STATES OF JERSEY

Public Accounts Committee
Energy From Waste Plant - Management of Foreign Currency Exchange Risks

FRIDAY, 24th APRIL 2009

Panel:
Senator B.E. Shenton (Chairman)
Connétable J.M. Refault of St. Peter (Vice Chairman)
Senator A. Breckon
Mr. A. Fearn
Mr. K. Keen
Ms. A. Heuston (Committee Clerk)

Witness:
Mr. D. Hager (Hewitt Associates)

Senator B.E. Shenton (Chairman):
Alexander is one of our non-States Member members; Senator Breckon; Constable Refault and Kevin Keen is another one of our other non-States Member members. When did you come over? This morning?

Mr. D. Hager (Hewitt Associates):
Yes, I came over this morning.

Senator B.E. Shenton:
Thank you very much for coming over.

Mr. D. Hager:
I do apologise, Chairman, for not being available on Monday and for any inconvenience that may have caused you.

Senator B.E. Shenton:
Normally we would like to give more of a lead-in time for these hearings, but obviously it is quite a very important issue and so we are trying to organise as quickly as possible. I have to go through a bit of housekeeping and read you a prepared statement. "The proceedings of the panel are covered by parliamentary privilege through Article 34 of the States of Jersey Law 2005 and the States of Jersey (Powers, Privileges and Immunities) (Jersey) Regulations 2006 and witnesses are protected from being sued or prosecuted for anything said during the hearings unless they say something that they know to be untrue. This protection is given to witnesses to ensure they can speak freely and openly to a panel when giving evidence without fear of legal action although the immunity should obviously not be abused by making unsubstantiated statements about third parties who have no right of reply. The panel would like you to bear this in mind when answering questions." If you could just start by giving us a little bit of background as to what Hewitt's relationship with the States is and why you were asked for advice

anyway.

Mr. D. Hager:
Hewitt's has provided advice to several States schemes over the years. The main pieces of advice have been to do with the investment policy of the Strategic Reserve, Social Security Reserve Fund and the Teachers, but not at present on the investment side for P.E.C.R.S. (Public Employees Contributory Retirement Scheme). There have been a whole series of various different engagements under one or more client agreements for those bodies. The services were originally provided by a partnership called Bacon & Woodrow which in 2002 was amalgamated into the American company Hewitt's business and that is in common with most U.K. (United Kingdom) actuarial firms that are becoming one way or the other global. We continue to trade under the name of Hewitt Bacon & Woodrow Limited and more recently we have dropped the Bacon & Woodrow bit so we just trade as Hewitt Associates Limited.

Senator B.E. Shenton:
For my sins I am on the Committee of Management for P.E.C.R.S. I take it you have seen the Auditor General's report?

Mr. D. Hager:
Yes, indeed.

Senator B.E. Shenton:
Where it refers to Hewitt and advice has been asked for, is this you that they would have spoken to or is it someone else?

Mr. D. Hager:
Yes, the report mentions 3 people in total who were connected in one way or another, but it is my responsibility for Hewitt's investment relationship with the States and, therefore, I am responsible for organising those individuals.

Senator B.E. Shenton:
In respect of this particular advice, was this more of a goodwill gesture, the offering of this advice, or was it something you were remunerated for?

Mr. D. Hager:
No, the client agreement which we have with the Treasury and Resources Department asks us to provide advice, essentially where requested, on the Strategic Reserve and on the Minister's responsibility for various funds. It is denominated so that we can give advice on any States asset, but equally that means that we are not required to do everything for the States in the way of advice because they take advice from lots of different people as you see from this particular paper here. You saw that Deloittes were appointed as financial adviser for this transaction; way back in 2007 this happened. Our connection, first of all, was in May 2008 where we were asked the question roughly how much would it cost, because they were not going to carry out the transaction, to buy a currency option until 31st October 2008. So is it 2 per cent, is it 4 per cent, is it 6 per cent, is it 10 per cent was the sort of advice that was required then and that was all. Apart from that I had a minor conversation, and what I mean by "minor conversation" is that in the course of coming over here to talk about the Strategic Reserve assets, the Social Security reserve assets, George mentioned that he had a problem with the waste project which you were carrying out and said: "What sort of factors would you take into account in deciding what to do?" So that, if you like, was a general conversation over a sandwich at lunch and really not much more than that. I went through the standard thing that you would do with this type of project which are things like what happens if the exchange rate goes very high, what happens if the exchange rate goes very low, how sensitive is the outcome to a change in the exchange rate? It does not really matter here whether

you say the exchange rate is denominated in fixed terms for the purpose of the contract because if you know the contractor has 50 per cent or 70 per cent of his costs varying on the euro that is a valuable piece of negotiation that you can use either for or against him depending on how you want to play it. So however you viewed this project, right from day one you would have had to have taken currency into account even if all the way through it was negotiated in pounds, quite simply to get value for money. If you put yourself in the position of the other guy, the contractor, you have to really know what makes him move in order to drive for the lowest possible price. So it was those sorts of general issues that one would be talking about to people like George Butler.

Senator B.E. Shenton:
In the early days Deloitte were contracted to provide the advice with regard to the currency and what you have just said is in the early days you were specifically used to price check or check out the cost of options and so on and so forth rather than specific advice.

Mr. D. Hager:
Yes, we were not asked to do anything specific until the piece of information that you see in there which was an incredibly generic piece of advice in October 2008.

Senator B.E. Shenton:
You mentioned it was "generic advice". We spoke to Royal London Asset Management and they said they just gave generic advice as well. Have you at any point been asked for specific advice with regard to this particular contract or has advice been more of a generic base?

