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BILLET D'ÉTAT

WEDNESDAY, 27th MAY, 2009

TREASURY AND RESOURCES DEPARTMENT –
CAPITAL PRIORITISATION

Addendum

The Treasury and Resources Department has requested that the attached addendum, dealing with matters associated with the General Revenue Cash Pool, be issued in respect of its Report on Capital Prioritisation, which is now to be debated at the States meeting to be held on 24th June, 2009.

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1. **Introduction**

The States Report on Capital Prioritisation contains the following paragraph:

> *The Department has also considered internal borrowing as part of the process. The States operates a General Revenue Cash Pool (includes General Revenue reserves and working balances and deposits from States Trading Undertakings, associated entities and a small number of charities and other organisations with a historic association with the States) which has in the region of £250million and has been used in the past to finance internal borrowings and overdrafts. The main advantage of funding from this source is that the rates charged are low relative to the market. However, the rate of interest paid will fluctuate with the market and therefore offers no certainty. It is estimated that the cash pool could be used to fund projects of up to £100million as there is a need to retain sufficient liquidity within the Cash Pool for the States and associated entities. This option would not remove the requirement to utilise external borrowing to fund the recommended capital programme.*

The Treasury and Resources Department now wishes to withdraw this paragraph and to publish the following supplementary information on the General Revenue cash pool and internal borrowing.

2. **General Revenue Cash Pool**

The cash pool is made up of a collection of cash balances deposited by 27 bodies which are pooled and invested in order to achieve the best possible return. The main depositors to the pool are summarised below:

- General revenue account cash balances
- Capital reserve
- Notes and coins reserve
- Corporate Housing Programme
- Social Security and States Trading undertakings
- Commercialised companies

The Treasury team moves all excess balances to a professional cash and treasury management company who place the cash on behalf of the States. They have a strict set of rules for the management of funds including liquidity requirements, a lending list and lending limits which are approved by the Treasury and Resources Department and regularly reviewed. The investments held include Treasury Bills, Certificates of Deposit and Government Bonds.

The depositors have instant access to their deposits and therefore the pool is kept very liquid with no investment over one year and a weighted average life of investments of three months. Interest on deposits is calculated daily and paid out on a monthly basis. The interest paid is the average return on the pool after expenses and is known as the States Treasury rate.

The balance on the General Revenue cash pool has averaged £250million over the past five years with balances fluctuating on a quarterly basis from lows of £204million to highs of £330million depending on the timing of cash flows. However, detailed modelling has shown that this balance is likely to reduce over the next four years, as set out below.

3. Internal Borrowing

The cash pool has in the past been considered as a source of funds for funding major capital investment through Treasury acting as bankers with the pool available for lending out at a commercial rate.

The Board of Administration's States Report on the Energy from Waste Facility (Billet D'État XX 2003) proposed that a loan of up to £80million be advanced from this source to pay for the plant. The Board of Administration also proposed a project to rebuild the Alderney breakwater in the same year (Billet D'État XVIII 2003) at a cost of £29million including contingencies which was to be financed through an *Alderney Breakwater Account.* This account was to be funded through "States working balances" and the cost amortised over the expected useful life of the breakwater.

Some low value loans have been issued from the cash pool, for example to the Health and Social Services Department for the purchase and installation of an MRI scanner. In addition, more recently, the purchase of the two oil tankers was sourced from the cash pool by way of a loan to Jamesco 750 Limited.

4. Interest Rates

Any loans issued from the cash pool will bear interest at the prevailing States Treasury rate which will fluctuate over time. The rate payable has to match the rate received through deposits placed in the market. This interest received on loans outstanding is then used to pay the interest to depositors.

The floating interest rate makes planning for repayment difficult as it offers no certainty. This is particularly the case if specific fees and charges are relied on for repaying the loan. There are certain risks associated with using a long term inflation protected revenue stream (e.g. gate fees) to replace the short term investment return that would otherwise be generated were the funds left with our manager.

Any such borrowing would require investigation into possible ways to hedge the mismatch described above. Preliminary advice indicates that a straight interest rate swap would not manage out the risk and that a more exotic product would be required rates. Such a product would have a cost which would increase the cost of borrowing from this source.

5. Cash Pool Forecasting

A detailed cash pool forecast has been undertaken and is shown at Table 1 below. This forecast is based on the information available including the expected capital cash flows for the proposed programme and any known planned capital expenditure from other depositors. The projections have been modelled assuming that the recommendations in this States Report are implemented and that £175million of external funding is received. The cash flow forecasts cash movements out to 31 December 2012.

It should be noted that these forecasts are deliberately prudent estimates of what might happen to the pool over the period and the actual position in four years time could be substantially different. Assumptions have had to be made in certain instances based on historic trends and known future plans and a full list of assumptions can be found at Appendix 1. The key points to note are that:

- The general revenue account balance will decrease in 2009 because of the planned deficit to be funded from the general revenue account reserve. The total of that planned deficit is £20million. However, only a £10million reduction has been included as it has been assumed that the balance will be found through working capital movements.

- The capital reserve is the largest single balance in the pool and that it will be almost entirely committed and spent under the recommendations of this States Report

- The loan to Jamesco 750 Limited has limited the cash available for other loans.

The model demonstrates how the balance on the pool is expected to decrease over the period to a total of £150million by the end of 2012.

