Thursday 2nd March: Hospital Project Team, Jersey Property Holdings and advisors from *Gleeds*

Friday 3rd March: Hospital Project Team, Jersey Property Holdings and advisors from *Gleeds*

Opus:

Thursday 23rd February: Treasury Department (including conference call with members of EY based in the UK)

Evidence Considered:

The Panel received a large quantity of information from both the Treasury Department and the Hospital Project Team (including detailed information form the advisors to each). The main elements of that evidence is listed below:

- P.130/2016 and its and associated amendments.[120]
- Series of confidential documents provided by Treasury Department and their advisor *EY.*
- Series of documents provided by the Hopsital Project Team and their advisors, *Gleeds.*
- Public Hearings held on the 17th and 20th March.[121]
- Briefings (as above)[122]
- Submissions from members of the public.[123]

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[120] Found here: http://www.statesassembly.gov.je/Pages/Propositions.aspx?documentref=p.130%2f2016 [Last Accessed: 11 April 2016]
[121] Transcripts for which, found here: http://www.scrutiny.gov.je/Pages/ReviewTranscripts.aspx [Last Accessed: 11 April 2017]
[122] Minutes to which (when available), found here: http://www.scrutiny.gov.je/panels/Pages/PanelMinutes.aspx?panelid=7 [Last Accessed: 11 April 2017]
[123] Found here: http://www.scrutiny.gov.je/Pages/ReviewSubmissions.aspx?ReviewId=256 [Last Accessed: 11 April 2017]

Annex A: Solicitor General's Statement in Full: Taxable Contributions

STATES OF JERSEY OFFICIAL REPORT (HANSARD) THURSDAY 19th JANUARY, 2017

Mr. M.H. Temple Q.C., H.M. Solicitor General:

"Yes, I have considered the matter overnight and I have reviewed the Public Finances Law and the Long-Term Care Law. I have also had regards to English case law concerning tax and contributions. Those are obviously not Jersey cases but in my respectful view they would be highly persuasive to the Royal Court in considering this issue. So in terms of how legally a tax is viewed and defined, in law there is a distinction between charges levied by a state which are contributions and those which are taxes. So the classic example of a contribution is social security whereas the latter taxes comprise all compulsory charges and taxes. So the distinction between a tax and a contribution is a contribution is, essentially, one of personal entitlement arising by virtue of having made contributions and being calculated with respect to the amount of the contributions. So a classic example is National Insurance, or social security contributions which in English law are not taxes. There is a case in England concerning Goldman Sachs where it was held that social security contributions are not taxes whereas a tax is one where a person is required by virtue of having done something or because the State's permission is required to do something simply because the person exists. A tax is, it might be said, to be something which the citizen does not really get any rights in return whereas a contribution is something where the payer accrues an entitlement. It does not need to be the case that a person who pays the contribution necessarily becomes entitled in due course. Other factors may affect that entitlement such as where the individual lives in the future but the causal link between the contribution and the entitlement must have some degree of reality. So here indirect taxes such as the impôt, stamp duty, land transaction taxes are taxes for the purposes of Article 21 of the Public Finances Law. So in my submission, that is made clear by the definition of taxes and taxation in Article 1 of the law. So tax includes a duty and taxation shall be interpreted accordingly. That is the definition of taxation in the law. Rates are also taxes because the legislation imposes an obligation to pay rates by virtue of land ownership or occupation. However, social security contributions are not taxation. So they are not included for the purposes of Article 21. However, taxes that are levied for specific purposes are taxation notwithstanding there may be legal limits on their use. All tax is levied for a purpose or a range of purposes but a particular tax is legally directed towards a single public purpose, so-called hypothecated taxes, does not make it any less the use of State power to

levy taxation. The fact that it is a hypothecated tax still means it is taxation. So a person who makes no contributions will still be able to benefit from long-term care in this case, whereas a person who makes large contributions to long-term care will not receive any additional entitlement under the Long-Term Care Law to benefits.

In this case, the long-term care fund is not separate from the States. It is not a fund like P.E.C.R.S. (Public Employees Contributory Retirement Scheme) or the Teachers' Superannuation Fund which are separate funds from the States. The Long-Term Care Fund is a fund that is managed by the Minister for Treasury and Resources that is set aside to pay a particular purpose. So ultimately it is a means by which the States will be able to meet expenses currently met by tax going into the Consolidated Fund. If the States were to stop paying someone out of tax paid to the Consolidated Fund but it allocated tax into a tax into a ring-fenced fund, has the States lost income? No, it is still meeting public purposes through taxation. I repeat, a hypothecated tax is still a tax and the expenditure it meets is still public expenditure. It changes nothing but appearances that the tax is being accumulated to meet future expenses, long-term care costs in this case. So for the purposes of Article 21(3) in my opinion in legal terms I view the long-term care contributions as a hypothecated tax and I do see it as income of the States for the purposes of the limit that is in Article 21(3) of the Law. That is my advice."

Annex B: Advisor Report: *Concerto*

States of Jersey

concerto
In tune for change

Cost Assurance Report

Future Hospital Project

Version number: **1.02**

Status: Final

Date of Issue to Scrutiny Panel: 31st March 2017

Chair of Scrutiny Panel: Deputy John LeFondre

Client: **Corporate Services Scrutiny Panel,** States of Jersey

Review dates: Feb 23rd -6th March 2017

Review Team Leader:
Matthew Symes, Concerto Partners LLP

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The authors acknowledge that this report is based upon the principles of the Cabinet Office document "Gateway Review 0 V4.0 (High Risk Delivery)" dated June 2008.

Executive Summary

In February 2017 the Corporate Services Scrutiny Panel of the States of Jersey appointed Concerto Partners LLP to consider the reliability of the budget for the New Hospital Project, reporting back before 7th March 2017.

It is a characteristic of all major projects that the uncertainty level of the cost forecast shrinks as time progresses. The range of uncertainty is greatest at the start of the project and progressively reduces as risks either crystallise or fall away with time.

The Future Hospital project is at the start of such a journey. Having selected the preferred site in December 2016, the project team is now in the early stages of planning, design development, risk management and cost forecasting. Our lines of enquiry in this review reflect that context.

We were reassured by several factors:

- The cost forecasts are derived from standard hospital cost models, tuned to this physical layout.
- Detailed recent benchmarked cost data also informs the cost build-up.
- The cost forecasts are based on early price estimates from the professional teams
- The level of planning / design development is relatively advanced, for this stage in the lifecycle
- The capability of the professional services team supporting the project team is high
- There is a strong focus on risk mitigation.
- The project team know they must maintain constant vigilance regarding scope creep, design development and change control

The project team are fully aware of several upward cost pressures on the budget:

- The timeline is tight. The sequence of activities required to reach the investment decision point is now most challenging. The project board sanctioned a justified beneficial change in January 2017 which extends the project completion date by three months. Such extensions consume the contingency funds roughly at a rate of £1-2 million per month.
- Several of the major risks are not in the project's team's control – for example the Planning Permission timings, the impact of Brexit both on labour availability and on pricing, and recent revisions to population growth assumptions on the island.

Our view is that the processes used by the project team to develop and validate the budget are robust and that the amount of contingency funding within the declared budget looks sufficient in relation to the risks. Under the UK Government Gateway review process, described in more detail in the report, we classify the cost elements of this project as **Amber-Green**.

