# STATES OF JERSEY

# FUTURE HOSPITAL FUNDING STRATEGY (P.130/2016): THIRD AMENDMENT (P.130/2016 Amd.(3)) – SECOND ADDENDUM

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**Presented to the States on 2nd May 2017**
**by the Corporate Services Scrutiny Panel**

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**STATES GREFFE**

## SECOND ADDENDUM TO P.130/2016 Amd.(3)

Following the deferral of the debate on P.130/2016 until 2nd May 2017, the Panel has taken the opportunity to seek external expert advice on the two options for financing Jersey's new hospital.

The Panel engaged the Chartered Institute for Public Finance and Accountancy (CIPFA) to undertake a high level desk top review of the proposals to either fund the new hospital by borrowing up to £400 million, or by using the Island's Strategic Reserve. CIPFA have most recently advised the Panel on the Budget 2017 and the MTFP Addition, and are familiar with the structure of the States of Jersey's finances.

Panel Observations

CIPFA's report confirms what the Panel has previously stated. This is, that if borrowing is decided as being the mechanism to fund the hospital construction project, then the Minister for Treasury and Resources' proposal is suitable.

However, CIPFA highlight that there are risks associated with Treasury's strategy, these include –

- a lack of headroom for future borrowing;
- the potential inability to contain significant cost escalation of the project;
- potentially lower than forecasted performance of the Strategic Reserve.

CIPFA comment that "*these risks, in the context of turbulent global economic and political environment (including the impact of Brexit) may be more difficult to contain*" should a 40-year bond of £400 million be issued.

CIPFA note that the Panel's Amendment *"provides more control and flexibility in the ability to adapt to future changes."* They go on to suggest a combined option of deferring the decision to borrow until nearer 2019 and using the Strategic Reserve in the meantime, or note an alternative option of a blended approach of issuing a bond of up to £200 million with a recapitalisation mechanism for the Strategic Reserve. The Panel would stress that these options are not currently before States Members for consideration.

The Panel is pleased to present CIPFA's report as attached to this Addendum. It is hoped that this will be helpful to States Members as they assess the options available to them for funding Jersey's new hospital and will also help inform the debate on Tuesday 2nd May.

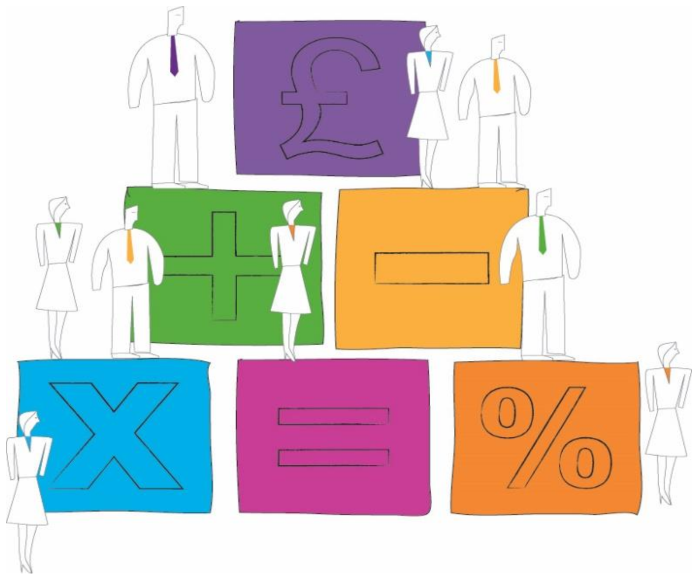
States of Jersey
States Assembly

États de Jersey
Assemblée des États

# States of Jersey – Corporate Services Scrutiny Panel

# Future Hospital Funding Strategy (as amended)

April 2017



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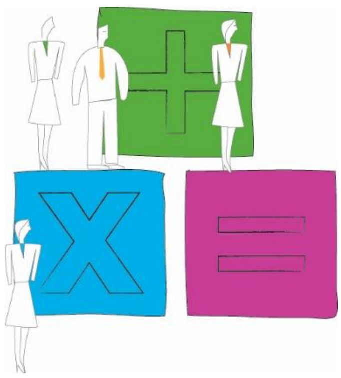


## 1. Preliminary Comments

1.1 In April 2017, the States of Jersey commissioned CIPFA Business - Finance Advisory (the commercial arm of the Chartered Institute of Public Finance and Accountancy) to support the work of the Corporate Services Scrutiny Panel in the Review of the Future Hospital Funding Strategy (as amended).