6. Risk Analysis

There are several risks to using the cash pool for “internal borrowing” purposes, some of which have previously been alluded to in this report.

As outlined above, the risk associated with using long term inflation protected revenue streams to replace short term investment returns could be partially hedged out by using derivatives. However, there would remain a residual risk to the States which the Treasury and Resources Department has not investigated further.

A further risk arises through reducing the flexibility of the States to respond to emergencies by eliminating cash which would otherwise be available through the pool. It is difficult to quantify the impact of this risk due to the associated uncertainty.

However, the Treasury and Resources Department is of the opinion that a separate emergencies fund should be established to mitigate this risk should significant internal long term borrowing be undertaken.

The other key risk is that Treasury is called upon to repay a cash pool depositor with insufficient funds available within the pool due to long term loans outstanding. In order to quantify this risk, a detailed risk analysis of the separate elements of the cash pool has been undertaken. The overall risk level has been determined based on two main factors:

1. The financial risk

   - This is based on the likelihood of withdrawal of funds from the pool or significant variations in them;

   - The historic volatility of each deposit element of the pool has been analysed as a proxy for future movements; and

   - All known or planned future withdrawals have been taken into consideration

2. The fiduciary risk. The factors considered in arriving at this were:

   - Whether or not the deposit belongs to the States of Guernsey; and

   - any other external considerations such as any impact on the credit rating or external perceptions of Guernsey

A risk level, represented through a red, amber and green colour coding system has been allocated against each cash pool deposit line and each risk type. These risk levels should inform any decisions to lend money from this banking pool. This analysis has revealed that the balance on the General Revenue Account, although uncommitted, attaches a high level of financial risk due to the considerable volatility in the balance depending on the timing of cash flows as well as the impact of overall States surpluses or deficits. The balances of the commercialised companies attract a high level of overall risk due to their expected future volatility and the reputational impact of using any of this cash.

Table - Cash Pool Projections

	01-Jan-09	31-Dec-09	31-Dec-10	31-Dec-11	31-Dec-12	Risk 1*	Risk 2*
<u>General Revenue Funds</u>							
Uncommitted:							
General Revenue Account	38	28	28	28	28		
Note and Coin Issue	36	38	40	42	44		
Sub total uncomitted funds	*74*	*66*	*68*	*70*	*72*		
Committed:							
Capital Reserve	87	158	165	70	37		
Corporate Housing Prog.	44	48	44	26	6		
Other Funds	12	7	7	7	7		
Sub total committed funds	*143*	*213*	*216*	*103*	*50*		
Less: Loans							
Loans to HSSD	(3)	(3)	(3)	(3)	(3)		
Loan to JamesCo		(16)	(15)	(15)	(15)		
Total General Revenue	***214***	***260***	***266***	***155***	***104***		
<u>Other Deposits</u>							
Social Security Funds	11	11	11	11	11		
Ports Holding Account	4	4	4	4	4		
States Works	1	1	1	1	1		
Guernsey Water	4	6	3	0	0		
HMRG/Seized Assets	3	3	3	3	3		
Charity/Other Fiduciary	3	3	3	3	3		
Superannuation Fund	(3)	0	0	0	0		
Guernsey Post	20	11	12	13	14		
Guernsey Electricity	16	12	9	7	0		
Other third party deposits	8	8	8	8	8		
Total Other Deposits	***67***	***59***	***54***	***50***	***44***		
Total Cash Pool Balance	**281**	**319**	**320**	**205**	**148**		

*** Risk categories:**

1 = Financial

2 = Fiduciary

7. Conclusion

The level of overall risk which is acceptable is a matter of policy. However, it is the view of the Treasury and Resources Department that it is not prudent to fund long term capital investment from the short term deposits made in the cash pool.

[It should be noted that any alternative funding options would need to be factored into the cash pool projections and risk analysis models in order to assess the impact on overall risk levels of those proposals.]

Appendix 1

Cash Pool Projection Assumptions

Source of Funds	**Assumptions**
General Revenue Account	Reduction due to planned 2009 deficit. The total of that planned deficit is £20million. However, only a £10million reduction has been included as it has been assumed that the balance will be found through working capital movements.
Note and Coin Issue	Growth based on historical trends (5% per annum)
Capital Reserve	Borrowing of £175m received in two tranches. Planned capital cash-flows for the T&R recommended programme
Corporate Housing Programme Funds	Funds spent in line with analysis provided by Housing Department
Other Funds	One off reduction following exhaustion of R&R Fund and review of Loans Funds. All other funds assumed constant
Loans to HSSD	Constant
Loan to Jamesco (given in early 2009)	Repayments in line with 20 year mortgage payback
Social Security Funds	Constant at the 2009 level due to investment balances now being held with Custodian
Ports Holding Account	Constant
States Works	Constant
Guernsey Water	Based on probable profile of capital expenditure as provided by Guernsey Water
HM Receiver General/Seized Assets	Constant but subject to decision of depositor
Charity/Amenity/Other Fiduciary	Constant but subject to decision of depositor
Superannuation Fund	Reverts to nil from overdraft position
Guernsey Post	As per GPL advice
Guernsey Electricity	No additional profits plus GEL planned capital expenditure
Other third party deposits	Constant but subject to decision of depositor