The Value Management process, which is being transparently operated, has so far been used to maximise performance within the budget ceiling. Following this philosophy means that the project has a lower chance of coming in under budget. If risks reveal themselves late on in the project there will be less financial headroom within which to find compensating savings. If this philosophy prevails, the rating would be closer to **Amber** from a cost perspective.

We make a few recommendations later on this report relating to our detailed findings. Our main recommendation is to reaffirm the balance of objectives between cost, performance and time. Is the project to be cost-driven or quality-driven or time-driven or some combination of the three and what is the desired balance?

Introduction & Terms of Reference

The Corporate Services Scrutiny Panel of the States of Jersey have commissioned Concerto Partners to review the reliability of the capital budget for the Future Hospital project and have separately commissioned Opus Corporate Finance to review the funding arrangements. The combined terms of reference are reproduced here with Concerto concentrating on the first point and Opus on the others (shown in italics).

- To assess the reliability of the level of identified expenditure on the future hospital capital project (£466million) and the Minister's contingency plans should expenditure exceed the current estimate
- *To examine the appropriateness of funding the project through a Public Rated Sterling Bond (up to £400million), supplemented by existing reserves level of borrowing*
- *To examine the reliability of associated financial forecasts*
- *To establish what other options have been considered and discounted by the Minister, and why*
- *To identify any appropriate alternative funding options (i.e. not examined by the Minister) that merit further consideration*
- *To assess the proposed use of the Strategic Reserve Fund as part of a "blended" funding strategy*
- *To examine the purpose, terms of reference and operation of the 'Hospital Construction Fund'*

The two reviews were conducted over the same time period, concluding by 7th March 2017.

The approach taken by Concerto in conducting our element of the review was to examine the processes followed by the project team, supported by their professional advisers, in building the elemental cost plan for the project, taking into account best practice at this stage in the project's lifecycle. We examined the processes followed and the benchmarks used in establishing those cost forecasts. We considered the risk management process and the associated change control and governance arrangements. We also examined the critical path and the nature of the detailed timeline and planning processes.

We would like to thank Will Gardiner and the project team from Gleeds for making themselves available throughout the course of this review to participate in several workshops and meetings and for making information available in a timely way.

We would also like to thank the Panel's Scrutiny Officers, Simon Spottiswoode and Tim Nicolle, for excellent support vis-à-vis planning, liaison, logistics and review organisation.

1. Findings

The following table summarises the total project costs and our findings. The commentary below the table expands on the findings in more detail.

Description	**Total Cost £M**	**Approach taken**	**Commentary on reliability of budget**
Works Costs			
Departmental Works Costs, after Location Factor	213	• Requirement development led by Project Director Health Brief supported by EY capacity modelling and Gleeds cost and project management specialists • Health Premises Cost Guides (HPCG) index/model + fine tuning including 15% space efficiency reduction	• Expected Requirement development process • But NB Final Project Brief not due to be signed off until Final Business Case (FBC) stage • Standard industry practice by Gleeds QS in developing cost model
		• Benchmarking against nine comparable UK hospitals	• Future Jersey Hospital costs look to be at the upper end of the benchmark range
		• Project has identified “abnormal site costs” to cover unique aspects of project over and above standard costs in HPCG data - for example piled foundations	• Good to be explicit about “abnormal site costs” as early as possible. • Process supported by specialist industry input for example Arup
		• Allowance for location uplift is based on Royal Institute of Chartered Surveyors Building Cost information Service (BCIS) indices supported by other local benchmarking	• BCIS data limited for Jersey, particularly for projects of similar nature and size to this hospital • Difficult to assess accurately at this stage
Works sub total	213		
Fees	32	• 15% allowance	• Standard industry allowance • Gleeds are contracted on fixed fee basis until FBC

Non Works Costs	15	• Property purchase costs based on professional advice by BNP Paribas	• Complex arrangement of freeholds, leaseholds and commercial owners/tenants • Compulsory purchase may be necessary
Equipment costs	19	• 15% allowance • Assumption is that there will be mostly new equipment when moving into new hospital	• Industry standard allowance • Detailed equipment strategy now being prepared
Project Cost Total	279		
Contingency and risk	74	• 12% allowance for changes during design and construction • Allowance for "Optimism Bias" which is a risk allowance based on UK Treasury Green Book approach • This is a standard calculation leading to a 13% allowance	• Construction allowance on low side for project of this type and nature at such an early stage but taken with Optimism Bias seems reasonable
Sub total	353		
Inflation	69	• 19.5% allowance • Based on BCIS indices	• BCIS data subject to variations looking ahead and can change significantly against judgements on future economic trends • Difficult to assess accurately but is current good practice. Some risk will always remain.
Main Hospital Forecast Outturn	421		
Relocation Works Costs	40	• A range of smaller projects including refurbishment of Westaway Court	• Work to be procured and delivered locally and costs based on local industry

			information with Gleeds oversight
Inflation on Relocation Works Costs	4	• Based on BCIS indices	• Relocation works largely in 2017/18 so limited scope for inflation
Relocation sub total	44		
Forecast Total Outturn Cost	**466**		

The structure of the table above mirrors that stated in the paper entitled “States of Jersey Future Funding Strategy” which was lodged au Greffe on 30th November 2016.

The £466M Forecast Total Outturn Cost excludes:

- Any explicit provision for possible extra capacity to the Patriotic Street Car Park, potentially by the construction of additional floors. This is to be expected, given that the future scale of the car park is not decided yet and that car park construction and management is usually a separate function in Jersey.
- Demolition costs of the redundant existing hospital buildings once the new hospital has been occupied.
- The development costs and value of the redundant existing hospital site. The value part of the equation may be significant, depending on Planning Permissions.
- Leasing costs for the new long-term off-site catering facility (which are included in the GEM).
- Any allowance for local Goods and Services Tax or UK Value Added Tax. The latter may apply if pre-fabricated / modular construction techniques form part of the built solution.
- The cost of financing debt.
- Currency risk – this applies to all non-Sterling purchases ranging from medical equipment through to elements of construction and potentially to the entirety of the construction scope
- Construction / finance costs for rehousing medical staff presently accommodated in Westaway Court.

There is always a grey area regarding the exclusions at the “edge” of a project and sometimes misunderstandings can develop about their extent. The exclusions above are logical and sensible but the States will need to make sure these costs are budgeted for somewhere within the overall system of Government.

Works Cost:

The works costs are highly dependent on the certainty level of the underlying Project Brief, many aspects of which are predicated on the successful transformation of the whole healthcare system in Jersey. The Project Director Health Brief, with support from the Gleeds medical planning team and EY, and with stakeholder key engagement are continuing to develop and manage the requirement.

The finalisation of the Project Brief is critical to this process and the resulting works requirement and cost. The Project Brief has been signed off but is developing further under the project's Change Control mechanisms – a process that will continue until Final Business Case Stage. EY are undertaking work to revisit the capacity modelling which underpins the requirement. This modelling work was originally undertaken in February 2015 and is being revisited to reflect, among other things, an increase in the population.

In order to give confidence to the works cost element of the Forecast Total Outturn Cost Gleeds have undertaken some top down strategic benchmarking against the cost of similar projects in the UK. This indicates that the estimated cost of the Future Jersey Hospital could well be at the upper end of the cost range for similar hospitals in the UK. At our request, the project team expanded the initial benchmark data set, comprising two Welsh hospitals, to include a further seven relevant hospitals from around the UK in a report delivered to us on 6th March 2017. The report as presented (for obvious reasons, given the speed of the analysis) lacks full commentary to explain the findings and assess the implications for the Future General Hospital cost forecast. Initial inspection by the review team leads to the conclusion that the cost forecast is at the upper end of the benchmark range.