Mr. D. Hager:
Let me get the reference so as not to mislead you in any way. The advice I am referring, when we were first involved, was paragraph 135 on 24th October and it is quite clear from this that there was a telephone the previous day which said: "We have a contract where the payments are to be made in euros." I am quoting from the start of paragraph 135: "We have the option to pay 1.28 million as an option premium. Here are some other options. Give me some advice." If you read the advice I gave which is set out in paragraph 136 - apart from somewhere where I am querying where I do not understand one of his figures which is subsequently obvious, by the way, from things that are in this report later on, but at the time I did not understand where the figure came from and do now - I ended up by making what I would regard as a generic statement and other people say is a specific statement, but I am saying to him here that most people would now close out this risk with a series of forward foreign exchange contracts. The second thing I showed him here was that in my view because the payments were upfront, and by "upfront" I mean a lot of money was going out in December and January, you were on a very short-term risk in the foreign exchange market and you have only a Chancellor to stand up in the Commons to ruin the foreign exchange in a day, in an hour, and in 2 months it can go anywhere. So it was a basic warning in here, as you can see, that things can happen in short periods and you cannot talk about purchasing parity and getting it right in the long term if all you have to worry about is payments in 2 months' or 3 months' time. It is just not enough time for the economic factors to come through so it was a bit of a warning. Given I had not been involved in the contract it is difficult to give this sort of advice when you do not know who else has been advising in the same territory and you do not know all the facts. When I look back on it I still have to say it is not a bad piece of advice knowing everything else that has gone on even though I say that myself.

Senator B.E. Shenton:
No, although they did not take your advice?

Mr. D. Hager:
That is a different issue. Life is a bit like that.

Senator B.E. Shenton:
So good advice, but not taken.

Connétable J.M. Refault of St. Peter:
What I would like to pick up, David, if you do not mind, is who was the relationship between, was it with the Treasurer or was it with the T.T.S. (Transport and Technical Services), the steering group, the project group?

Mr. D. Hager:
No, I had no dealings at any stage in this with the project group. In the days when George Butler was around all my dealings with the States was through George Butler.

Mr. K. Keen:
Because he was the strategic investment manager, was he? That was his title, was it not, or something?

Mr. D. Hager:
I would have to look at the back. Over the years I have dealt with Ian Black, Jason and George, but when George was around my dealings were with George. Since George departed the scene clearly Maria Washington does not work full time so therefore, inevitably I deal with both the Deputy Treasurer and with Maria. But I do not deal with other people apart from Ian Black. I did see Kevin Hemmings, but that was only through this project in the November/December time. I have never dealt with him, over all the years I have been coming here, prior to that date and have not dealt with him since.

The Connétable of St. Peter:
Within the last 6 months did you have any contact at all with the Treasurer of the States on this advice?

Mr. D. Hager:
I would not normally speak directly to the Treasurer, but I have spoken to him on, I suppose, half a dozen occasions.

The Connétable of St. Peter:
Within the last 6 months?

Mr. D. Hager:
Yes, and I would see him at meetings for the Strategic Reserve and Social Security Reserve Fund, but my conduit normally is through his deputy. I have spoken to him this week, for example. In fact, I speak more to his deputy on average than I would to him personally.

The Connétable of St. Peter:
But on this particular topic, on the energy from waste plant project, have you spoken to him …

Mr. D. Hager:
Yes, mainly through Jason.

The Connétable of St. Peter:
But have you had any contact at all …

Mr. D. Hager:
Very limited.

The Connétable of St. Peter:
But you have had some contact?

Mr. D. Hager:
Yes, but very limited.

The Connétable of St. Peter:
Directly with the Treasurer?

Mr. D. Hager:
Yes. It would be relatively limited and all my information here … when the Auditor General came along to me I copied out all the emails on my system so he has everything I have. If it is not in here I do not have it basically because we have an electronic system for recording all these things which I can show you and that was the easiest way to give you all the information. Any conversation that is not here is inconsequential and does not include advice.

The Connétable of St. Peter:
Would it be fair to say then that your conversations with the Treasurer, albeit on the E.F.W. (Energy from Waste) plant, were on a casual basis rather than an official basis?

Mr. D. Hager:
Yes, because I would be dealing with his Deputy or with Kevin Hemmings over this particular project. If you look at the emails concerned in November, the initial email came from Kevin Hemmings, I think on paragraph 135, and I think all the replies went back to him or to Jason Turner from the emails you see in here. I do not think there is anything directly to Ian Black, but he may well have been copied in on them. I can check that point for you.

The Connétable of St. Peter:
That would be useful, thank you, if you would not mind. I think that would be quite useful for us to have that.

Mr. D. Hager:
If you can understand, I would have to go away and do that and drop you a note if that is okay.

The Connétable of St. Peter:
Yes.

Senator B.E. Shenton:
When Ian Black was interviewed initially concerning the fact that they had not hedged the euros, he said this was on the back of advice given. Would you categorically state that at no time did Hewitt say: "Do not hedge the euro?"

Mr. D. Hager:
No. No, because …

Senator B.E. Shenton:
In fact, your advice was to purchase forward foreign exchange contracts to fix the exchange rate?

Mr. D. Hager:
One of the things I am very careful to do, and it is nothing to do with the States, is over the years I have learned that you do not give advice by telephone calls that you do not then supplement with emails. So

anything of consequence is an email advice and I think my advice in paragraph 136 is pretty clear: "In summary, therefore, most U.K. Treasurers, I think, buy a series of forward foreign exchange contracts to fix the sterling costs at this time and to remove the exchange rate uncertainty." I am, by the way, not differentiating particularly between holding sterling and then taking out forward forex contracts or alternatively putting the money in a euro account and accumulating euros. For convenience normally forward forex is simpler if you have the things in place that you have and I understand why a euro account works pretty well. You can see nothing in my advice that suggests you to not hedge the euro, except the fairly obvious thing that comes in December where I have put the risk equation forward. If you are a millionaire going on holiday to Paris for the weekend your first thought is not to go out and hedge the currency you are going to spend in a couple of months' time because you can afford to run any sort of risk. So the thing I was trying to make clear in December is can you afford to run the risk of not hedging and I clearly stated that in my advice. I said while I think the balance of probabilities may well be having had this big fall that the chances of some sort of bounce are greater effectively, even 50 per cent, I did clearly ask the question whether you can run that risk of not hedging it out.

