STATES OF JERSEY

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

Presented to the States on 13th April 2017
by the Minister for Treasury and Resources

STATES GREFFE

COMMENTS

The Minister strongly opposes this amendment. It is regrettable and disappointing that he is having to present his comments without the benefit of the Corporate Service Scrutiny Panel's Report on their review being presented. As a consequence, Members and Ministers have not had time within Standing Orders deadlines to consider that Report and present their own amendments. However, the Minister considers that it is vital that Members have the opportunity to read and consider his views prior to the planned resumption of the debate on P.130/2016 on 18th April 2017.

Since the suspension of the debate on 19th January 2017, the Minister and his Department have provided significant volumes of information to the Panel and their advisers in a timely fashion. The Minister and/or Treasury officers attended 2 public hearings and 4 briefings with the Panel and/or their advisers. The most recent briefing took place on 30th March 2017, attended by all members of the Panel, the Assistant Minister for Treasury and Resources and the Treasurer of the States. The discussion at this briefing centred around finessing the wording of the Minister's second amendment to P.130/2016 to ensure as far as possible that it met the requirements of the Panel, particularly with regard to safeguarding the level of the Strategic Reserve. It was therefore with some surprise and disappointment that the Minister read the Panel's third amendment on Monday 3rd April, 2 working days after this meeting, when no mention of it had been made at the time. The Panel's amendment has been made in a way that has allowed the Minister, and his colleagues on the Council of Ministers, very limited time to consider his response and put his views across to Members. Reluctantly, the Minister has concluded that it would be better to delay the debate for 2 weeks, to allow time for Ministers to fully comprehend the risks and consequences of a complete change of direction for the Island's finances, and requested the Panel to back a delay. The Panel chairman responded that the Panel would not agree to a delay of debate, even though their own proposition would have been proposed only 2 weeks before a debate, and the Panel has yet to provide its own sensitivity analysis of its proposals to identify the very real risks that it presents. Consequently, the Minister has had no choice but to comment on the Panel's amendment without seeing the Panel's Report.

The Minister, his officers, and the Council of Ministers have been working on the funding proposals contained in P.130/2016 for many months. No option was ruled in or out without detailed consideration. Renowned expert advisers have been employed throughout. The proposals of the Minister have also now been subject to 3 months' scrutiny by the Panel, who in turn have employed their own expert advisers. The Minister has amended P.130/2016 to meet the stated concerns of the Panel, and believed that an acceptable solution had been reached that is right for the Island. In contrast to this measured policy development, the Panel has lodged an amendment which does not seem to have any evidential basis in the work of their advisers, and which has not been subject to any external scrutiny. The Minister urges Members to think seriously about the implications of accepting this proposal, not just in financial terms, but as an indicator of how Jersey conducts itself and manages its affairs.

However, notwithstanding the above, the Minister hopes that all Members will genuinely look at the issues raised, the opinions of experts and the facts presented in arriving at their decisions. This is the largest and most expensive capital project we have ever embarked on in Jersey. How we, as an Assembly and as a Government, deal with this matter will be observed by those around the world who respect our stability and gravitas and want to do business with us.

The rationale for the Panel's amendment would appear to be argued on 2 main points –

- that it provides Members with a choice; and
- that it presents less risk at a time of world economic uncertainty.

These points will be examined in turn.

Presentation of a choice

The Panel's amendment undoubtedly provides this Assembly with a choice. A choice between a well-researched and well-scrutinised proposal which has had the input of expert advisers, and one which appears to have little evidential basis.

Members already have a choice with P.130/2016, as amended by the Minister for Treasury and Resources. The choice is to accept or reject the proposals of the Minister. Rejection of those proposals would mean the Minister would need to think again, and would need to return to the Assembly with a properly-researched and evidenced plan which he, and the Council of Ministers, would be confident of delivering. The alternative proposal is predicated on unknowns, and results in greater uncertainty. To weigh the Minister's proposition as amended, against the amendment, is simply not comparing like with like. If Members are really unconvinced by the Minister's proposals then the proper course of action for Members is to reject those proposals or to request further assurances or information. The Minister would be bound to accept such a decision and return with an alternative. That is the proper way to make decisions.