The Gleeds team know they must actively monitor the cost of the project and, as design work develops, they will prepare a Cost Plan, at RIBA Stage 2, in July 2017. This will be an important point at which the validity of the works cost can be considered; the more detailed design will enable the QS to prepare an elemental estimate of the building costs, based on actual design information.

Location Factor:

Adjusting the works costs to account for the Jersey location factor is not an easy exercise given the size, scale and complexity of the hospital project and the anticipation that it will be procured from an off-island contractor, probably UK-based.

The BCIS location data for the relative costs of building construction in Jersey, based on tendered projects when compared to UK prices, is based on a small sample of projects and does not provide a consistent picture over time. The Energy from Waste project, the most recent large project in Jersey, indicated a cost of upwards of 25% more than an equivalent facility in the UK. The current allowance is therefore reasonable at this stage. The proposed hospital project will be more than three times the scale of the Energy from Waste Project so there may be a volume efficiency which would reduce the scale of the Location Factor.

Fees:

Gleeds are instrumental in ensuring that the project budget is well-managed and controlled and that it is delivered to time and quality objectives too.

The project team's approach is to place Gleeds on a lump sum fee arrangement, awarded in stages. This helps reduce the risk of an over-run on their fees, unless there are scope changes in which case it would be normal to provide compensation for the effects of the change.

Looking ahead it might be worthwhile aligning Gleeds' fee remuneration model to that of the main contractor once appointed. For example if there is a cost incentive mechanism on the main contractor to achieve savings and efficiencies (sometimes called a "pain/gain" mechanism) it might be worth structuring Gleeds' fees accordingly. This would align behaviours across the professional and delivery teams.

Contingency/Optimism bias:

The allowance for contingency and risk / optimism bias, at £74M, is clearly significant.

As part of our work we asked Gleeds to test a range of scenarios to judge the sensitivity of the overall £466M budget. The scenarios tested included assessing the impacts of a one year delay to the start, or to the finish. They included examination of potential labour cost rises of 10% and 20% due to Brexit. The worst of these scenarios produced an adverse impact of £21 million, which potentially could be covered by the contingency/optimism bias funds.

Project Programme:

The project has a lengthy programme and any changes could have a significant impact on the reliability of the current project budget due to the criticality of inflation and time-related preliminary costs within the main contract.

The front end of the project programme is considered tight, particularly in the first year. There are a number of significant activities which are likely to be on or near the critical path and in some cases have elements outside the direct control of the project team. These include:

- Town planning – a UK based inspector will be appointed to consider the application and a recent high profile school project in Jersey has had its application rejected. That said the project team are taking appropriate steps to mitigate the risk of delay and consequential cost increases. This work includes early engagement with among others the planners and influential bodies such as the Jersey Architects Commission.

- It is also likely that the Planning Authorities will require some work or financial contribution over and above the road improvement work in the budget under Section 106/Community Infrastructure type arrangements.

- Finalisation of Project Brief will be a challenge, requiring sign-off from multiple health stakeholders, alongside financial stakeholders.

- Finalisation of the procurement strategy, tender process and appointment of contractor.

- Enabling works, particularly the redevelopment of Westaway Court.

- Work to free up the existing hospital site following the vacation of the buildings including asbestos removal, isolation of building services, temporary works and demolition.

In our view the programme has several critical or near critical paths in the period up to the main contractor starting on site. As a consequence a delay in any of these areas could lead to overall programme delay and pressure on the project budget. Such slippages will consume the contingency budget.

Inflation:

An inflation allowance of 19.5% has been included which is based on the BCIS information currently available. The index has a tendency to fluctuate and since preparation of the Forecast Total Outturn Cost of £466M the BCIS index has indicated that future inflation may not be as great as was anticipated at that time.

As a result of favourable changes in the index, an additional £13M of headroom has recently been identified against the originally budgeted figure and the Project Board in January 2017 took a decision to reallocate £11M these potential savings towards funding some value-enhancing changes. The main change approved by the Board was the demolition and reconstruction of Westaway Court, rather than its refurbishment. This potentially added six months to the programme critical path, but half of the delay was absorbed by float within the project programme. The net result is that the completion date for the new hospital has been delayed by three months against the approved baseline.

The decision to reconstruct Westaway Court had to be made quickly, being an activity at the front-end of the timetable. We saw evidence that the project took the decision fully within the agreed governance mechanisms in a timely way. That said, in due course the inflation index could subsequently turn upwards, as could the cost risk in other variables. Once Westaway Court's reconstruction is underway the project team would have to find compensating savings from other areas of scope or functionality or eat into the contingency funds to accommodate the pressure.

Procurement Strategy:

The project team is finalising the procurement strategy, probably predicated on a two-stage design and build arrangement. This has the advantage of facilitating early contractor involvement with the possibility of novation of the design team to the contractor. The project team are also favouring a maximum price target cost arrangement.

The commercial arrangements within the procurement strategy will have an important bearing on the reliability and future control of the project budget. For example the mechanism for agreeing the target price of the final design will be critical to controlling cost between the two stages of the procurement process. If it is not possible to agree a full framework for establishing the final target price (for example if the scope isn't sufficiently settled) then the levels of profit, overheads and preliminaries will need to be agreed to keep commercial tension in the procurement process and control the potential for cost growth. Gleeds are fully aware of this.

2. Conclusion

The UK Government Gateway review process asks review teams to grade projects according to stated Delivery Confidence Assessment criteria as follows:

RAG	Criteria Description
Green	Successful delivery of the project/programme to time, cost and quality appears highly likely and there are no major outstanding issues that at this stage appear to threaten delivery.
Amber/Green	Successful delivery appears probable. However, constant attention will be needed to ensure risks do not materialise into major issues threatening delivery.
Amber	Successful delivery appears feasible but significant issues already exist requiring management attention. These appear resolvable at this stage and, if addressed promptly, should not present a cost/schedule overrun.
Amber/Red	Successful delivery of the project/programme is in doubt with major risks or issues apparent in a number of key areas. Urgent action is needed to ensure these are addressed, and establish whether resolution is feasible.
Red	Successful delivery of the project/programme appears to be unachievable. There are major issues which, at this stage, do not appear to be manageable or resolvable. The project/programme may need re-base lining and/or overall viability re-assessed.

In forming our view, we saw evidence of a number of competing factors some of which re reassuring and some of which promote concern.

The following points provide reassurance on the reliability of the budget

- The design development is well underway for this stage in the lifecycle. Design work is already progressing at the 1:200 scale, which will facilitate more detailed cost forecasting.
- The cost forecasts are based on standard hospital costs models supported by relevant benchmarking data; this indicates that the current cost forecast is at the higher end of the benchmark range.
- The professional services support teams have a high capability and appear to have a grip on the costs, timelines and performance requirements.
- The project team also has a strong grip on costs, timings and quality / performance objectives
- The risk management process is comprehensive and matches good practice
- The change control process is transparent and robust
- The stakeholder engagement process appears extensive and comprehensive, thus reducing the risks of subsequent (costly) changes

- The governance arrangements look robust
- The contingency funds and risk allowances appear reasonable.