**Scope**

1.2 We were asked to review the proposed Future Funding Strategy lodged by the Minister for Treasury and Resources (as amended on 18 January 2017) the main feature of which is for the States of Jersey to issue a bond of up to £400 million to finance the hospital project. The scope of our work also included a review of the corresponding proposal lodged on 4 April 2017 as a third amendment by the Corporate Services Scrutiny Panel to use the Strategic Reserve (SRF) to fund the hospital construction cost of £466 million and introduce a recapitalisation mechanism over a 40 year period to return the Strategic Reserve back to the same level as if the bond had been taken out.

**Approach**

1.3 The primary nature of our approach was desk top review. This incorporated the documents outlined within Appendix 1. In the course of our work which was conducted between 21 to 26 April we were able to speak with an adviser from Opus Corporate Finance and Corporate Services Scrutiny Panel support.

**Treasury approach**

1.4 Given that the base policy submission relates to the initial Future Hospital Funding Strategy as submitted and amended on 18 January 2017 it is appropriate to focus our initial attention on this submission.

1.5 In essence the Future Hospital Funding Strategy lodged by the Minister for Treasury and Resources proposes to fund £400m of total estimated project costs of £466m through the issue of a bond with returns on the investments from using funds held by the Strategic Reserve being used to fund the costs of servicing the bond. The Strategic Reserve would also be used to fund some of the 'gap' in capital requirements between the overall borrowing and total project costs. Without going into significant background detail we will consider the following aspects of the Minister's submission[1]:

- Funding Options – External Financing
- Incidental issues

**Funding options – External Financing**

1.6 Yields and spreads are at a historical low. Looking at the work that has been carried out to date we would agree with the Treasury proposition that the Rated Public Sterling Bond is the best option in the context of external project financing. This long-dated bond (40 year tenor) with bullet redemption appears to be uncomplicated and has obvious attractions for both investor and issuer. Such an option would be attractive for the financing of the Hospital project subject to:

- The proposed 40 year tenor equating to the expected unmodified/enhanced asset life of the Hospital

[1] Future Hospital Funding Strategy (P.130/2016) – Second Amendment - 4.4.17

- Linked to the extended tenor is the level of borrowing and maturity costs. A level of precision around the estimated price of the bond being obtained is needed to help properly assess this option. We understand that the most recent rate modelled is around 2.5% - estimated at 2.61% as at 8 November but we understand that this is closer to 2.5%[2]

1.7 The Treasury option of using investment performance on the Strategic Reserve to finance the cost of the bond in addition to some of the project capital requirements seems an eminently sensible strategy. Leveraging the expected arbitrage between investment returns estimated to yield an annual minimum of 5% (based on RPI at 3% +2%) and annual coupon costs and eventual repayment costs appears to offer a positive option which minimises the impact on the Strategic Reserve being used a funding vehicle as the conduit of funding with the new Hospital Construction Fund.

1.8 On a more negative note the issuance fees and costs are not insubstantial with bookrunner fees alone being estimated to be as high as £1m and other adviser fees likely to reach £0.6m. However, in terms of the overall proportionality of costs associated with the bond, such costs should be assessed against the extremely low coupon costs over the life of the bond. It is noted that this proposed external financing solution is less sophisticated than other available external options including staged drawdown bond financing.

1.9 Given the partial funding of the project and the staged cash flow where material investment is not significantly delivered until 2019 there is a notable lack of connectivity between the investor and the project in scope. We are uncertain if this is going to impact investor confidence.

**Incidental issues**

1.10 In terms of building the case for recommending the Public Bond the submission includes issues which we consider to be incidental. These include:

- Tax yields
- Further Taxes/charges
- Asset sales
- GDP – borrowing ratio

1.11 Outwith any call on the Strategic Reserve to make good on a significant and unexpected downturn in tax yields we would not consider tax yield variances to be an influencing factor in the context of relative stability over the last four years – certainly in the short term. We would expect that a recalibration of expenditure would take place in the event of markedly lower than expected tax yields – the flexibility that would allow such recalibration can be evidenced within the States Medium Term Financial Plan 2016-19, the annual budget setting process and the incidence of carry forwards and underspends.

