STATES OF JERSEY

MEDIUM TERM FINANCIAL PLAN 2013 – 2015 (P.69/2012): EIGHTH AMENDMENT (P.69/2012 Amd.(8)) – COMMENTS

Presented to the States on 5th November 2012
by the Council of Ministers

STATES GREFFE

COMMENTS

Deputy J.A.N. Le Fondré of St. Lawrence is proposing to amend the Medium Term Financial Plan proposition such that it removes the capital programme funding dependency on the redemption of the JT Group Ltd. 9% Preference Shares. This means that £8,500,000 will be removed from the 2013 funding sources, £4,743,000 from the 2014 funding sources and £1,757,000 from the 2015 funding sources.

Deputy Le Fondré further proposes that the intended redemption of the States 9% Preference Shares be reviewed by the Corporate Services Scrutiny Panel.

This will have the effect removing £20 million of funding from the Medium Term Financial Plan – £15 million that was allocated to the capital programme and £5 million that was allocated to the Innovation Fund.

The Council of Ministers has considerable difficulty with Deputy Le Fondré's amendment. It is asking the States Assembly to remove the dependency in the capital programme on the redemption of the JT Preference Shares of £15 million, but without proposing how the proposed projects would be funded. Furthermore, Deputy Le Fondré's amendment would mean that the Innovation Fund would have no money in it. This would be a significant impediment to making progress with the Economic Growth Strategy that the States agreed in July 2012. Small and innovative businesses would be prevented from bidding for and receiving support at a time when the Island needs to help its entrepreneurs and emerging businesses.

The amendment also questions redeeming the JT Preference Shares at their face value of £20 million. JT is 100% owned by the States of Jersey and the redemption of the Preference Shares makes no difference to the States ownership of JT. The States would continue to receive the full benefit of any dividends declared by JT. The Council of Ministers' proposal would release capital from JT for capital investment in key services.

On that basis, the Council of Ministers opposes this amendment.

Council of Ministers' Comments

<u>The impact of the proposed amendment</u>

The amendment does not accurately reflect the overall impact of the Jersey Telecom (JT) 9% Preference Shares not being redeemed. The proposed £20 million is allocated in the Medium Term Financial Plan as follows –

- Capital projects £15,000,000
  - £8,500,000 in 2013
  - £4,743,000 in 2014
  - £1,757,000 in 2015
- Innovation Fund £5,000,000.

On 17th July 2012, Projet P.55/2012 "Economic Growth and Diversification Strategy" was approved by the States, which included the establishment of a new Innovation Fund. The aim of the Innovation Fund is to support innovation, and it will be available to support a wide range of activity, from direct business support to strategic infrastructure investments, in the private, public and third sectors. Whilst the fund was to be created with an initial investment of £10 million, the proposition said that £5 million had been identified to date, and the Minister for Treasury and Resources would work with the Minister for Economic Development to identify the additional budget for the Innovation Fund.

The amendment is silent on the £5 million for the Innovation Fund, and yet this would be affected by the review of the redemption of the Preference. There is an issue both in timing and funding source.

The withdrawal of the redemption of the Preference Shares would leave £15 million of the capital programme without an identified funding source. The Deputy is not proposing to withdraw the capital schemes from the 2013 – 2015 Medium Term Financial Plan and amend the net revenue expenditure for these years.

The second part of the amendment is asking the Corporate Services Scrutiny Panel to independently review the redemption proposal ahead of any vote. If members agree to this amendment, the review process will delay this decision which is critical for JT in order to implement their strategic plans, and will introduce funding uncertainty in the capital projects and the Innovation Fund.

Approving the redemption of the Preference Shares, and not delaying this decision, shows the States' continued support to hold its Strategic Investment in JT in the long term by seeking to protect its long-term investment value in the company. Clearly, by seeking short-term dividend, returns would be at the expense of maximising the States' long-term capital growth in its investment in the company, and would greatly impede the company when trying to implement its strategic plans.

<u>Other key points from Deputy Le Fondré's amendment</u>

The Medium Term Financial Plan reflects the redemption of the Jersey Telecom (JT) 9% Preference shares in a number of ways. The Deputy is correct that the States currently receives £1.8 million per year in income, and the Medium Term Financial Plan reflects this loss of income from 2013 onwards. The key point here, however, is that JT remains 100% owned by the States and will continue to receive equity dividends. The overall dividends received from JT as a result of the redemption of the Preference Shares will not be affected by the corporate restructuring. There is one pool of funds available to the shareholder and the States of Jersey remains the sole shareholder.