Factors that create concern at this stage include the following points:

- The critical path is already tight and has (transparently and under change control processes) slipped three months since publication of the budget, consuming savings that would otherwise either have returned to the contingency funds or lowered the total forecast completion cost. Further critical path slippage will challenge the contingency funds at a rate of £1-2 million per month.
- Recognising that this is a once-in-a-generation project, the Project Board or team may tend to maximise the quality of the delivered solution, staying within the total budget envelope. This philosophy reduces the chances of the project coming in under budget – more the aim is to come in on budget having maximised the delivered functionality / performance. If, however, risks reveal themselves late-on in the project, with the budget fully committed, there may not be headroom to find solutions at that stage within the budget envelope.
- Several of the major risks are outside of the project team's influence. It is too early to know yet whether Brexit will inhibit labour availability on the island and push up costs or create delays, or affect material prices. It is also too early to say whether the recently revised population forecasts have a material impact on the proposed solutions. Or whether the Planning Permission process will proceed within the expected timelines. Such factors may translate into major time and cost pressures for the project.
- The raw benchmarking data provided at our request during this review indicates that the Future Jersey Hospital forecast total outturn cost could be at the upper end of the expected range. While it is prudent at this relatively early stage in such a complex project to have a conservative budget, further work should be undertaken to mature the benchmarking report provided on the 6th March 2017.

In the round, based on the insights gained in the review, we conclude that the cost aspects of the project "grade" is Amber-Green, given the level of contingency funding available and given the grip that the project team has on the risks, on change control and on design development. We would however grade the costs as "Amber" if the philosophy of maximising value and consuming savings / contingency prevails throughout the remaining time - as this will commit funding and constrain the ability to find solutions if risks materialise late-on. This is a philosophical point that reaches to the heart of the change control process and we make some recommendations on this in the section below.

3. Recommendations

3.1. This review of the Future Hospital project costs has raised some improvement opportunities that the Scrutiny Panel may wish to discuss with the SRO in the first instance and subsequently with the project team.

- We recommend reaffirming the precise balance and trade-off between the three objectives (performance, costs and time), for example
  - Is this a quality-driven project, maximising quality within the budget of £466 million?
  - Or is it a more cost-constrained project in which the aim is to maximise the savings below £466 million, by limiting scope and performance enhancements to the current vision / level of expectation?
  - To what extent is this a time-driven project – for example what is the extent that existing services can cope with potential delays?
  - In a nutshell – what are the relative priorities between cost, time and performance?
- With the project underway, we recommend clarifying the contingency ownership:
  - A simple approach, but effective, is to determine which body within the governance structure owns the contingency sums (or relative proportions of them). For example the Treasury could hold a defined amount of the contingency, not to be accessed without sanction. The Project Board could hold the rest.
  - A more insightful approach is to allocate contingency money to specific risks and similarly decide which body in the governance structure can best manage those risks and should hold the relevant contingency funds.
  - Under both management approaches, rules are needed for the "return" of contingency that is no longer needed (e.g. does it go to the Treasury contingency pot or to the one held by the Project Board?). Similarly rules are needed for unforeseen risks – who holds the pot for unknown risks? Clarity is essential.
- Consider incentivisation of advisers, in line with the cost, time and performance objectives.
- We recommend that the benchmarking report provided to us on 6th March 2017 is developed further, in terms of its logical or contextual analysis and in terms of possible implications for the project budget

APPENDIX A

Interviewees

Name	Role
Mike Penny Nigel Aubrey Tom Brader	Gleeds Lead Technical Adviser Gleeds QA Partner Gleeds Cost Management
Will Gardiner	Project Director – Delivery
Ray Foster	Director – Estates, Jersey Property Holdings

Annex C: Advisor Report: Opus Corporate Finance

opus

Corporate Services Scrutiny Panel – States of Jersey

Future Hospital Funding Strategy

March 2017

Strictly Private and confidential

JERSEY HOSPITAL FUNDING STRATEGY

Background

1. The States of Jersey is proposing to build a new hospital and to fund it principally through the issuance of a bond equivalent to the capital value of the hospital.

2. In this context, we have been asked to provide an independent and impartial professional analysis of the evidence received by the Panel in the course of a review and to assist in directing the Panel's ongoing research of matters falling within its terms of reference.

3. The Panel has stipulated that it is seeking assistance in the following areas:

   • the proposals to fund the majority of the project costs through the issue of a bond, and whether the type of bond proposed is the most appropriate option.

   • what other options were considered and whether the decision to proceed with a bond in preference to other options is a sound one.

   • the use of the Strategic Reserve to fund the costs of the bond and some of the capital, including (on the basis that the predicted returns are accurate) whether there is sufficient headroom (particularly in the short term) within the accumulated returns without having to utilise the capital.

   • the appropriateness of the proposals to hold the monies raised in a separate "Hospital Construction Fund"

4. In a subsequent communication (following an exploratory visit to Jersey including a meeting with members of the Panel), the Panel asked for the following specific issues to be considered:

   - If the Bond is drawn down in full up front, the predicted returns that the £400m will generate while sitting in the Hospital Construction Fund (presumably invested in liquid assets so not generating the same return as the Strategic Reserve predictions). And to consider this against the possibility that the bond could be drawn down in different tranches.

   - What strategy is in place to hedge the strategic reserve against downturns in the markets?

   - Given the uncertainty over Brexit and the unknown potential impacts on the Crown Dependencies, is now the right time to be considering external borrowing of this magnitude?

   - What is the optimal tenor for the bond?

Process and documentation

5. In reaching the views contained in this paper, we have had access to a suite of relevant documents. We have also had the benefit of interviews with officials from the Treasury and their advisers EY; extensive discussions with the Scrutiny Office and a meeting with members of the Panel itself. In addition, we have liaised closely with Concerto, who are advising the Panel on issues relating to the likely cost of the hospital project.

6. On 13 March 2017, we received a further document from EY addressing issues raised during our meeting, in particular deferred drawdown options and RPI-linked debt (both discussed in more detail below), and also some additional issues raised in email correspondence on 3rd March 2017, such as hedging, tenor considerations and issuance costs (also covered below). This EY advice is referred to as the "EY Response Document" in the remainder of this paper. We understand that Members of the Scrutiny Panel can have access to EY's advice and thus facilitate cross-references to that advice in this document.

Context and principal findings

7. The hospital would represent a major new asset for the States of Jersey, at an expected cost (in today's money) of £466m – by way of comparison the capital cost is equivalent to more than half of the States predicted average annual income over the next three years and about 100 per cent of the self-imposed borrowing limit relating to that income, taking into account the existing borrowings.

8. Against this cost, the hospital itself is not projected to produce any significant income, which rules out most forms of private finance and project finance to help fund the hospital.

9. As a result, the entire funding programme of +/-£450m needs to be found from the resources of the States of Jersey. The two principal sources of capacity to achieve this are:

    a. The Strategic Reserve Fund, which had reported capital of £771m as at end of 2015 (as per Strategic reserve forecasts provided by Treasury) and anticipated income of £34.3m in 2017, predicted to increase steadily each year in the "no hospital" forecast provided by Treasury. The most recent total accumulated income balance is £92.4m, although there are already committed drawings totalling net £123m scheduled over the next 3 years; and
    b. The States of Jersey's unutilised borrowing capacity within its current credit rating. A further constraint is the States of Jersey's self-imposed cap on total borrowing by reference to its annual tax revenues.

10. The present proposal is to issue debt securities in the name of the States of Jersey, to transfer the proceeds on demand to the Hospital Construction Fund to meet construction and related costs; and to service the resulting debt interest and repayments from the income of the Strategic Reserve Fund.