Senator B.E. Shenton:
Yes, that is right, but to honest with you by December, looking at the way exchange rates had gone and bearing in mind that they were asked to fix the risk on the side of the contract which was some months before, by 15th December, the horse had not only bolted he was half-way up the field, was he not?

Mr. D. Hager:
By the time I was asked to put a policy in place in the middle of December, I think the issue was ... yes, you are dealing with a situation where the fall had already occurred and that is the difficult problem.

The Connétable of St. Peter:
You are fire-fighting essentially, are you not?

Mr. D. Hager:
I guess without in any sense wanting to change the subject when I read through this report I would have expected far more comment pre-July 2008 than is here. I think the lessons for the future are nearly all pre-July 2008 and not post-July 2008 for me. The issues were much more in a planning stage. The only reason we are concentrating on November and December is because we had a really big fall at that time. This project would have been really quite interesting if we had the fall in May 2008; fascinating what would have happened then because you would have suddenly had a much bigger problem on your hands before you decided. The second problem that is interesting here is the States statement in July 2008 that they wanted it fixed at the time of the contract. That generated further a whole a series of problems and with payments that are only going to come in December and January unless you have signed a contract incredibly quickly after July you are on the hook for a huge amount of uncertainty having essentially issued instructions that the thing should not be sorted for the contract. For me the lessons for the future are much more how it is one can take into account exchange rates and projects at a much earlier phase, maybe even when the States has not agreed to go ahead, but one knows there is some likelihood of going ahead.

Senator B.E. Shenton:
So just to reiterate you think the decision to fix the exchange rate on an arbitrary date which would be the signing of the contract is in itself flawed? It is a bit like saying: "Buy me some Barclay's shares on 12th December at 2.00 p.m." and you do not know what on earth the risk is or what the price would be or anything else?

Mr. D. Hager:
When we looked back on a series of words I do not know how the words came about, but my guess is

there was a wish - and I am only guessing here - by the States to fix the contract and somehow in the proposition it got to be the date of signing the contract, but they did not mean that really, I think. They meant they wanted the exchange rate risk taken out and did not perhaps accept or understand, or it was not made clear - I do not know - that there was a huge risk between saying: "Let us go ahead" in July and signing a contract some months later when all you were really arguing about is a number of minor contractual terms. Clearly, I am guessing, but I am just trying to say what lessons would I learn for the future and for me it is how is it one can do something when one does this type of project again or lengthens a runway or does something else involving significant overseas expenditure how it is we can take currency risk - and it was very clearly set out in the terms of reference for your adviser in 2007 - how it is we can take it into account and somehow here … I thought the terms that were given to the financial adviser were very good. I have no idea how they came about and they covered the right areas: value for money, financial risk, et cetera, all good stuff. But somehow in-between that the currency risk got lost in the process and for me that was long before November 2008.

Senator B.E. Shenton:
Because, of course, if we had fixed the currency at the date of the proposition the differential is in the region of £12 million?

Mr. D. Hager:
You would have always been looking at: "We messed up somehow" because you would not have got the amounts right, but you might have decided: "We think this proposal is going to go ahead, it is going to go ahead with some contract or other. Most of them have got at least 50 per cent euros in their bids. We are going to just hedge out €50 million." That could have been the argument. That seems to me a lesson for the future. Is that a viable thing to do? So that is where I would have been concentrating and personally I would have said should we have taken a contract at that time? But I am looking back with the benefit of hindsight.

Senator B.E. Shenton:
Can I just go back to your advice on 15th December?

Mr. D. Hager:
Sure, absolutely.

Senator B.E. Shenton:
If we look at paragraph 2.10, is this from you? Is this from Hewitt's?

Mr. D. Hager:
Yes, this I wrote.

Senator B.E. Shenton:
Towards the end of page 15: "Hence my inclination would be to take a chance on the exchange rate." What exactly do you mean by … this is taxpayer's money so are you saying: "Speculate on the exchange rate?"

Mr. D. Hager:
You were in the position whereby you have lost a lot of opportunity cost by the exchange rate having gone against you and you have 2 choices. You essentially always have had the proposition here that you can take out the future cost at today's spot rate - you can do that now in this contract and go to the market and take it out at, I do not know, €1.10 or €1.11 or whatever it is today. I have not looked this morning; in fact I looked last night. So the issue was if you do that you crystallise a high sterling cost, but that is fine. You need to take out the cost. You cannot run the risk. You need to know what it is

then obviously that is the thing to do, take it out at the spot rate, but if you do not do that you are going to run some risk and with the benefit of hindsight that can be called speculating with taxpayer's money, gambling et cetera, or it can be viewed as a reasonable thing to do. You can say you are already in the cart because the exchange rate has fallen, should you give yourself an opportunity of improving on the current situation today and that for me was the issue here. Bearing in mind one of the things that comes out as a recommendation against the advice we gave it is suggested we could take an option out: "Why was an option not taken out to limit the downside here?" Quite simply because the price of options was very high then and it continues to be high so you were looking at the rate having come down to something like €1.12 at this time; you would have had to have spent something like 5, 6, 7, 8 per cent extra, depending on precisely how you took the options out, as a premium. That takes you down somewhere to taking the whole thing out at 1, 2, 3, 4 et cetera. So there is some real issues and yes, I understand the Auditor General saying that risk should have been taken out, but if that is the issue - the risk should have been taken out - my argument would be you may as well have taken it out in the spot market and not even bothered to take out any options quite simply.