1.12 Given the latest tax strategy outlined within the MTFP 2016-19 and the wide range of public sector pressures and the overall strategic direction of travel on the MTFP, we would not expect income tax to change purely as a result of any additional funding required specifically for the new hospital project.

1.13 The Minister's submission includes the potential for other sources of funding to be utilised:

[2] Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Minister of Treasury and Resources – 13 April 2017 Page 4

*"Other ways of paying for the debt may be used, such as a further savings target, use of part of the capital allocation, further asset sales or other revenue-raising measures as a last resort."* [3]

1.14 As estimated asset sales are already factored into the MTFP 2016-19 such utilisation would merely be a diversion and would not represent any new additional source of funding to the overall states finances. In this context such a presumption should be discounted for the purposes of assessing options on the funding of this project.

1.15 The proposition appears to make the case that some comfort could be derived from Jersey's relative debt position as an expression of GDP (Gross Domestic Product). The current measure is comparatively strong:

*"The States of Jersey has low levels of debt compared with most governments across the world, the current rate of debt to GDP being 6%. This has been used to demonstrate Jersey's economic position of strength for some time now. If further debt of £400 million was entered into, that would increase the rate to 16%. By comparison, Australia's debt to GDP rate is 37% and the UK rate is 89%. So increasing our debt to this level still leaves Jersey in a very strong economic position*. "[4]

1.16 Whilst the GDP ratio reflects the actual position at Jersey, in context, given the relative scale of the island to the national comparative examples used we would respectfully suggest that this measure should be treated with some caution. The ability of the economies of both UK and Australia to withstand economic shocks is going to be significantly different to that of Jersey. In such a context we would not consider this particular measure to add assurance to the recommended level of borrowing.

### Material risks in context

1.17 Whilst we would fully agree with the submitted funding strategy that any external borrowing should be facilitated through the utilisation of a Rated Public Sterling Bond we believe that such borrowing of £400m over 40 years at this point in time represents some material risks:

- Hospital Budget
- Borrowing capability
- Arbitrage risks

### Hospital Budget

1.18 Substantial work has been undertaken in the construction of project cost estimates and assistance has been sought from Gleeds and EY. Some diligence work has been undertaken on behalf of the Corporate Services Scrutiny Panel by Concerto. In terms of a current status the Treasury submission outlines the following:

*"The cost estimate incorporates all main works to the main Hospital, together with all related relocation, site acquisition and enabling works and associated fees. This is an indicative estimate, founded on area-based assumptions. Significant further development and design work, as well as planning and procurement, is needed before a final cost can be provided."* [5]

1.19 We would consider this project to include a high level of complexity and would not fully reflect a standard new build construction given a range of factors including location and in context to the challenges posed by public sector reform in Jersey.

[3] Future Hospital Funding Strategy (P.130/2016) – Second Amendment - 4.4.17
[4] Future Hospital Funding Strategy (P.130/2016) – Second Amendment - 4.4.17 – Page 18
[5] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 7 - Budget

1.20 Relevant issues include the following:

- Unit costs
- Contingencies - Optimism Bias
- Project Management Risks – Public Sector reform

1.21 We understand that the "*An indicative capital cost of up to £466 million for the project cost of developing the concept envisaged in the approach proposed in P.110/2016 has been developed and is set out within* P.68/2016 *('Draft Medium Term Financial Plan Addition for 2017 – 2019')*"[6]

1.22 In their report to the Corporate Services Scrutiny Panel on Cost Assurance – Advisers Concerto concluded that in respect of confidence on the robustness on the basic costing model adopted:

- 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 [7]

1.23 From our desktop review of the available background documents on cost estimates we would readily concur with Concerto's opinion on the apparent rigour around the construction of base works cost estimates. The £466m budget is split as follows:

| Component | Total £ |
|---|---|
| Works Costs 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 - Sub total** | **421,885,490** |
| Relocation Costs | 39,932,329 |
| Inflation | 4,092,597 |
| **Total Costs** | **465,910,416** |

1.24 The Proof of Concept Site Option Addendum[8] prepared by advisers Gleeds provides an element of detail behind the construction of the main project costs. The cost base elements appear to be well constructed with estimates based on reasonable assumptions around fees, equipment and location.