11. This approach would appear to be a pragmatic way forward, given the self-imposed restraints referred to in 7. and 9b. above but the scale of the resulting indebtedness is such that the proposed bond (taken in conjunction with the £250m bond already in issue) would utilise a very substantial proportion of Jersey's available borrowing capacity at its present

credit rating, at least in the earlier years through construction, with little room to absorb capital cost increases and/or additional project funding. It would also require the capital in the Strategic Reserve Fund not to be used, at least in the early years, and subject to some constraints until the hospital debt was largely paid off, thus restricting (severely in the early years) the insurance value of that fund for other purposes.

12. Within the overall plan to issue a new bond, there are several more detailed issues that need to be addressed and would repay more detailed analysis than is apparent from the documents that we have reviewed. Each of these is considered in the main body of this memorandum but they include:

    a. The risk that income from the Strategic Reserve Fund is inadequate to service the new debt, either because the capital in the fund needs to be deployed for some other purpose; or because investment returns fall/become more volatile, so as to prove an unreliable or inadequate source of debt service. We consider these risks to be strategic and hence worthy of a clearer and more explicit combined strategy bringing together the investment strategy for the Strategic Reserve Fund in the context of the management of debt service risk.

    b. The optimal timing for the issue of the bond. There are three main issues under this heading:

        i. Profile: It is cheaper to borrow all the money in one go (due to optimal sizing and liquidity constraints, and also the costs of issuance) but the spending profile of the hospital covers many years, meaning that the proceeds of the bond must be reinvested until required. Whether such reinvestment can be at the same rate as projected for the Strategic Reserve Fund as a whole needs further investigation.
        ii. Commitment and drawdown: other recent capital project fundings have sought to use deferred drawdown bonds as a way of locking in today's historically low rates, judging that the commitment cost payable until drawdown is worth paying against the risk that rates rise in the meantime.
        iii. Market conditions: is it a good time to borrow, given historically low yields and margins, or would it be better to wait bearing in mind the uncertainty associated with Brexit and the US political scene? Certainly, bond yields and spreads are historically attractive, which argues in favour of borrowing now (notwithstanding the carrying cost). But given the level of contingency in the hospital budget, there is some risk of overfunding, if the full amount is borrowed early.

    c. Whether the bond should be wholly or partly index-linked. Index linking offers lower debt service costs in the short run, but creates a larger (and potentially uncapped) repayment requirement on maturity. This profile is potentially better suited to the States of Jersey's financial profile (given the projected States deficits in the early years of the hospital project) but the projected risk profile relating to the repayment is a deterrent. We agree that index-linking may not be the optimal solution at present, but believe that this issue should at least be reconsidered when the bond issuance is due to go live, if only to confirm this finding.

d. Tenor: the Treasury is proposing a long-dated bond (e.g. 30 or 40 years, although the proposed tenor is not yet finalised). To the extent that this is longer than the projected life of the hospital, there is a risk that there will be pressure on capital resources to fund any refurbishment or renewal of the hospital now being planned.

e. Management of the Strategic Reserve Fund. Various scenarios have been given for the performance of the Strategic Reserve Fund, which would appear to show that the income from the fund should be sufficient to service and repay the Hospital Bond (the proceeds of which will have been used to pay construction and related costs). It is not clear whether the management of the fund is going to be in any way tailored or altered in order to achieve the necessary flexibility, in terms of deploying funds to the Hospital Construction Fund and in terms of securing the necessary returns to service the debt; and whether this results in an increased or decreased risk of investment outcomes from the fund. It would be good if Treasury, as advised by Aon Hewitt, could be more explicit about this. It may be advisable to establish an oversight group to monitor the investment strategy in the light of bond liabilities.

f. Contingency. It is clearly possible for the project to exceed its projected cost and/or for the Strategic Reserve Fund to be unable to service the debt. At present there seems to be no adequate plan for dealing with that possibility, both in terms of preventing the problem occurring and in terms of dealing with it if it does. Given the scale of the project relative to the States of Jersey's borrowing capacity at its present credit rating level, this would seem to be of considerable importance.

More detailed discussion of issues

13. Whole costs

The sum of £466m has been stipulated for the construction cost of the hospital and this is commented on elsewhere by Concerto.

This figure does not take into account:

(a) Interest during construction. In the way that the project has been presented, interest during construction is netted off the returns to the Strategic Reserve Fund, rather than capitalised as part of the overall project cost, which would be a more normal accounting treatment. To that extent, the true cost of the hospital, including contingency, may be understated at £466m; nor

(b) Capital refurbishment and renewal during the life of the new hospital. We understand from Treasury that it is intended that these costs should be addressed through the capital programme in those years or through the base revenue budget, as appropriate, but it should perhaps be acknowledged that these items represent a further capital drain associated with the Hospital within the likely life of the bond.

It would be helpful to see more analysis on these numbers.

14. Funding approaches

We have been asked whether a bond issue is the right approach for the financing of this hospital project.

EY have done a good review of the other options available and we fundamentally agree with them that, given the constraints, a bond issue is probably the most sensible and pragmatic way to fund the hospital. These constraints are, however, worth a bit more discussion.

It has been decided not to utilise external equity (or near-equity) to finance the hospital. We are aware that the Private Finance Initiative (PFI)/ Private Public Partnership (PPP) routes have not got a particularly good reputation in the States of Jersey – and it is true that the cost of finance for these types of solutions is higher than that achievable by issuing a bond in the name of States of Jersey. On the other hand, these types of investment structures offer a more comprehensive risk sharing structure, both in terms of sharing the capital burden but more particularly in creating an additional layer of protection, with third party support, compared with a 100% Government funded structure. Private sector cost control and governance can add both financial muscle and commercial wisdom to project management. This paper does not seek to reopen that policy decision but to point out that the scale of the project (and the risk inherent in it) is partly a result of this policy constraint.

We understand that it is proposed that the hospital generally should not charge for its services, other than in respect of the relatively small percentage relating to private patients. Two consequences of this are (a) that there is no internal cash-flow to help debt service or to act as a back-up should the proposed arrangements prove inadequate and (b) the financing (via a States of Jersey bond) effectively becomes separate from the hospital project itself, leading to an unusual situation where the bond investors have relatively little stake in the project which they are funding. Again, it is not the purpose of this paper to try to change policy in this area, but I think it would be helpful to reserve the right for the hospital to charge for its services (subject to whatever governance conditions need to apply) as part of the contingency plans (see section 18 below), and that having such a right in reserve would make investors in the Hospital Bond feel more confident.

The consequence of these two constraints is that traditional PFI/PPP approaches, which involve private capital, and traditional project finance, which is typically secured on the project cash-flows, can be ruled out. That essentially leaves state-funded solutions. Leaving aside tax-based solutions, which we also understand to have been ruled out from a policy perspective, the only realistic sources of capital reside in the States of Jersey's borrowing capacity and the Strategic Reserve Fund. The question would therefore appear to be how to use these two sources of capital in combination to best effect.

15. Bond options

EY recommend the use of a straightforward Sterling long-dated bond with bullet redemption. This is analogous to the £250m States of Jersey bond already in issue and has the merit of simplicity and certainty as to the timing and quantum of capital repayment.