Senator B.E. Shenton:
But if you move to your recommendation 2.11 where you are using an averaging system as the rate moves, you are in some ways cutting your profits and running your losses because if you have not put a stop loss in the only advice you have given is - and I will be a bit flippant here - basically it says: "Cut it out if it goes up, but if it goes below 105 have a meeting."

Mr. D. Hager:
Because there are 2 large front-up payments on this and then a whole series of payments over time, you have an immediate short-term problem, but once you are past that short-term problem you have quite a lot of time for things to either go your way or go against you. If the thing is going to bounce back then the issue is you need to have some procedures in place to take advantage of the bouncing back. It is worth saying that by having this in place you did buy some euros at better than €1.15.

Senator B.E. Shenton:
Yes, but it has started coming back now. One strategy would have been to have a rise in stock loss. As the rate went with you, you pull up your stop loss and that way you have a certain amount of certainty.

Mr. D. Hager:
Absolutely, but the issue goes back. As I see it, the spot rate was of the order of €1.12 at the time we were talking here, on this particular date, and formulating the policy. The issue is do you take a whole lot out at €1.12 and I agree you can do a whole series of stop losses to go with it. You can take out options et cetera, but at the end of the day you have to decide whether you are going to take it out at that time or see what happens in future and take some risk. It is about taking risk; there is no doubt about that and I make it pretty clear in the advice that I gave that there is risk attached to it. I even refer to the fact: can you take the risk - I say a bit later on - and that is in 2.13. I accept that moving forward without cover brings a chance of a worse outcome, but it does seem to me that on the balance of probabilities that it is a risk worth taking providing, of course, you can afford to take that risk and that is what this is all about. If you cannot afford to take the risk you take it all out at the spot rate.

Senator B.E. Shenton:
So the rate did move, as you say, to €1.15 and we did convert some more euros at that rate, but now it has come back. Are you saying under this bit of advice: "Just watch it come all the way back to €1.05 and then we will think about it again?"

Mr. D. Hager:
No, what I am saying is if you have capital available such that you do not have to take it out at today's

spot rate - or the spot rate then - you can afford to take some risk, you have some contingency margins which you are prepared to essentially back your judgment with, then there is a chance of a better financial outcome here. Equally, I accept there is a chance for a worse financial outcome and it is all a question of how valuable a guarantee it is to you? How much do you want to guarantee this price in sterling? That, to me, is quite fundamental. You might accept a £1 million fluctuation, a £5 million fluctuation. I do not know in detail what fluctuations are acceptable to the States, but it seems to me that only the person with that knowledge can take that decision. I can give advice, but at the end of the day it is not my money at risk. It is really do you have that capital at risk that you want to chance? Any investment decision is all about assessing probabilities.

Senator B.E. Shenton:
This is a bit of a hypothetical question so you might not be able to answer it, but say we get €1.05 today, what would your advice be then?

Mr. D. Hager:
For the present it is merely interesting because we do not have to do any business in the near future. We have all the payments covered until October at the present time. You have some income coming in from the euro zone of around 6 million euros a year so we are not all that vulnerable in the immediate term to a payment. So yes, there is risk of course and the thing does have to come our way by the end of the year, but at the present it is only of academic interest the rate is €1.05 because we do not have to deal with it. Some of these payments we do not have to deal with until 2012.

Senator B.E. Shenton:
Yes, but the €6 million that we have coming in they in the accounts at the rate at the start of the year so you are going to have exchange rate risk on that whether it is a cash flow or not.

Mr. D. Hager:
I am a simple guy. If I have 6 million coming in a euro account and I have to pay some other euros out it is all in euros as far as I am concerned. How you account for it … I mean for the airports I would account for it personally on the date it came in and I would give the credit at the euro spot rate to the airports people. How I then managed the euros is a question of managing the euros in the most efficient way. For me, I would offset airport euros versus waste payments because for Jersey itself as an entity it is then not in a problem with taking exchange rate risks. So between now and this contract finishing we have more than 2 years of those payments to come in so that cuts again the need to go into the market for euros so some of the exchange rate risk is going down over time.

Mr. A. Fearn:
David, that specific discussion that you have just outlined with regards to airport income has that been discussed by yourself with any of the people in Treasury and Resources?

Mr. D. Hager:
Yes, that is how the information became available.

Mr. A. Fearn:
To your knowledge is that an approach that they are going to use, that they are going to use the offset income, or is that something that has been actively discussed to your knowledge?

Mr. D. Hager:
I do not know what the Treasurer has decided to do on that and there has been discussion on the currency flows which the States had for, I guess without looking, 6 weeks or 8 weeks. I would have to go and look. I now know in detail what you might get in other currencies and that is of considerable

help in managing these payments assuming one manages them on an integral basis for the whole of the States. It is not for me to decide how airports account or budget, but it seems to me if I got one year on an account called the States euros I would use it personally. The whole basis in this report is making a big euro account to pay for waste and to get the most euros in there we can at the right rate and if we got some coming in from somewhere well, great.

Mr. A. Fearn:
Yes, and it avoids your bid offer spread.

Mr. D. Hager:
Absolutely. I do not care where I get the euros from, if you like, as long as they come in.

Mr. A. Fearn:
With regards to the advice that you have provided, and it is outlined in the report, your terms and conditions, if you like, your guidelines, were they clear at any stage? It seems obviously you have a clear remit with regards to the Strategic and Social Security funds. This is a bolt-on, obviously, I would suggest. So with regards to that bolt-on how clear did you feel the guidelines were around your understanding of what this advice related to and what the specific scenario was?