1.25 It is good practice to adjust assumptions about costs, benefits and timing to allow for optimism bias. HM Treasury Green Book Appraisal and Evaluation in Central Government is the benchmark guidance for project cost and benefit evaluation. The introduction to the Green Book explains its scope:

*"All new policies, programmes and projects, whether revenue, capital or regulatory, should be subject to comprehensive but proportionate assessment, wherever it is practicable, so as best to promote the public interest. The Green Book presents the techniques and issues that should be considered when carrying out assessments."*[9]

[6] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 7 - Budget
[7] Cost Assurance Report – Future Hospital Project – Concerto – Executive Summary Page 2
[8] Jersey Future Hospital – CO025 – Appendix 15 Capital Cost
[9] HM Treasury – Green Book – Page 1

1.26 The Green Book provides valuable guidance across all issues that face project evaluation. A contingency against risk is optimism bias. The rationale for considering this contingency is outlined in the Green Book Supplementary guidance as follows:

*"1.1 There is a demonstrated, systematic, tendency for project appraisers to be overly optimistic. To redress this tendency appraisers should make explicit, empirically based adjustments to the estimates of a project's costs, benefits, and duration.*
*1.2 As discussed in the Green Book, it is recommended that these adjustments be based on data from past projects or similar projects elsewhere, and adjusted for the unique characteristics of the project in hand."*

1.27 The methodology on application of optimism bias used is relatively standard. For the Hospital Project Gleeds have calculated this contingency as 13% or [redacted] [10] with the detailed calculation laid out in Appendix 18[11] [redacted] Additionally we would like to obtain evidence that substantiates the level of mitigation factors used within the overall 13% calculation as identified covering Procurement, Project Specific, Client Specification etc. [redacted] [12]:

[10] Jersey Future Hospital – CO025 – Appendix 15 Capital Cost
[11] Jersey Future Hospital – CO025 – Appendix 18 Optimism Bias
[12] Jersey Future Hospital – CO025 – Appendix 18 Optimism Bias

[redacted]

1.28 Advisers Concerto formed a view 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.”* [13]

1.29 Such a view was undoubtedly shaped by a view taken on the capability of the project team:

- 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[14]

1.30 Whilst we have no reason to doubt the capabilities of the project team, success will be highly influenced by the level of effective integration with the wider machinery of States government. Progress on overall public sector reform has been challenging with many competing demands including demographic changes, rising service demands/expectations against an ever restrictive financial operating envelope. The ability to remain within the overall Hospital Budget is likely to be extremely challenging. The new Hospital “will be Jersey’s largest single capital investment in a generation.”[15] The public sector within the UK have consistently struggled with keeping large capital investments within budget. We have no reason to think that conditions in Jersey will make such a task any easier to those faced by UK colleagues managing such large capital investment and infrastructure projects.

### Borrowing capabilities

1.31 Jersey has a credit rating of AA- which is regarded as “*an example of a high-grade sovereign*.”[16] The credit reference agency Standards and Poors had reduced Jersey’s rating by a notch to AA- with a stable outlook as a consequence of the UK voting to leave the EU. The Public Finances (Jersey) Law 2005, (Pt.3 Art. 21) imposes an overall cap on borrowing – effectively a self-imposed borrowing limit independent to that assessed by external credit agencies:

*“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.”*

1.32 In essence, given that estimated tax yields for 2016 was £665m and the fact that the Housing Bond utilised by Andium Homes equated to £243m the balance on this self-imposed borrowing capability would be substantially absorbed by almost all of the proposed £400m bond financing leaving little headroom for any additionality should project costs significantly escalate above current estimates. The self-imposed borrowing ceiling appears to be a prudent measure based on a link to tax yield income generating capability. This is an eminently sensible approach in that full reliance on sources used to meet debt servicing costs should not include speculative investment income.