Issuance fees and costs

The Scrutiny Panel asked us specifically about issuance fees and costs. The EY Response Document has provided further information about these issues. The biggest single fee is the book-runners (estimated at £800,000 to £1,000,000 or 20-25bps). This would represent an improvement over the bookrunner fees charged for the debut £250m bond, which was 27bp. This estimate for a follow-on Bond seems reasonable. On top of this is a whole slew of legal, accounting and listing fees estimated by EY at £530,000 to £590,000. These seem reasonable as well, particularly at the lower end.

The EY Response Document helpfully sets out an example of a typical discounting for the Hospital bond (on page 11) and we believe that the approach they have outlined is reasonable and in line with market practice.

Other issues

There are a number of issues that merit further discussion and analysis around some of the details of the bond:

a. Timing of issuance and of drawdown. Bond market yields and spreads are close to historic lows. This makes early drawing of the bond attractive, since there is clearly more upside than downside risk in interest rates and spreads. However, the bulk of the capital costs of the hospital construction project are spread over five to six years from 2019 onwards (and that assumes no delays in the planning or preparatory processes between now and then). This conjunction suggests that consideration needs to be given to the optimal timing of any bond issue and also of the drawdown of the proceeds of that issue.

   Recent issuance by Bazalgette Tunnel Limited, a major UK infrastructure project presently being financed in the market has seen that Company issue bonds that are committed now but drawable up to various points in the future. A commitment fee is paid on the undrawn amount. That company has judged that the commitment fee is worth paying to lock in today's historically low rates.

   That is a much larger project, so each tranche of debt is big enough not to attract a premium in terms of issue costs and/or liquidity. In the case of Jersey Hospital, the profile is such that each individual year's expenditure is too small to justify an individual bond issue, so even a delayed drawdown strategy will only approximate a matching of the funding to the expenditure. Nevertheless, the principle as to whether to lock in now or wait for the expenditure to be closer in time is an important consideration and did not appear to have been very thoroughly considered as a funding option prior to our review.

   This issue has now been addressed in more detail by the EY Response Document which notes that utilising debt instruments which incorporate a deferred drawdown capability could lead to lower all-in financing costs, supported by calculations shown on p6 of that document. However, the EY Response document concludes overall that a straightforward non-deferred Sterling bond is preferable, when the cost of hedging the deferred drawdown instrument is taken into account, and when the risk of adverse rate movements is taken into account if the deferred drawdown is unhedged. Our view remains that this issue ought to be re-considered when the time for financing is actually live and that is well worth testing the options available in the market at the time, rather than plumping now for a single option funding strategy.

One reason why this is important is that the future for the States of Jersey must be considered more uncertain now than at any time in the last seventy years. There appears to have been remarkably little unsettling effect following the Brexit vote (Jersey was downgraded from AA+ to AA in February 2016, but this was unrelated and was the result of a systemic change by Standard & Poors rather than anything specific to Jersey. Jersey was also downrated to AA- in July 2016 and put on negative watch as a result of the Brexit uncertainty, signalling some unease about a negative outcome). Treasury have reported to us that they had a positive meeting with Standard & Poors earlier in 2017 who appeared to be sanguine about Jersey's prospects despite the Brexit vote. Treasury also explained to us that Jersey's economy has diversified away from City of London-linked business.

Nevertheless, it is clearly possible that Jersey's future will be affected by Brexit, either because the UK itself becomes more competitive as a relatively tax-light regime for certain activities; or because the EU – and indeed the world more generally – becomes more hostile towards such regimes. As of today, the impact on Jersey is hard to foresee and predict, including the longer term impact on Jersey's credit rating and borrowing capacity, but it points up the main choice to be made here, whether to take advantage of today's historically low spreads and yields or to adopt a more cautious approach in terms of allowing time to see how and when the costs of the project pan out and to tailor the borrowing more closely in terms of quantum and time (albeit in return for the risk of borrowing costs increasing in the intervening time). This in turn puts a great emphasis on the ability of the Strategic Return Fund to achieve its returns.

One way of looking at this is that, based on the Funding Plan as presented, the States of Jersey would be well advised to borrow now and enjoy the arbitrage on returns from the Strategic Return Fund even in the absence of the need to build the hospital. Indeed, if the strategy is so risk-free, it might be asked why this has not already happened.

b. Index linking

The index-linked market allows borrowers to borrow at a rate such that the ultimate capital repayment is related to movements in the RPI from the date of issue. Typically interest costs are lower in this market than in the "vanilla" bond market, but there is risk around the amount to be repaid. RPI-linked bonds can be a useful part of a Company's funding profile, particularly where some or all of their revenues are linked to RPI (e.g. the utility sector in the United Kingdom).

In the case of the Jersey Hospital, there are no revenues to be considered as part of this equation, so the question falls more to the profile of the receipts of the States of Jersey (the underlying creditor) and to the returns on the Strategic Reserve Fund (which is servicing the debt). If these were expected to systematically outpace inflation, then an RPI linked bond (as part of the financing mix) might be considered appropriate, particularly as the lower interest rate cost in the early years would chime well with a period of negative balances on the States of Jersey accounts, as forecast to 2019.

It has already been noted that the £466m of capital to be raised does not allow for more than one or two bonds (if financing efficiency is to be maintained), so a partly RPI-linked strategy might lead to one or two slightly under-sized bonds. Nevertheless, this is an issue which merits more analysis than was apparent in the original EY report.

The EY Response Document addresses this issue more thoroughly and comes to similar conclusions to those mentioned above, for similar reasons. So we accept that index-linking is probably not the optimal funding option given the overall objectives of the financing.

As with the deferred drawdown arguments, we would recommend that these issues are considered again by Treasury and the Bookrunner again at the time of going live with the bond issuance, if only to validate this conclusion.

c. Hedging strategy: the hedging strategy needs to consider the hedging of the bond itself (to minimise uncertainty about debt service costs) and the relationship between the profile of the resulting debt service payments and the returns from the SRF. The EY Response Document is considerably more specific on these topics than their original advice, provided to us for review.

   In terms of the bond, the hedging approach and costs are set out on p13 of the EY Response Document. This recommends pre-hedging the yield of the benchmark gilt to lock in the gilt yield that forms the major (and the most volatile) component of the all-in cost of funds. In the absence of any other consideration (such as the natural relationship between the debt service costs and the return from the SRF), such hedging would appear to be recommendable.

   The cross-hedging question is not addressed by the EY Response Document. This may be because it is not EY who are responsible for the investment strategy for the SRF. This dichotomy, while understandable in terms of the relevant skill sets of the relevant advisers, creates a fundamental risk which we believe ought to be addressed by pulling together the strategies that will determine the debt service obligations and the SRF returns in order to optimise the opportunity to lock in the arbitrage (as far as is possible) and to minimise the risk of each strategy creating more risk.

d. Tenor: the tenor advocated by EY is 40 years. This period is not particularly linked to the useful economic life of the hospital but driven by a combination of the desire for certainty over the life of the financing and optimal market pricing given the shape of the yield curve and market appetite, while also allowing sufficient time for the bond to be fully repaid. More detail on this is helpfully set out on p12 of the EY Response Document. It is clear that lower borrowing costs could be achieved with shorter term bonds, but these expose the States to the risk of higher rates when they mature (as indicated by the forward yield curve), and also give less time for the arbitrage between the bond cost and the yield on the SRF to provide the income for debt service payments.

   This judgement goes to the heart of the financing strategy which is to lock in today's favourable borrowing rates (yields and spreads) to optimise the chance that the SRF income will be sufficient to meet the debt service on the bond. It is implicit in this approach that the return risk on the SRF over a similarly long period is also optimised.