Mr. D. Hager:
Clearly I did not have all the information that is now in this report and it appears that lots of people did not have the whole picture that we now have so I am not going to suggest I understood every ramification on it. I think all I really needed to know, even with the benefit of hindsight, was the table of cash flows in the back, the current exchange rate and what we had done, if anything, up to that point. So even with hindsight I do not think I was put in the wrong position to advise. There is nothing I would really want to change even with hindsight in the way I was briefed. I suppose the only one thing I would have spent more time doing is if I knew what the currency flows had been from the airports and a few other things I would have factored that in the advice. I cannot really say that the contract was a problem. I was not badly briefed. I was not put at a disadvantage. I was not made to feel guilty. None of those things that you could possibly say I was advising with one hand behind my back or I was in a conflict of interest - none of that is really fair. The one thing I did do at the time which I can be criticised for, with hindsight, is I did know that various people had been involved in giving advice through this project when I started. That was told to me and I also knew that the first payments were pretty adjacent to the giving of advice and, therefore, I said I will help but if you take proceedings out against me that is really very unfair because I am trying to deal with a situation which we have here which I have not created. So that is why I put that clause in and I do not regret doing that, but some people may say that is unreasonable for a professional person to do. I do not feel it was unreasonable but I can understand criticism that might come my way quite simply because if legal proceedings are to be taken out you obviously join all the advisers in as a matter of course and sort it out from there, and that would seem to me pretty tough going if that was to happen in this particular case. So it was a little bit on the back foot and that is the only hiccup, if you like, in the works. I did not go to the extent of doing other than set that out in an email, so I did not ask the Treasurer to give me a letter or anything like that because I thought that was reasonable just to point that out. So it is not in the client agreement in a legal status, but I would hope it would be honoured.

Mr. K. Keen:
Can I ask, you regard yourself as formally engaged to advise on hedging this risk from 15th December at least?

Mr. D. Hager:
No, I was asked to do a particular project which was this project that we are talking about here. How is

it that the Treasury can formulate a policy to deal with the situation which they then were in?

Mr. K. Keen:
Were you specifically remunerated for that?

Mr. D. Hager:
I will be specifically remunerated for it. I have not been paid, but I am not sure that we have asked for it.

Mr. K. Keen:
In your email where you said that were providing the advice on the basis that the States would not take any legal action, at that point did you anticipate that you would be getting remunerated for it?

Mr. D. Hager:
Yes, of course.

Mr. K. Keen:
So you were giving advice, but you expected to be paid for that advice?

Mr. D. Hager:
But not sued for it given the unusual nature of the advice. I did not ask for that in respect of the Social Security fund, the strategic reserve or any of the other advices; only in this particular issue where it was very clear right from day one that it was exceedingly difficult to fix this with 20-odd million euros going out within a matter of weeks.

Senator B.E. Shenton:
You do also say in your email: "We do not provide professional advice on short-term currency transactions."

Mr. D. Hager:
Absolutely. We are not forecasting where the currency is going this month, next month or the month after. What we are saying is there is a balance of probabilities here, there having been a big fall: "Do you see if there is any chance of recovering any position that is better than where you are now? If not, buy out now."

Mr. K. Keen:
Was your fee on a time basis or on a ...?

Mr. D. Hager:
Most jobs with the States are either on a fixed fee basis if the quantum can be sorted in advance. As Senator Shenton pointed out with P.E.C.R.S. our fees used to be on a completely fixed basis for P.E.C.R.S. In the case of the States …

Mr. K. Keen:
I am asking about this one though.

Mr. D. Hager:
I am trying to give you a context. So if somebody says to me: "Will you do it on a fixed fee basis? Will you do it on a time cost basis?" we would do it on either of those. In this particular case the job could not be specified in advance so I agreed to do it on a time cost basis. Our current agreement provides for both provisions and says if there is no explicit agreement for a fixed fee basis then a time cost basis will

prevail.

The Connétable of St. Peter:
Can I just take you back on a bit of a management thing for me? Just go back to 15th December. At that time you say you were asked to formulate the policy?

Mr. D. Hager:
I do not formulate the policy. I write down some suggestions and the Treasurer formulates it, but in essence I am doing a fair bit of the drafting.

The Connétable of St. Peter:
Who asked you to do that?

Mr. D. Hager:
Probably Jason Turner. I think, without looking at my diary, I was here anyway. I was going to see the Treasurer and the Deputy Treasurer over the Strategic Reserve and I came around a bit early. I think that is how it happened from memory, or it was the previous day; I was over here anyway on business.

The Connétable of St. Peter:
This was an addition now, an extra job to what you were over here to do?

Mr. D. Hager:
Yes, I was over here for the regular stuff anyway so this was something that because I was over presumably they wanted to discuss with me. If I had not been over they would have probably sent it by email. So I went to see them and I can remember Jason was there, I think Kevin Hemmings was there, but I would have to go back and have a look.

Mr. K. Keen:
The airport cash flow seems to me to be an entirely sensible thing to do. I must have missed them in this report when did that get factored into your advice that those cash flows were …

Mr. D. Hager:
That has been more recently as we have tried to … this thing has not been static since the date of this report on 15th December so clearly there is an ongoing situation here about what you do and that occurs with every payment. Obviously, somebody in my position is going to watch changes in the exchange rate pretty closely because we are looking to see should we take a bit more out? It is not really trying to guess the exchange rate or predict it; it is just saying we are where we are, do we try and put some aside?

Mr. K. Keen:
Who are you dealing with in providing that support and advice now?

Mr. D. Hager:
I was predominantly dealing with Jason Turner over that specific item.

Mr. K. Keen:
So would it be fair to say that the Assistant Treasurer is now dealing with this matter personally?

Mr. D. Hager:
I would expect so.

Mr. K. Keen:
That is your experience at the moment?