[13] Cost Assurance Report – Future Hospital Project – Concerto – Executive Summary Page 2
[14] Cost Assurance Report – Future Hospital Project – Concerto – Executive Summary Page 2
[15] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 13 – rated Sterling Bond
[16] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 13 – rated Sterling Bond

1.33 Outwith the self-imposed borrowing parameter we note that advisers EY have identified that the current credit rating would allow the States of Jersey to borrow up to £850m which would be approximately £607m net of the Housing Bond. Advisers Opus Corporate Finance reflect on the lack of potential headroom:-

*"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 Fun. 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."*[17]

1.34 Trading a credit downgrade for additional borrowing headroom is clearly not in contemplation and it would appear to import additional risks. Jersey has created some level of stability in financial strategy through its Medium Term Financial Planning (MTFP) process. Jersey's Public Finances Law imposes clear rigour around how such a mechanism provides prudent fiscal planning. The building of the new hospital is not classified as a standard build and in context of locational factors and site characteristics will be deemed to be complex. In terms of balancing risk there is the real possibility that total project costs may well exceed the current Hospital Budget of £466m. By committing to a level of borrowing that eliminates substantive additional borrowing to cover this additionality further down the line (say in in 2020) would mean that other sources would need to be considered and this may ultimately impact on the stability of existing strategic financial planning.

**Arbitrage**

1.35 In order to deliver up investment income the Strategic Reserve would need to be fully committed to servicing the Hospital Bond coupon and repayment. This effectively takes out the nexus and primary purpose of the Strategic Reserve which was to provide a 'hedge' against the collapse of an island economy sector. Committing the fund to debt servicing will diminish the opportunity for the States to deal with significant unexpected 'left field' issues as they arise. Diminution of this reserve will obviously impair leveraging arbitrage.

1.36 By drawing down £400m we assume that this sum will not be invested in long term products and would be close to liquid assets. Obviously such investment returns will be lower as a consequence of their attributes and it may well be the case that the opportunity cost of borrowing such a sum within the early years of the cash flow forecasting may exceed the returns achieved by holding this sum. For example it is not until 2019 before significant works costs are likely to be incurred[18]:

[17] Future Hospital Funding Strategy – Opus Corporate Finance – Page 12 - Contingency
[18] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 7 Provision Cost Estimation

| Year Cash Flow<br>Inflation Separate | Total<br>£ | 2016<br>£ | 2017<br>£ | 2018<br>£ | 2019<br>£ | 2020<br>£ | 2021<br>£ | 2022<br>£ | 2023<br>£ | 2024<br>£ | 2025<br>£ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Works Cost after location factor | 213,004,188 | 0 | 0 | 3,101,870 | 48,219,710 | 76,477,922 | 65,961,098 | 19,243,588 | 0 | 0 | 0 |
| | 31,950,628 | 2,076,791 | 10,383,954 | 9,006,083 | 2,795,680 | 2,795,680 | 2,795,680 | 2,096,760 | 0 | 0 | 0 |
| Fees | 15,419,921 | 0 | 205,000 | 10,727,500 | 50,000 | 450,000 | 682,000 | 2,900,000 | 405,421 | 0 | 0 |
| Non-Works Costs | 18,650,035 | 0 | 0 | 0 | 0 | 0 | 0 | 18,650,035 | 0 | 0 | 0 |
| Equipment Risk | 74,108,981 | 0 | 0 | 1,079,211 | 16,776,729 | 26,608,401 | 22,949,360 | 6,695,280 | 0 | 0 | 0 |
| Inflation | 68,751,737 | 169,883 | 849,417 | 1,218,717 | 9,368,273 | 20,462,754 | 23,103,976 | 13,445,840 | 132,877 | 0 | 0 |
| Main Project Costs | 421,885,490 | 2,246,674 | 11,438,371 | 25,133,381 | 77,210,392 | 126,794,757 | 115,492,114 | 63,031,503 | 538,298 | 0 | 0 |
| Relocation Costs | 39,932,329 | 430,995 | 25,094,837 | 8,747,260 | | | | | 332,266 | 4,645,290 | 681,681 |
| Inflation | 4,092,597 | 10,847 | 1,333,480 | 654,378 | | | | | 68,758 | 1,758,598 | 266,536 |
| **TOTAL COST** | **465,910,416** | **2,688,516** | **37,866,688** | **34,535,018** | **77,210,392** | **126,794,757** | **115,492,114** | **63,031,503** | **939,322** | **6,403,888** | **948,217** |