Risk and uncertainty

Turning to the Panel's views on risk and uncertainty, the Minister fundamentally disagrees with their assertion that the amendment presents a safer and financially more secure option. The following factors are relevant.

<u>Total cost of borrowing</u>

The Minister urges Members not to be seduced by the use of the total interest payments over the 40-year period to arrive at a total estimated cost of borrowing for the new hospital of between £800 million and £850 million. The capital to be borrowed and repaid is proposed to be between £300 million and £400 million. Yes, the interest payments need to be met, but these are financing costs. If an individual is buying a house for, say, £400,000, does that individual then calculate all of the interest payments over the life of his or her mortgage, add those to the capital sum and say that amount is the total cost of the house? In practice, the individual will look at the amount of money available to him or her, look at the likelihood of that money being needed in the future, look at the cost of borrowing as opposed to what he or she can earn in interest by investing the money he or she has, and arrive at a balanced view of how best to finance the purchase looking across the whole life of the loan. That is precisely what the Minister for Treasury and Resources has done.

Level of the Strategic Reserve

At the end of 2016, the Strategic Reserve had a balance of £819.6 million. It was established and protected by our predecessors in this Assembly to insulate the Island against severe economic shocks. As recently as September 2014, this Assembly voted to protect the capital value of the Strategic Reserve in P.129/2014. This protection was viewed as sufficiently important to require specific inclusion in the proposition for P.130/2016 by Connétable C.H. Taylor of St. John in the first amendment, lodged on 4th January 2017. Indeed, as late as 31st March 2017, the Panel were requesting that the Minister for Treasury and Resources specifically include this assurance in his own (the second) amendment to P.130/2016. He was glad to do so, recognising the importance of the Reserve as the Island's "safety net", its buffer in times of uncertainty. Yet the amendment of the Panel reduces the level of the Strategic Reserve below the recently set minimum level for a period of 17 years, at a time when, as the Panel points out in the report accompanying its amendment, "the Island (and the United Kingdom, as well as Europe) are in the most uncertain position both economically and politically, for the last 70 years". 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. The Panel's logic is difficult to fathom and the Minister cannot, in all good conscience, endorse a proposal that risks the Island's stability to this extent. The potential effects on Jersey's credit-rating of such a proposal are unknown, but are extremely likely to be unfavourable. In their words, the rating agency place reliance on our "considerable fiscal buffers". They state in their last rating (January 2017) "we regard Jersey's liquid fiscal assets as a key rating strength". Would our householder (referred to above) use his or her own savings to the extent that they were placed in a position where they could not guarantee their own security of providing for themselves and their family in the event of unknown events? If the payment for the house was to be made in stages instead of a single payment, would our householder be prepared to risk not having the assurance of "money in the bank" to make those future stage payments?

Cost of borrowing versus investment returns

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%. Interest rates are historically low, and present a hugely attractive opportunity to borrow at a beneficial rate for Islanders. Would our hypothetical householder turn down the opportunity to borrow at 2.5% and invest at 5%, the cautious long-term projected investment return? And by doing so, reduce his or her buffer against uncertainty and spurn the opportunity to add to it for the foreseeable future?

Funding of recapitalisation of the Strategic Reserve

The Panel's amendment proposes that the level of the Strategic Reserve is replenished by a contribution from the Consolidated Fund of £5 million to £7 million per year at today's prices. The Panel appears to consider that this is a painless and straightforward solution. They say they do not consider it "to be an onerous task". In putting their plan forward, they cite a level of underspend of around £25 million in recent years.