16. Investment strategy

A critical part of the overall funding plan is to service debt payments (and even repayment) from the profits of the Strategic Reserve Fund. Aon Hewitt has provided various scenarios for the performance of this fund which show a comforting degree of robustness in terms of the fund's ability to service the debt.

However, it is apparent that returns from investments, even a broadly based fund of the size of the Strategic Reserve Fund, cannot be guaranteed. It is also apparent that returns from investments are not necessarily well correlated with borrowing costs. To take an extreme case, if the investments were all in companies or situations that benefited from reductions in the cost of borrowing, then the risk between the liability on the bond and the return from the investments would not be well correlated.

It is therefore reasonable to ask whether the investment strategy for the Strategic Reserve Fund is being monitored and/or adjusted in order to provide as good a hedge as possible to the debt service of the bond, consistent with still providing the required returns. The documentation that we have seen is not particularly revealing about this point.

It is clearly important that the Strategic Return Fund has the flexibility to meet debt service payments when due (these should have a high degree of predictability so those managing the fund will need to ensure that there is sufficient cash to meet the payments out of the Fund).

More fundamentally, the Strategic Reserve Fund's capital will need to be fully reserved to servicing the Hospital Bond, at least in the initial years when the risk of an overall mismatch is greatest. This means that the capital in the Strategic Reserve Fund cannot be used for any other purpose until it is clear that the returns from the fund are more than adequate to service the Hospital bond, in which case it might be possible to envisage using pre-defined criteria to enable a release of capital.

Thus the insurance aspect of the Strategic Reserve Fund (that would let it be used, for instance, to pay in the event of the sudden collapse of one of the island's key industries) is removed, and at the same time the capacity of the States of Jersey to borrow its way out of an event to which the Strategic Reserve fund could have been applied is diminished. Indeed, if the event or circumstances arise in which, in the absence of the hospital construction, the Strategic Reserve Fund might have been drawn, there may be additional short or medium term pressure on the States' borrowing capacity, thus eating into the apparent "breathing space" of +/- £140m between the £600m of additional borrowing capacity at today's credit ratings and the £466m to be borrowed for the hospital. In the circumstance where the hospital cost overruns and an extraneous event/circumstances occur(s), there could be significant pressure on the States' finances.

We have considered in this context whether it could be more efficient to use the capital in the Strategic Reserve Fund to meet the early capital payments on the hospital so that a bond could be issued in an optimal amount one or more years into the construction of the hospital with the dual purpose of meeting the payments on the hospital and replenishing the Strategic Reserve Fund. On the face of it, this route would be more expensive, since the whole proposed scheme relies on the arbitrage between the borrowing cost of the Hospital Bond being less than the return on the Fund, but it would reduce the timing risks and also reduce the interest cost during construction, but with an increased risk relating to refinancing costs in later years, including the risk of higher interest rates. Consideration of this approach points up the confidence that is required in the returns from the Fund, which in turn points up the question of whether the fund should be more explicitly managed to generate the profile and quantum of returns necessary to service the Hospital Bond.

It is clear that the management of the Strategic Reserve Fund is critical to the success of the proposed plan. We understand that the Treasury Advisory Panel is established to bring together the most critical stakeholders in the project to regularly review the investment strategy and disbursements in the context of progress on the hospital construction. It would make sense for this group (if it does not already) also to review the arrangements relating to the debt issuance and hedging, so that there was a natural forum to bring together all the financing issues.

17. Funding structure. We understand that it is proposed to establish a dedicated Hospital Construction Fund to receive monies from the Strategic reserve fund that are earmarked for expenditure on the project (but not its financing costs, which will remain a direct liability of the Strategic Reserve Fund).

    This proposed structure seems to be sensible in that it allows for proper processes to be established to call for and distribute payments, which can help safeguard good governance of the project.

    It would be sensible for the Terms of Reference for the Hospital Construction Fund to be clear about its remit in certain areas, such as:

    - Validation of payment claims by contractors (including reach-out to principal sub-contractors)
    - Agreement of variations in the main works and related contracts (subject to whatever wider governance is required for this)

- Calls for funding from the Strategic Reserve Fund
- Management of funds between receipt and on-payment to contractors

In terms of management of the Hospital Construction Fund, we would assume that it should be closely tied to – and aligned with - the financial control of the project as a whole.

18. Contingency. Despite all the careful planning there is clearly still a risk that the project gets into financial difficulties. In that case, it will be important to be clear about how best to manage those risks (mitigation) and how best to act if the mitigation proves inadequate.

The three most obvious risks are:

- overspend. Mitigation against cost overspend is principally covered in Concerto's paper. The need for sound contract structures, delivery team incentivisation etc, is important to financial investors because they will want to know the project isn't going to turn into a "black hole" that could destabilise the States of Jersey's credit rating; and
- the Strategic Reserve Fund proving inadequate to meet debt service requirements. Mitigation against this risk is discussed above in this paper in terms of trying to minimise debt service costs and optimise investment returns, together with the suggestion for a more co-ordinated approach to matching the liabilities to the expected returns.
- Some extraneous event or circumstances occurring that require additional funds (for which the Strategic reserve fund might have been used), thus putting overall pressure on the States' finances.

The project would benefit from a clearer contingency plan if these mitigations fail.

One approach would be to establish progressive lines of defence (beyond the risk mitigation mentioned above), for instance:

(a) Additional borrowing and/or sale of assets in the Strategic Reserve Fund. Advice from EY is that the States of Jersey could borrow about £850m at their present credit rating (i.e. £600m net of the £250m housing bond). This seems a reasonable estimate, in the present market, but would leave the States of Jersey with very little flexibility for other borrowings. To devote such a huge proportion of the entire States borrowing capacity is also questionable in terms of balance and risk. The circumstances in which the hospital had significantly overspent and/or the Strategic return fund had delivered less than expected might well reduce this headroom. This might be the sort of crisis for which the strategic reserve fund could in fact be used, allowing for more borrowing over time to replenish the Fund. It would clearly also be possible, at least in theory, for the States of Jersey to accept a ratings downgrade and borrow more, but the viability and desirability of this would have to be considered at the time in the light of the States' finances and prospects. Trading a new hospital for a credit downgrade is clearly not part of the main plan now.

(b) Allow the hospital to charge for some or all services – there may be merit in allowing the Hospital/Department of Health to take that power now, even if they do not intend to use it – and such use can be protected by whatever governance the Government wished to impose - so that it could be shown to investors that this line of defence was potentially available. This would be of some reassurance to investors that the project could generate income if needed

(c) Sell all or part of the hospital or its operations. This would also represent a major policy shift, since it would involve part- or full privatisation of the hospital, which might in turn also require some charging power to be available to the hospital in order to recompense private investors for the capital deployed in stepping into an equity role.

These are merely suggestions for consideration. But it would be advisable to have an agreed plan as part of the project planning and preparation.

Annex D: Corporate Services Scrutiny Panel: Amendment to P.130/2016 (4th April 2017)

STATES OF JERSEY

FUTURE HOSPITAL FUNDING STRATEGY (P.130/2016): THIRD AMENDMENT

Lodged au Greffe on 4th April 2017
by the Corporate Services Scrutiny Panel

STATES GREFFE

FUTURE HOSPITAL FUNDING STRATEGY (P.130/2016): (AS AMENDED)
THIRD AMENDMENT

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1 PAGE 1, PARAGRAPH (b) –

Delete the words "and to approve the Fund's purpose, terms of reference and operation as set out in the Appendix to the report accompanying this proposition;" and substitute the words –

> "the terms of reference for which are to be brought forward by the Minister for Treasury and Resources for approval by the States Assembly at a later date;".