Members will be aware that JT is going through a period of investment, both in terms of on-Island infrastructure projects, but also in terms of growth through off-Island acquisitions. These projects are not short term, and JT have been open with the States as shareholder about the need to retain cash in their business to fund this growth. This has to be for the long-term benefit of Jersey, both for individual customers and business customers. It is essential that the telecommunications network keeps pace with global developments to support not only our existing finance industry, but also our ambitions to grow in the Digital space. This period of growth is detailed in the latest business plans from JT and these have been used to support the short-term dividend reduction and the proposal to redeem the 9% preference shares.

In his amendment, Deputy Le Fondré makes reference to the fact that the Preference Shares are worth just under £30 million.

Whilst the amendment is correct in stating that the Preference Shares were valued at £29.5 million in the 2011 financial statements, it is important to point out this is a valuation solely for accounting purposes and not for disposal purposes. There are many methods available to use when valuing a company or its shares.

This valuation does not reflect the worth of the Preference Shares in the sense that that would be the price that a third party would be willing to pay for part-ownership of JT, nor the price that the States would be willing to relinquish part-ownership of this important strategic investment. The value of being the sole owner of JT is that all available dividends come to the States irrespective of capital structure. Any change to capital structure that gave rise to additional shareholders would lead to uncertainty about dividend return and change the nature of the relationship with JT. For this reason, the States would not undertake lightly an exercise to test the marketability of these shares to a third party, as the 100% ownership of JT gives benefits that outweigh any difference in cash receipts for the Preference Shares. 'Worth' of the shares in the sense that Deputy Le Fondré uses it, therefore, is not the correct consideration in terms of this redemption.

What is important is that, as both a shareholder and a stakeholder in JT, the States remembers that the company must sustain its market presence and grow in line with its competitors so it can carry out its strategic aims. The growth of the company is dependent on its ability to revise its capital structure to attract new debt financing monies. By offering the redemption of the shares, it has become more attractive to private placement bond lenders (debt financing) and this in turn secures the States of Jersey's investment in JT in the longer term, with the intention in future years to preserve; and where possible, growth of our capital and dividend investment returns for the States as sole shareholder in JT.

If JT were not able to redeem the Preference Shares in the way set out in the Medium Term Financial Plan then it would need to reconsider its overall funding arrangements, and this may lead to it coming to the States as shareholder for further funding. JT must maintain capital adequacy to preserve market position, and it is imperative that it can operate in its commercial market place. JT is not just an organisation which operates in Jersey, but also holds an off-Island presence. The nature of its services and geographic coverage means that it is a capitally intensive business which needs to invest in order to survive. From a shareholder perspective, company growth impacts and protects the value of our Strategic Investment in the Balance Sheet.

<u>Governance Arrangements</u>

Whilst the amendment leads the States to assume that a 9% Preference Share was issued to ensure a minimum level of performance by the Board, this is not in the Telecommunications (Transfer) (Jersey) Regulations 2002. Instead, the Regulations are silent on this, and the supplementary Report to the States said –

> *"The total value of the net assets (excluding goodwill and after deducting relevant pensions liabilities) to be transferred to the group is approximately £58 million. Because of the right to a 9% dividend attached to the £20 million of Cumulative Preference shares, and because that right carries forward from one year to the next if the dividend remains unpaid (it is cumulative as well as*

preferred in advance of any dividend on the Ordinary shares), the board of directors will have a base return to achieve for the group's owner – the States. The board of directors expects (and so does FEC) to do much better than this. Its performance will be evaluated by reference, principally, to the dividend stream on the £20 million Ordinary shares. At present FEC is looking forward to a minimum dividend of 13% per annum. The remaining equity of approximately £18,000,000 will take the form of realised profits (distributable reserves) at vesting (Regulation 15(8))."

JT current returns have been in excess of the 13% dividend per annum stated in the original proposition to the States, and are forecast to remain in excess of that after providing JT with the agreed level of support for the £9 million reduction for several years in relation to Gigabit Jersey project (now impacting financial years 2013 to 2014). Since incorporation, JT have returned dividends of £83 million to the States of Jersey in the period 2002 – 2011, which is rather better than the minimum requirement of £18 million in that period.

The Memorandum of Understanding (MOU) established with JT when it was incorporated in 2002 clearly sets out the duties of JT to –

- be as profitable and efficient as comparable telecommunications business that are not owned by the States of Jersey; and
- enhance the long-term value of the shareholder's investment in the company and deliver sustainable returns to the shareholder comparable to telecommunications business that are not owned by the States of Jersey.

Under the MOU, JT's Board is required to adhere to the Principles of Good Governance and the Code of Practice which comprises of the Combined Code that is incorporated into the listing rules of the UK Authority. Under the Financial Reporting Council, the Combined Code on Corporate Governance, June 2006, the supporting principles are –

"The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met."