1.37 Planned arbitrage on investment returns estimated to yield an annual minimum of 5% (based on RPI at 3% +2%) against annual coupon costs and eventual repayment costs appears to be a prudent level of return based on the work carried out by Treasury. Financing costs have been calculated at £10-£11 million per annum over the life of the 40 year tenor[19]. Indeed, the Strategy submission indicated that:

*"The modelling work done by the States Treasury and reviewed by advisers demonstrates that Bond financing costs should be affordable from excess returns on the Strategic Reserve."*[20]

1.38 Some of the historical excess returns made were highlighted within the Treasury position, however, the current operating environment is very different from 1986 when a return of 8.1% was achieved, 19.9% in 1997 and 9.6% was achieved in 2012. Such is the differing operating conditions now faced within the investment market that these examples have little relevancy for comparative purposes in making the case to set a prudent forecast. In the latest submission by the Minister for Treasury and Resources the latest investment return metrics were highlighted:

*"Over recent years, the investment returns of the Reserve have been 6.4% over RPI(Y), the equivalent of 7.7% on average (3 year figures to December 2016). If the States borrow between £300 million and £400 million by way of issuing a bond, the interest rate payable looks likely to be in the region of 2.5%".*[21]

1.39 There is a marked downward trend in returns. The potential for further retrenchment in investment returns below the latest 6.4% is evident. Due to a number of factors it may well be the case that this apparently prudent forecast may be subject to some risk as a result of:

- Sustained low interest rates over the medium term – a lack of economic growth, an increasing level of consumer/public debt are not strong conditions for high investment yields on low to medium risk products
- Negative impact on markets from a high level of uncertainty associated with Brexit and the political environment within the United States
- In-year investment risk changes - the need to shift towards products attracting higher end risk as a result of the requirement to meet the 5% rate of return

[19] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 24 – Ongoing Costs
[20] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 19 – Ongoing Costs
[21] Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Minister of Treasury and Resources – 13 April 2017 Page 4

1.40 We understand that investment strategies covering each of the main funds managed by the States is overseen by the Treasury Advisory Panel and that such *"Strategies reflect the risk and return acceptable to each of the Funds based on the purpose of the Funds."*[22] We further understand that the current strategy provides for a split of investments as follows[23]:

| Fund | Strategic Reserve £m | Stabilisation £m | Social Security (Reserve) £m | Health Insurance Fund £m | Currency Fund £m |
|---|---|---|---|---|---|
| **Fund balances as at:** | | | | | |
| 31.10.2016 | 866.5 | 0.0 | 1,546.6 | 83.8 | 89.8 |
| 31.12.2015 | 772.0 | 0.0 | 1,289.0 | 74.0 | 111.0 |
| Amount of money held not for investment | | | | | 14.8 |
| **Current Investment Strategy R.812016– 28.7.16** | | | | | |
| Equities | 50% | | 68% | 40% | 20% |
| Alternatives (1)(2) | 10% | | 20% | | 60% |
| Bonds | 40% | 80% | 10% | 45% | 10% |
| Cash | | 20% | 2% | 15% | 10% |
| | 100% | 100% | 100% | 100% | 100% |

1.41 Whilst the strategy set for the mix of investments outlined above appears to be prudent the 40% level of Strategic Reserve fund exposure to Bonds on approximately £866.5m will undoubtedly provide stability in returns but may not be considered to yield high rates that may act as a robust buffer to some volatility covering equity investments. Whilst on the face of it a 5% return on the Strategic Reserve would appear to be a prudent position taken given the level of emerging global economic and political risks to investment stability such a measure should still be treated with some caution.

1.42 We are aware of the level of stress testing that advisers to the Treasury applied to reach a level of assurance on such a critical assumption:-

*"Advice from the Treasury's investment advisers, Aon Hewitt, has been sought in order to test our target and to further assess assumptions being used. Their analysis assumed that the current strategy would remain in place over the long term, and had prudently assumed market returns from asset. They believe that investment returns are likely to be challenging in the short term, but have advised over the longer term, i.e. the likely term of the Bond, that there is a higher likelihood of returns being stronger, and that our target figures seem reasonable.*

*From this data it should be assumed that the target return may not be met each and every year, and that it may be necessary to use capital value in those years. This would then be repaid once returns are sufficient to so do. In the longer run, previous years' outperformance would provide some protection of the capital value."*[24]