2 PAGE 1, PARAGRAPH (c) –

Delete paragraph (c) and renumber the remaining paragraphs accordingly.

3 PAGE 1, PARAGRAPH (d)(i) –

After the words "States Assembly" delete the remaining paragraph and substitute the words –

> "and a compensating payment into the Strategic Reserve from the Consolidated Fund will be made each year in order to recapitalise the Strategic Reserve Fund which will be funded through a mechanism to be proposed by the Minister for Treasury and Resources and subject to approval by the States Assembly;".

4 PAGE 1, PARAGRAPH (d)(ii) –

After the words "in agreeing to", delete the words "the borrowing specified in paragraph (c)" and substitute the words "(d)(i)".

5 PAGE 1, PARAGRAPH (d)(iii) –

Delete paragraphs (d) (iii) and (d)(iv) and renumber the remaining paragraphs accordingly.

CORPORATE SERVICES SCRUTINY PANEL

REPORT

The principal purpose of this amendment is to allow States Members to debate, and properly decide on whether they want to fund the new Hospital project through external borrowing (e.g. via a bond) or through internal funding (e.g. the Strategic Reserve). This Amendment provides Members with a clear alternative option.

From the work we have performed – which will be identified in the report we will be issuing before the debate on P.130/2016 – the proposals from the Council of Ministers are not, at first glance unreasonable, if external borrowing is considered the best way forward.

The Minister for Treasury and Resources is seeking to borrow up to £400,000,000 by issuing a bond to the markets, to fund the cost of the Hospital Project. It is likely that the interest rate on the bond will be somewhere between 2.75% and 3%, which will represent an annual interest charge of between £11,000,000 and £12,000,000, for the entire life of the bond. At present it is expected that this will be 40 years, therefore the total interest charge will be between £440,000,000 and £480,000,000 over and above the amount of capital that will have to be repaid (of £400,000,000).

The Treasury Department consider that this can all be met from the Strategic Reserve, particularly in the context of historically low interest rates and the level of past returns that have been achieved by the investments held in the reserve.

They have considered various scenarios, and many of them do show satisfactory results in this regard.

One-off shocks to the investment performance of the Strategic Reserve indicate that the main underlying capital of the Reserve can be retained. The total value of the Strategic Reserve was stated in P.130/2016 as being £866 million at the end of October 2016.

The Panel's principal concerns relate to other scenarios considered by the Treasury Department. These are scenarios which consider what happens when there is a permanent change in certain circumstances.

The Panel has seen evidence that should investment returns fall by as little as 1.5% from those assumed by the Treasury Department, there will be a significant impact on outcomes. This is particularly the case if another event was to occur at the same time (for example a cost over run on the project).

This evidence further suggests that a structural fall in overall States revenues of as little as 3.5%[1] would result in very little remaining of the Strategic Reserve. In the event that there was a structural fall in revenue of between 4% and 5% (approximately) this would wipe out the Strategic Reserve within 25 years, and would create a deficit of £1,356,220,000 (£1.356 billion) within 40 years.

It is this evidence, and its analysis of how extremely sensitive the strategy is to relatively minor changes in income forecasts, that has significantly influenced the views of the

[1] This assumes this generates deficits which would have to be funded from the Strategic Reserve.

Panel. This is why the Panel is of the opinion that States Members should be given an alternative funding option to debate and vote upon.

It is clear that at this moment in time, the Island (and the United Kingdom, as well as Europe) are in the most uncertain position both economically and politically, for the last 70 years. No-one at this stage can predict the outcome of the Brexit negotiations, and the structural impact they will have on our revenue and tax base. This could arise out of direct financial pressures, a change in the nature of the financial services industry, or even greater political pressure (with a consequential financial impact). Given the uncertainty, the Panel believes that it is sensible to consider what happens should a less than favourable situation arise.

A further concern that the Panel has, is that States Members are being asked to make a decision without being provided with an overview of the total liabilities of the States.

Following a preliminary calculation by the Panel, as set out below, members should consider the Treasury Department proposals in light of adding to an already considerable level of liabilities.

	£'000
PECRS Pre-1987 Past Service Liability	274,619[2]
Provision for JTSF Past Service Liability	104,452[2]
Finance Lease Obligations	4,698[2]
Andium Bond	250,000
Sub-total	**633,769**
Other Liabilities (estimated)	
SOJDC	74,000
Hospital Bond	400,000
Sub-total	**1,107,769**
Note : In addition there are known to be the following total interest obligations:	
Andium:	
250M @ 3.75% for 40 years[3]	
[£9.375 million per year]	375,000
Hospital (estimated) :	
400M @ 2.75% – 3% for 40 years	
[£11M – 12M] per year	440,000 – 480,000
Total	**1,922,769 – 1,962,769**

The Panel are concerned as to the magnitude of the liabilities that the States already needs to service, and the impact that a bond of this size would have in increasing such liabilities.

The Panel considers that there is an alternative option that States Members should consider. That is, to utilise the funding already available to the States from the Strategic

[2] Per States Accounts – year ended 31St December 2015
[3] Note: This represents total life of bond, some of which has already expired.

Reserve and to introduce a mechanism by which this can be recapitalised. It should be noted that the Treasury Department did model the concept of utilising funding from the Strategic Reserve, but did not model the subsequent recapitalisation.

Precise calculations are still awaited by the Panel. Our initial calculations indicate that the annual sum required (in present day terms) would be between £5 million and £7 million per year (to be uplifted annually by the Cost of Living).The Panel has not specified the exact amount in the Amendment, because rightly this should be left in the hands of the Minister for Treasury and Resources to determine. The Panel considers that the objective should be to recapitalise the Strategic Reserve to the level that is the estimated target under the present proposals of issuing a bond for £400,000,000.

The Panel do not consider a proposal to pay a minimum of £5 million – £7 million per year (uplifted by cost of living) into the Strategic Reserve Fund, to be an onerous task. In fact it seems highly realistic. For example, carry forwards over the last 4 years average over £25 million. It would mean that there was no debt to service (of £11 million – £12 million per year) and it would mean there was no capital to repay (of £400 million).

In summary

Given that a favourable outcome (from issuing a bond) could be reversed by relatively small permanent changes in income forecasts or returns on investment, the Panel therefore considers that an alternative should be available to States Members for debate on 18th April 2017.

The choice being presented is therefore to borrow £400,000,000 externally from the markets; or to use our own funds. This avoids having to repay £400,000,000 of capital AND over £400,000,000 in interest over the period, but requires a commitment to a small annual payment in order to top up the capital balance. The Panel considers this to be a more far-sighted and prudent strategy, which acknowledges the inherent dangers of borrowing large sums of money, exacerbated by the uncertain economic climate in which we find ourselves. We therefore offer this amendment to Members, to give them a valid option to funding the future hospital.

Financial and Manpower Implications

There are no manpower implications created by this amendment.

There would be a financial commitment to pay into the Strategic Reserve Fund a sum of money (to be subsequently determined by the Minister for Treasury and Resources). However, the Amendment would remove the commitment to pay both the annual interest and the final capital figure on the proposed borrowing.

Note:
A copy of the "as amended" version of P.130/2016 can be found via this link (P.130/2016 – 18th January 2017)