The Minister for Treasury and Resources, as representative for the States, meets the JT Board regularly to discuss and ensure they deliver their Strategic Business in Line with the MOU obligations. This includes the setting of new Strategic Business plans and discussions around the Company's capital requirements to ensure they have sufficient financial resources to implement their strategic objectives.

This is further re-iterated in relation to the Telecommunications (Jersey) Law 2002, Article 7, where the Minister for Economic Development has clearly defined duties, some of which include –

- *"perform his, her or its functions under this Law in such manner as each considers is best calculated to promote efficiency, economy and effectiveness in commercial activities connected with telecommunications in Jersey";*

- *“to further the economic interests of Jersey” and*

- *for the Minister “to ensure that persons engaged in commercial activities connected with telecommunications in Jersey have sufficient financial and other resources to conduct those activities.”.*

Investment in Gigabit Jersey and future dividend returns

The Ministerial Decision relating to the Gigabit project, MD-TR-2011-0139, was prepared in November 2011 and was approved for the Gigabit Jersey financial case, which included the latest financial estimates available at the time.

The dividend forecasts included in the Medium Term Financial Plan are based on revised dividend forecasts during Q2 2012. During March to May this year, the Minister for Treasury and Resources and Officers of the States met with JT to discuss their annual strategy review. JT commissioned 3rd party consultancy advice at the end of 2011 to help work with them to derive a new long-term strategic direction and plan for the Company.

It was during these discussions that the need became clear to restructure their debt financing in order to attract new external debt financing; as a good employer the States needs to work with its strategic investments, but not stifle them from growth as a result of it not being able to provide additional internal financing to them. As Shareholder, our focus has always been on protecting long-term shareholder returns, as this is an investment the SOJ plan to hold in the medium term and that we should not seek to extract high short-term dividend returns at the expense of long-term capital growth.

As part of the discussions, we have given JT a letter of support for its new Strategic aims and agreed to revise the current dividend policy on a new, more commercial, basis in order for it to become more attractive to potential external debt financers. Dividend policies will continue be reviewed annually as part of the shareholder strategic review process.

Once the Gigabit Jersey project is completed, which is capitally intensive for JT, and as a result of the Company’s acquisition plans, like the recent acquisition of Worldstone, it is anticipated that dividend returns will stabilise, if not increase.

Completeness of Dividend returns

The dividend returns referred to in the amendment only relate to those from the States of Jersey Strategic Investment. Therefore, they exclude the interest payable on the recently issued £10 million 2.5% preference share – infrastructure investment which is accounted for in part of the investment returns forecast by the Consolidated Fund.

Council of Ministers’ Key Themes

Key Theme – Balanced Budgets

The States endorsed a 3 part plan to address the deficits which were forecast from the move to a zero/ten tax regime and the impact of the economic downturn. The 2012 Business Plan presented proposals for a balanced budget from 2013 and this has been the basis for the States Strategic Plan and Council of Ministers' proposals for the Medium Term Financial Plan.

This 3 part plan is delivered and is working –

1. Savings have been removed from budgets to deliver over £61 million by 2016,
2. Economic growth has been boosted by a fiscal stimulus package, and
3. Taxes have been raised where necessary to close the remaining gap.

The Medium Term Financial Plan proposes balanced budgets in 2013 through to 2015, and the Council of Ministers is proposing a number of budget reductions and other measures over the next 3 years to ensure that these balanced budgets can be maintained while providing the necessary resources to deliver the agreed Strategic Priorities.

It is important to keep public sector spending under control so that the Island can remain competitive with relatively low levels of inflation. If the States is to provide sustainable services to the public, it is fundamental that we take account of the economic outlook, be prudent in our spending plans, ensure that savings and efficiencies are implemented, and not increase public spending unless it is matched by savings or additional income.

It is also important that the States endorse the proposals for balanced budgets and do not dilute the tough decisions that have been taken so far on tax and spending by accepting amendments that would not result in balanced budgets.

Balanced budgets are essential to provide a certain, stability and confidence in the Island to be able to deal with uncertainty, to enable the Island to be competitive internationally, and to be in a position to take advantage of global economic growth when it returns.

Financial and manpower implications

There are no direct manpower implications. There are only financial implications as follows –

- Capital projects £15,000,000.
  - £8,500,000 in 2013
  - £4,743,000 in 2014
  - £1,757,000 in 2015

- Innovation Fund £5,000,000 in 2012.

No comments have been made specifically about the financial or manpower consequences of not providing funding to each of the independent capital projects. However, it is anticipated that if funding is not provided for each of the projects there will be numerous impacts on the operations of Health and Social Services, Home Affairs and Transport and Technical Services Departments.

Furthermore, the Innovation Fund would have no available funds in order to carry out its objectives as approved under Projet P.55/2012 "Economic Growth and Diversification Strategy" in July 2012.