Mr. D. Hager:
If you said to me if I saw the exchange rate at €1.20 tomorrow who would be the name on the email to, it would be Jason Turner. I might copy in Ian Black and I might copy in Maria Washington, but the email would be to Jason.

Mr. K. Keen:
The matter is now being dealt with at a more senior level than it appeared to be earlier on?

Mr. D. Hager:
Since 15th December I think you will find that Jason has spent a lot of time on it.

Senator B.E. Shenton:
Can I ask you where you got the rates of €1.15, €1.20 and €1.25 from? They are just random?

Mr. D. Hager:
They are random. I asked the question where people would be happy to get to. Where do you want the sterling cost to be on this and that determines where your triggers are. The average is, I think from memory, about €1.23-€1.24 on this.

Senator B.E. Shenton:
I was a little bit surprised reading the report that no one mentioned about zero cost options or cylinder options. Is this something that you had considered?

Mr. D. Hager:
You could always, in the options market, if you buy a put option you can finance it by selling a call option. Those are easy things to do, but at any time you do it you need to have a big enough gap between the rate at which you buy the put and the rate at which you can sell the call for and that is just a question of where you are at any point in time in the market. So those are always things that one can easily look at, but at the present time you have the big problem of cost for financing the puts is really high and has been right throughout this period. So, for example, now if you want to go and take out a put option, and we looked at these figures just a few days ago, but if we want to go and deal with some of the longer put options - for 2 years, for example - and we want to do it at the spot rate of €1.11 which is what we were dealing with the other day, you have to put aside over 8 per cent as a premium. Even if you do a zero cost option, essentially in financing the zero cost option you have to get a premium of 8.3% by selling the right to something. So these are big numbers to do and when you get up to numbers like 8.3% you find you are selling away too much of everything in which case you just go out and deal with it at the spot rate. There is just no point in holding and buying a put and selling a call. You may as well just enter the spot market, just get rid of the whole problem because you are just not going to make enough if it goes right. That really is the issue on zero cost options. You can use them in the stock market. We look at them quite a lot. Whether you take them or not just depends solely on the strike prices you can get at any point in time, but of late these premiums have been too hefty to really have a lot of effect.

Mr. K. Keen:
Does Hewitt do a lot of foreign exchange exposure management? Is it something that you do a lot of?

Mr. D. Hager:
We do a huge amount. The job of an investment actuary basically is a lot of risk minimisation or risk

control of various sorts. So when you look at somebody's overseas portfolio you have to help them with whether they should hedge any part of that currency risk. That is true for all sorts of portfolios you look at; what sterling fluctuation can you tolerate dependent on how the exchange rate moves. These are just standard risk techniques, but we are not in the foreign exchange market, buying and selling currency for anybody. We do not do that job, but we do say to people is: "How do we deal with this currency risk you have? How do you minimise the risk?" In some cases: "How do you maximise the risk?" because it is not always that people want to minimise the risks. Some people want to run the risks and, therefore, it is a question of how big the problem gets. So we calculate things like value at risk because people want to try and control their adverse exposures. So, if you like, on this project you could have managed it by looking at value at risk the whole time and dealt with it as a capital fluctuation with a certain probability. So Hewitt is very well in the market for dealing with these risk items and this is a standard piece of cake in that sense. It is just the tolerance of foreign exchange on your capital cost. It is a really simple project. You do not have to multiply anything by a probability factor which is what an actuary is normally doing most of the time. So these are certain costs, not probable costs. If you had been doing this job at the start of 2008 you might have had a 90 per cent probability on this and a 70 per cent probability on that and a 50 per cent probability on that, so these calculation are a piece of cake.

Senator B.E. Shenton:
Deloittes did do some …

Mr. D. Hager:
Yes, absolutely, I am sure they did.

Mr. A. Fearn:
So, David, for my benefit, to summarise your advice is simply around risk management as an actuary?

Mr. D. Hager:
Yes.

Mr. A. Fearn:
One would normally expect, however, the States to be advised by a foreign exchange house so that you could then work with the Treasurer to review that advice to help work out a risk strategy?

Mr. D. Hager:
Absolutely, and as it turns out in this case H.S.B.C. (Hong Kong Shanghai Banking Corporation) gave broadly the same advice as we gave on how to deal with this transaction. In this particular case we have been dealing with Northern Trust's dealers, but it does not matter whose dealers we have been dealing with, so the Treasurer has access to the advice of those Northern Trust dealers. As you say, it is a question of putting the whole thing in the melting pot and trying to take a reasoned decision, notwithstanding the fact that in investment my job is frustrating because I am rarely 100 per cent right indeed. If I am 60 or 70 per cent right it is a pretty good outcome so there is always plenty of error in my job and it is a question of minimising the risks and controlling the risks of those adverse decisions.

Senator B.E. Shenton:
Are you aware under local J.F.S.C. (Jersey Financial Services Commission) regulations that a local firm to give currency advice needs the ACI diploma and an individual without that cannot give advice?

Mr. D. Hager:
The advice that is being given, and we have taken legal advice too on this, is that the overseas persons exemption is perfectly valid here and that most of the transactions, indeed probably all the advice here, does not even need to be authorised in the U.K. These are not transactions that are being taken; it is on

risk advice issues. Most of this is plain, generic stuff which is just non-authorised either here or in the U.K. If you turn around and say should you do something specific with an option, should I go and cost an actual option rather than an indicative option with a view to going ahead with it, that is different. Certainly, our belief is that we have the required qualifications under the U.K. law. We discussed with the Financial Services Commission here the way in which we give advice in Jersey, they have been kept fully up to date with that. They have been shown the legal advice that we have received and they know perfectly well that we are using the overseas person's exemption for this advice and see no problems with it.

Senator B.E. Shenton:
I suppose the crux of the matter is a large portion of the contract is still unhedged?

Mr. D. Hager:
Absolutely.

Senator B.E. Shenton:
So are you comfortable with that?