[22] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 12 – Option 1
[23] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 12 – Option 1
[24] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 20

1.43 However the level of excess returns requires a basic level of fund balances. Within the overall states finances there is an interdependency upon funds and this is well reflected within the MTFP. This is acknowledged within the initial Treasury submission:

*"If income tax receipts were to fall to a lower level or other events resulted in further withdrawals being required from the Strategic Reserve, there may not be sufficient excess returns in every year, and there may be a need to use the capital value in the short term to fund the coupons. This use of the capital value of the Strategic Reserve would then be repaid when sufficient excesses are achieved.*

*Alternatively, over the longer term, other ways of funding the financing of the debt may be sought, such as a further savings target, use of part of the capital allocation, further asset sales, or consideration of further revenue-raising measures as a last resort."*[25]

1.44 There is obviously a recognition that the balance on the strategic reserve may be needed to meet other contingencies. Forty years is a considerable period of time and it is reasonably foreseeable that there will be a drawdown/call upon the Strategic Reserve at some point to meet a reduction in planned income /additional operating cost pressures. This will be particularly relevant where there is no political appetite to raise Income Tax (Personal or Corporate), other taxes such as GST or charges. A draw of significance could significantly impair the States to enjoy arbitrage in a way that meets the financing costs of the bond.

### Funding through the Strategic reserve and Re-Capitalisation

1.45 We note that the Corporate Services Scrutiny Panel submitted an amendment on 4 April 2017 proposing that :

*"…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;"*[26]

1.46 The Panel's concerns relating to the concept of borrowing £400m primarily relate to the potential impact of permanent change and the extent that some important components of the proposed funding strategy is extremely sensitive to change. Examples include a "*structural fall in overall States revenues of as little as 3.5% 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. Nb - This assumes this generates deficits which would have to be funded from the Strategic Reserve*.[27]

1.47 The Panel considers that the ability to recapitalise the Strategic Reserve through annual payments of just over £5m from the Consolidated Fund "not to be an onerous task". We would consider that this approach would certainly provide added impetus in finding efficiency savings across the public sector in Jersey which we would consider to be an extremely positive outcome. Such additional funding is certainly not going to be surplus to requirements but should be feasible in the context of overall public sector reform. Given that annual Bond financing costs are estimated between £10m and £11m such an approach appears to have some merit although the likely reduction in

[25] Future Hospital Funding Strategy - P130/2016 (re-issue) Page 21
[26] Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Corporate Services Scrutiny Panel - Page 2
[27] Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Corporate Services Scrutiny Panel - Page 5

the Strategic Reserve Balance in directly funding the hospital capital spend is going to be significant. Indeed:

*"In 2022, if the Panel's amendment is adopted, the Strategic Reserve balance is forecast to be £577.7 million, when its protected balance should be £828.5 million"*[28]

1.48 Whilst financing hospital capital expenditure via the Strategic Reserve with recapitalisation will inevitably significantly reduce the Strategic Reserve and investment return capability, it would provide some mitigation against the risk of locking into a level of borrowing that limits headroom in the light of unexpected/unforeseen additional borrowing requirements and/or weaker performance on arbitrage. In the event of a significant uncontrollable escalation in project costs it would provide additional opportunities to reflect upon other financing options further down the life cycle of construction period.

**Concluding comments**

1.49 We would conclude the following:

- Where external financing is required the Sterling Public Rated Bond is the preferable option

- Given the historically low yields and spreads there are clear advantages with the approach proposed by the Minister for Treasury and Resources

- In respect of the issues attached to this complex and sizeable project there are a number of risks including the potential inability to contain significant cost escalation within an approved budget which may light on optimism bias contingency, little or no future headroom to borrow externally in the event of a significant unforeseen event or needed public reform investment and potentially lower than forecasted performance on arbitrage. Collectively these risks, in the context of a more turbulent global economic and political environment (including the impact of Brexit) may be more difficult to contain should the States proceed with a £400m Bond over a 40 year tenor. The Bond offers significantly less flexibility in the ability to change course on funding strategy within the construction cycle should externalities require the States to do so

- The amendment proposed by the Corporate Services Scrutiny Panel reflects the current and potential lack of stability and recognises the sensitivity of small changes on key assumptions used within the original proposal. The Panel's proposal provides more control and flexibility in the ability to adapt to future changes. The additional impetus on funding from budgets is regarded as positive. On the downside the Strategic Reserve will be significantly reduced during the course of the project but the ability to consider other forms of financing 'further down the line' is protected.