The Panel are correct in their statement of the level of underspends and carry-forwards. Where they, and other commentators are completely incorrect, however, is in making the assumption that such funding is somehow surplus to requirements. The following considerations are relevant –

- For any year's budget allocated by the Assembly, there will be demands on resources that were not envisaged at the start of that year. It is only natural that, rather than call on central contingencies, departments should seek to make savings whilst still delivering those services and "bid" to use the saved resources to deliver the unknown and unresourced demands. This is good, prudent, financial management.

- Not all expenditure starts and finishes neatly within a financial year. Many approved carry-forwards relate to activities which will be completed beyond the end of the year in which they are first resourced. Again, this is good, prudent, financial management.

- Underspends are a natural consequence of the States' prudent approach to managing its finances. The Public Finances (Jersey) Law 2005 forbids an accounting officer, who holds a delegated budget, to overspend. Therefore, unless budgeting is extraordinarily precise, an underspend is the only legal and likely outcome at the end of any financial year.

- The level of underspends, at around £25 million, represents only 3% of the States' annual revenue expenditure. This is a perfectly reasonable consequence given the above points. With the level of savings committed to in the Medium Term Financial Plan 2016 – 2019, some of the current underspends relate to those savings being delivered early. Others have been planned to fund other expenditure, for example in Health. It is unreasonable to "bank" on this level of underspends continuing into the foreseeable future as a source to recapitalise the Strategic Reserve. Equally, it is unreasonable to assume that this level can simply be removed now from departmental cash limits as a saving in perpetuity.

The required recapitalisation, at £5 million to £7 million today, when index-linked rises to £14 million by the end of the 40-year period under discussion. This is a hugely significant requirement, given the savings exercises and the restraints upon budget increases that departments have undergone in recent years. Anyone who has experience of delivering essential services in this climate over the last 10–15 years would severely dispute that finding, yet more savings is "not an onerous task".

Should the Assembly approve the amendment of the Corporate Services Scrutiny Panel, then the Minister for Treasury and Resources needs to put on record that he cannot discount the need to bring forward revenue-raising measures should it prove unrealistic or impossible to deliver the further spending reductions that would be necessary.

Impact of % reductions in interest and income

The Panel makes much of its sensitivity analysis on investment returns and the States' income. It states that the "Panel has seen evidence that should investment returns fall by as little as 1.5% from those assumed by the Treasury Department, there will be a significant impact on outcomes.". Taken at face value, that would appear to be a valid concern. A fall of 1.5% (or 1 in 66) seems eminently possible. However, what the Panel has not articulated is that the calculations they present relate to a potential fall of 1.5% from returns of 5%. This is a fall of 30%, which although not impossible, is far less likely; would take much longer to manifest itself; and would offer ample opportunity to take corrective and alternative action. This needs to be put into context. The Treasury has modelled a prudent assumption of returns to investment of RPI plus 2%. Over the last 3 years, the Strategic Reserve has returned 6.4% above inflation (RPI(Y)). The Minister questions what evidence the Panel has to suggest that returns over the next 40 years will drop so dramatically. Additionally, the Panel has consistently suggested that the Treasury's income forecasts are "optimistic and do not reflect current levels of uncertainty" (see, for example, their report on the Budget 2017). These suggestions have been demonstrated to be consistently unfounded.

In times of uncertainty it is vital to retain a financial buffer. The risks that the Panel attributes to the Minister's proposal apply equally, if not more so, to their own alternative proposal. If investment return rates were to fall, then the required recapitalisation rates would need to rise. If this occurred at a time when the States' income was also falling, then it is not difficult to envisage a situation whereby the States could not afford to maintain the level of the Strategic Reserve, or potentially the construction costs of the new hospital, if this was to arise in the early stages. To borrow in those circumstances would be likely to cost significantly more than the current low interest rates available. Jersey would be a less attractive proposition for lenders. Borrowing when we need to may simply be impossible.