Mr. D. Hager:
It comes back to the issue that it is not my capital at risk. I am merely saying to you if you do not have the capital at risk behind that contract and you cannot tolerate this Sterling fluctuation you have to go into the market and do something. That is a pretty simple issue as I see it. If it is that you can put some fluctuation at risk it may well be that you can get out of this position in a more beneficial position and that really is the situation today. As part of that analysis you can carry out the various modelling exercises to show what the likely fluctuations on the outcome can be and that is part of the risk job and what one is trying to do here. There is no doubt if you do not want any more Sterling fluctuation, you want to know what the sterling cost is then the best thing to do is go straight on the spot market and buy all the euros we need; not take any more risk at all. I am not in any sense wanting you to take risk, I am merely saying I do not know what your tolerance for risk is, but as the sums get smaller the overall fluctuation obviously, for the total project, gets smaller.

Mr. K. Keen:
That is an interesting point. I do not work in investments as you have probably guess already, but if you were providing advice would you not then want to know what the client's tolerance for risk was before you proceeded or are you still relying on the quasi-indemnity that you cannot be sued for that advice?

Mr. D. Hager:
No, I wanted to mention indemnity, but that is in a sense of we cannot make short-term forecasts on currency and, therefore, do not want to be inadvertently sued by somebody, going and chasing every supplier and adviser involved in that transaction.

Mr. K. Keen:
That does not stand now, then, the thing of 15th December?

Mr. D. Hager:
I am saying that I do not want to be sued for being accused of getting it wrong and being negligent on short-term currency variations. I am not trying to get out of incorrect modelling or things like that.

Senator B.E. Shenton:
One of the fundamental aspects of regulation is K.Y.C. (Know Your Client) and one of the fundamental aspects of Know Your Client is know your client's risk tolerance.

Mr. D. Hager:
Absolutely; of course.

Senator B.E. Shenton:
You are giving advice here and by your own admission you do not know the risk to your client.

Mr. D. Hager:
You never know any client's risk tolerance how ever much you ask them. At the end of the day it can only be the client that takes the decision whether to run that risk or not. The adviser can advise, but at the end of the day I just do not know what is acceptable to any client. As I say, I can ask all the right questions, but it is extremely hard to know. You do the best job you can, but at the end of the day I just go back to my standard statement. If you do not want the fluctuation then you go on the spot market. If you are prepared to accept the fluctuation, what sort of fluctuations are acceptable and I did encourage George Butler, as I mentioned right out in the earlier advice, to put in scenarios about what could be the worst exchange rates you can think of, what could be the best exchange rates. Ask yourself the question: "Can you accept those tolerances?" If you can then you go ahead and you do not put a hedge out; if your view is you can do better than the position, do that.

Senator B.E. Shenton:
So the decision ultimately lies with the client which in this case is the Treasurer of the States of Jersey?

Mr. D. Hager:
It can only be, in my view, with the client. I am sorry, but that is the way I see it. It is not a question of me not asking enough questions; it is that I just cannot understand at the end of the day exactly the risk tolerance that person has. He can tell me the best he can, but only really he can decide; I cannot decide.

Mr. A. Fearn:
Can you help me understand what questions specifically around risk, and what debate specifically around risk, has there been with the Treasurer and the Treasury Resources Department to get to this stepped approach? Obviously, that will indicate in my mind a different level of risk from purely buying spot versus buying forward contracts based on spot tied into the forward payment dates. So there is obviously a slightly different level of risk here.

Mr. D. Hager:
Of course, and bearing in mind the first suggestion is to go out and buy forward forex to match.

Mr. A. Fearn:
That is very clear. This seems to be a retrieval strategy, if you like, of a loss reduction strategy from a negative position, or a more negative position, than there was in October.

Mr. D. Hager:
Yes, I think that is a very fair comment. The way to view this must be as a loss reduction strategy. All the numbers you are doing, therefore, and all the things you are trying to do is say how much can I improve my lot if things go my way and are we in a position whereby we can accept the downside at each point in time. As part of this process we looked at the cost of cutting out the downside completely and there is only a one-line reference in the final terms that we would not look at options at the first stages of the process, but clearly options were part of the thought process. It is just they did not work because the premiums were too big and the broad situation was, as I understood it, that the Treasurer would be broadly happy if he could secure something like €1.23, €1.24, €1.25 as the beneficial side of the equation. So that gives you a bit of a feel. It does not give you the perfect risk view, but that is

where you are trying to get to. If you are at €1.11-€1.12 now it is no good spending the difference between €1.11 and €1.25, let us say, on an option premium because you are giving away all the upside. So all of this is about can you improve slightly on where you are without giving too much away. Sure, if you could have got €1.25 the following day that is where, as I understood it, the ideal position would be. So there was no suggestion at any stage through this that we were going to run this to €1.40 or €1.50 or leave it open for the exchange rates we have seen over the last 2 years. This is, as has been correctly described, a loss improvement position or a profit enhancement or an opportunity cost enhancement strategy and all risk must be seen against the, if you like, fully matched position of just going into the forward forex market.

The Connétable of St. Peter:
One last one from me. Are you aware of what the Treasury may have in place now to deal with short-term currency transactions advice? You say you do not provide that. Are you aware if they have engaged somebody else to offer them that?

Mr. D. Hager:
I do not if the States are taking advice from other sources such as H.S.B.C., such as Royal London. I am aware the States has had some advice from Northern Trust on where the triggers could go. Interestingly, when we hit €1.15, Northern's dealers thought we would hit €1.20 very quickly thereafter, so there has definitely been advice there. I would have expected that advice is taken from other places, whether formal or not, in a sense of a formal client agreement and whether it is legal advice is another issue. I am talking about getting people's views and I am sure when the Treasurer meets any investment manager, and I hear him do this at meetings anyway with regard to the Strategic Reserve, you get a view from these managers, like Investec, UBS or now AXA Rosenberg on where the dollar is likely to be. The Treasurer is going to be talking in the course of his job - and the Deputy Treasurer - to lots of other people about exchange rates so I am pretty sure he is getting quite a lot of comment, whether it is technically advice or not.