1.50 Whilst we recognise merits in both approaches it would be our considered view that inherent conceptual benefits from both could be harnessed in a way that reduces exposure to the risks highlighted by our analysis. This could be achieved by deferring the decision to borrow until nearer 2019 and meeting the initial 2017 and 2018 capital payments from the Strategic Reserve. The States would be in a much stronger position to borrow, what would be considered to be an 'optimal' amount as project costs and risks become clearer. The downside of this approach is the potential for interest rates and bond prices to be higher. However, due to sustained economic weaknesses across the UK and Europe there are no current indications that this will happen in the short term.

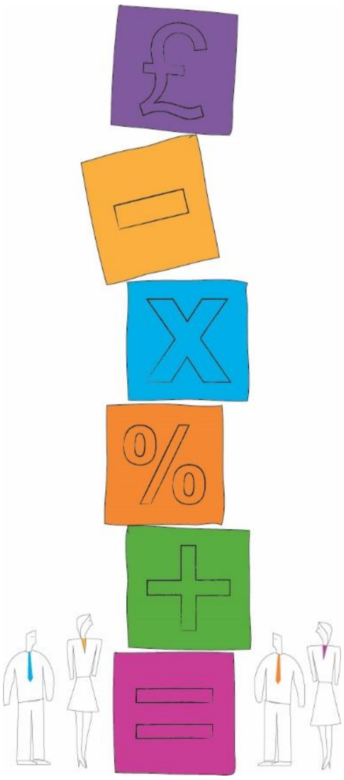
[28] Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Minister of Treasury and Resources - Page 4

1.51 A further option is an alternative blended approach using aspects from both the Minister and the Corporate Services Scrutiny Panel's proposals. This would include the reduction of the exposure of Bond financing to say £200m (we are led to believe that the Bond market would not repel such lower amounts). This would allow the potential arbitrage benefits to be realised albeit with lower risk and allow more borrowing headroom. The preservation of an enhanced saving requirement to fund any gap through a re-capitalisation on any balance of capital expenditure would also be a positive step.

**Appendix 1**

## Documents Reviewed

Future Hospital Funding Strategy - P130/2016 (as amended - re-issue – 18 January 2017
Future Hospital Funding Strategy (P.130/2016) (Second Amendment) – 4 April 2017
Future Hospital Funding Strategy (P.130/2016) (Second Amendment) – 25 April 2017
Future Hospital Funding Strategy - P130/2016 (Amd.3)(Third Amendment) lodged by the Corporate Services Scrutiny Panel – 4 April 2017
Future Hospital Funding Strategy - P130/2016 (Amd.3)(Third Amendment) lodged by the Corporate Services Scrutiny Panel – 13 April 2017
Future Hospital Funding Strategy - P130/2016 (Third Amendment) lodged by the Minister of Treasury and Resources – 1 April 2017
Future Hospital Funding Strategy – Opus Corporate Finance
HM Treasury – Green Book
HM Treasury – Green Book Supplementary Guidance
Gleeds - Jersey Future Hospital – CO025 – Proof of concept - Appendix 15 Capital Cost
Gleeds - Jersey Future Hospital – CO025 – Proof of concept - Appendix 16 Inflation
Gleeds - Jersey Future Hospital – CO025 – Proof of concept - Appendix 17 Location factor
Gleeds - Jersey Future Hospital – CO025 – Proof of concept - Appendix 18 Optimism Bias
Gleeds - Jersey Future Hospital – CO025 – Proof of concept - Appendix 19 Investment Summary
Appendix 17 – Equipment Strategy
RIBA – Summary Programme
Cost Assurance Report – Future Hospital Project – Concerto
EY Capital & Debt Advisory – 18 January 2017
EY – Project Torrin II – Debt Capacity Analysis
Future Hospital – Feasibility Study - Project Board - Capital Monitoring Update – January 2017
Governance Pack 20161205 – Cost and Risk Report
Governance Pack 20170112 – Cost and Risk Report
Governance Pack 20170207 – Cost and Risk Report



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