The Treasury carried out stress-testing of all the options it considered, and provided these to the Panel. These included testing of extreme scenarios, even to "destruction" level where the Strategic Reserve would be exhausted (on paper – in practice it is impossible for the balance on the Strategic Reserve to be negative). The Panel has used this test data to portray the Minister's proposals as risky. In fact, if any of those extreme scenarios were to arise, the Panel's proposals would result in the Strategic Reserve being exhausted earlier.

Before summarising his considered opposition to the Panel's amendment, there are 2 additional points the Minister wishes to address:

- Firstly, the Panel may assert that their proposal mirrors one previously put forward by the Minister for Treasury and Resources in the Budget 2014, when the Assembly's approval was sought to fund the £297 million cost of the new hospital entirely from the Strategic Reserve. At that time, that was the correct proposal. However, events have moved on and the world is a different place –

- The budget for the hospital is now £466 million.
- Brexit and the election of President Trump in the U.S.A. have heightened European and World economic uncertainty.
- The cost of borrowing was higher.

This was the right solution in 2013. It is not the right solution today, and that approach would have been modified through proposals brought back to the Assembly.

- Secondly, the Panel's report contains an interesting calculation of the total liabilities of the States. The relevant accounting standard states that borrowing costs directly attributable to the construction of a qualifying asset must be capitalised, but only while that asset is under construction. The calculation included by the Panel is therefore incorrect. On current estimates, the figure for the hospital should be £85.7 million, not £440–£480 million as stated. All of these future liabilities identified by the Panel have funding-streams agreed by the States.

Summary

The Minister has set out above the reasons why he considers the amendment of the Corporate Services Scrutiny Panel should be rejected. In doing so, he does acknowledge that the Panel members genuinely believe they are performing a valuable service by offering an alternative proposal. Indeed, Scrutiny Panels have previously been criticised by the Executive for criticising <u>without</u> offering any alternatives. However, the Minister considers that this is not the right time or the right method, and that there is a danger that a superficially attractive proposal could gain support to the detriment of the Island's financial standing.

In summary, the Minister requests Members to consider the following –

- The Minister's proposals are well-developed and researched and have been subject to expert advice. The Minister has the backing of the Fiscal Policy Panel, the Treasury Advisory Panel and EY. It is understood that Opus, the Panel's own advisers, are not critical. The Panel's proposals, by contrast, appear hurriedly developed and ill-thought through.

- The Panel's proposals, whilst purporting to reduce risk in uncertain times, actually increase that risk. They increase the risk of funding not being available to complete the construction of the new hospital. They reduce the buffer of safety available in the Strategic Reserve to meet unknown future shocks, at a time when we most need them.

- The Panel's report on its amendment is unnecessarily pessimistic in presenting the potential likelihood of downside risk on investment returns and the States' income crystallising.

- The current historically-low cost of borrowing is less than the level of return being earned by investing Strategic Reserve. The majority of financial advisers would not only wonder why we are considering <u>not</u> borrowing at this stage, they would wonder why we had not done so sooner.

- The demands on the already-stretched resources of departments would be heightened by the need to recapitalise the Strategic Reserve, according to the Panel's proposals. The Minister would be unable to rule out additional revenue-raising erasures to meet this requirement.

- Under the Minister's proposals, the level of Jersey's borrowing would still be relatively low (at around 16% of GDP) and its level of reserves would be high. It is possible that the proposals could impact unfavourably on Jersey's S&P credit-rating and, potentially, mean that it may appear less attractive to investors than other jurisdictions which currently have the same rating, such as Guernsey.

- Proposing an amendment diametrically opposed to the thrust of the main proposition does not make for good decision-making.

The Minister strongly urges Members to reject this amendment from the Corporate Services Scrutiny Panel. The Minister's proposal is prudent and recognised by the Fiscal Policy Panel, Treasury Advisory Panel and EY as a sensible and balanced solution in the current circumstances to fund a new hospital.