Mr. A. Fearn:
My comment, if I may, that is seeking views and obviously one should not provide advice without understanding the specific parameters under which that advice should be given.

Mr. D. Hager:
Absolutely, yes, but I think the key issue at the present time is trying to gauge any market sentiment that might be helpful because the foreign exchange market has historically run a fair bit in the short-term on sentiment so that does affect some of the things one does. There is some point in listening to the way things are going.

The Connétable of St. Peter:
Just a supplementary on that, just asking your personal view now. Do you think that a better way forward would be to marry in some proper advice on the short-term transactions with the strategy you have put forward?

Mr. D. Hager:
I think that is a quite separate problem about how does one manage projects long-term in the States and it is a quite separate issue of how do we get out of where we are now for the waste project. Dealing with the first one, my view is that it could be helpful and you have a great basis already with the Deloitte terms of reference, but I think a lot more time could be spent on the early stages of a project in minimising the currency fluctuations if that is what you are trying to do. It turns out that there was a great wish to minimise the currency fluctuations, but that did not seem to get factored enough in the first stages of the project. I would think most of the effort for me would need to go into that part. I think it is

a much later stage saying: "We have this budget, we have got it going, we have decided we want to definitely go ahead with it, now can we deal with the currency risk of it?" That to me is not quite the right way to go about it, but it is not really my issue. I am just saying where I would come from on this particular thing. The latter issue as to how we deal with this particular problem, as I say, we have a short-term window in that we do not need to enter the market for probably 6 months or so. It goes back to how much risk you are prepared to take on a capital project, but it is not an immediate problem in that we have to fix it today, tomorrow or next week. I am sure if we do get any favourable movements, and the markets do have a habit of fluctuating quite a lot, we are poised and prepared to take advantage of that. The policy has been modified to a minor extent that if we see €1.15 again we will take some more money out at €1.15.

Senator B.E. Shenton:
But you have no stop loss there, have you, so if we went down to parity or even through parity the loss to the Jersey taxpayer just increases and increases? You have a fixed liability there and you are saying let us just rise and see how we get on, fingers crossed and ...?

Mr. D. Hager:
No, I am saying the alternative is to take it out on the spot market. I am absolutely …

Senator B.E. Shenton:
What you are saying is the policy being followed is we are going to run the currency; the decision to do that lies not with you, it lies with the Treasurer of the States?

Mr. D. Hager:
Absolutely, but I am saying it is perfectly reasonable if you want to not run that risk to take it out. I am not saying to people they have got to run it. I have been asked to look at ways in which we can improve on the situation. That is against the alternative of taking it out on the spot market. So if you do not want to run this risk then we should not be running it, but it is worth looking at the schedule of payments quite closely because they do go over a long period of time. Only the October 2009 payment is chunky, really chunky, so a lot of these others are quite small. We will be able to get a fair number of them out of the airport income so that is 6.4 million euros or something like that. So the currency fluctuation for 2011 and later on in 2010 we can probably deal with quite easily. We are probably only at risk realistically for the payments between November 2009 and August 2010, something like that. I would not want folks to think there is quite as much exchange rate risk now as there was run in November and December.

Mr. A. Fearn:
With regards to the ongoing monitoring of that position, for example obviously today the rate is down €1.10 so there is a short-term strength again although some of the houses do view euros as ... see a weakness coming through. In your understanding is the monitoring process of those positions robust enough at this stage? Is that something that you would recommend on or is that something that either the people giving the short-term currency advice to the Treasurer … who has the responsibility for monitoring those triggers and monitoring the market movements?

Mr. D. Hager:
Northern Trust has those triggers in place already so if the rate goes past those triggers you are not relying on somebody at the Treasury to do it. That is already in place so for the next trigger nothing needs to happen as far as I am aware.

Mr. K. Keen:
But the trigger of the €1.05 is, as the Chairman said, habit?

Mr. D. Hager:
I am sure if you asked Jason what the rate was at any time of the day, as at the previous night's close, he could tell you. I am sure this is deeply embedded in the Treasury at the present time, the monitoring of this exposure.

Mr. A. Fearn:
That monitoring process, has that been something that the Treasury have come up with themselves or have they sought specific advice on that monitoring process?

Mr. D. Hager:
They have not sought it out from me. I think it is a question of keeping a daily check on the exchange rate and we have not re-priced options every day, but they have been incredibly … the market has been volatile. You do not even need to work it out; they are big enough numbers so you just get one indicative price and call it a day. We did work them out in detail the other day, but that is very much …

Mr. A. Fearn:
So, for example, the Treasury, to your knowledge, are just looking at rates and not looking at the volatility levels, for example, which is what one would perhaps consider in addition to ...?

Mr. D. Hager:
Yes, but the key issue, the driver for what has been decided - for right or wrong - is the level and as I say, we have a slight window between now and October so that is a big issue. It is not as if we are meeting a payment next week, next month, which is good news in many ways for dealing with this. As I say, the key problem is really December 2008 and January 2009 and even fixing it in November 2008 was too late to be dealing with that in my view. It should have been done a year prior to that if that was the key concern to keep sterling fixed. If it was not the key concern then fine, but I do not know exactly what was in people's minds as they agreed to the project.

Senator B.E. Shenton:
Does anyone else have any questions? Thank you very much for coming along.

Mr. D. Hager:
Thank you, and I will come back, Chairman, if I may, on the email point.

Senator B.E. Shenton:
No, that is fine, thank you very much.