CAPITAL PRIORITISATION – FUNDING OF PROJECTS

ALTERNATIVE PROPOSALS (VERSION TWO)

THIS REPORT HAS BEEN PRODUCED
FOR THE CONSIDERATION OF STATES MEMBERS
BY THE FOLLOWING PEOPLE'S DEPUTIES:

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1. Executive summary

This report has been written by a group of independent people's deputies in response to Billet d'Etat IX of 2009 – Treasury & Resources Department: Capital Prioritisation, which is due to be debated at the June meeting of the States of Deliberation.

We appreciate the work of Treasury & Resources in the preparation of its States Report, and we agree with much of its content. In particular, we are very supportive of the improved process of capital prioritisation introduced by the department.

However, we strongly disagree with Treasury & Resources' recommended funding model for the programme of capital investment.

This report outlines the case for two alternative funding models essentially based on three principles:

- limiting any exposure to borrowing;
- maintaining the policy that borrowing should be considered only against capital projects with a secure, associated income stream; and
- providing future States, and the island generally, with a more sustainable fiscal legacy.

Against these criteria, we believe that there are compelling reasons to support our more disciplined alternative funding proposals.

Our first and preferred funding model (Model A) excludes external borrowing in its entirety. A loan requirement of £83million would be provided in full by internal borrowing (i.e. from the States Treasury) and allocated exclusively against the solid waste treatment plant, the income from which would be set to repay the internal borrowing in full.

Our second funding model (Model B) proposes borrowing £113million externally, considerably less than the amount recommended by Treasury & Resources. This loan would be allocated strictly against the solid waste treatment plant and part of the airport pavements rehabilitation project, and only income arising from those projects would be used to repay the loan.

It has been the policy of the States for the past six decades to borrow only against projects with an associated income stream, and then only sparingly, and almost always internally. Our funding models are consistent with this feature of the island's historically prudent approach to the management of public finances.

In 2007, the States resolved to invest £20million per annum in capital expenditure. Implicit in Treasury & Resources' interpretation of that States Resolution is the assumption of annual appropriations from general revenue to the capital reserve account of £20million (at 2009 values).

However, Treasury & Resources' proposals for funding this round of investment in capital projects would require a substantial proportion of these annual appropriations to be redirected into a sinking fund established to repay the principal and interest on £175million of external debt which the department wishes to raise by issuing States of Guernsey bonds.

Under the department's proposals, £10million per year would be absorbed by the sinking fund set up to repay the debt. These payments would be made out of funds which would otherwise be allocated to pay for essential capital projects of the future.

As the department's States Report makes clear, capital expenditure of future States would be limited to amounts significantly below the island's long-run average, unless annual appropriations from general revenue to the capital reserve were substantially increased or the States undertook additional borrowing, albeit that the latter would then create even heavier repayment commitments.

Our funding models do not require any part of the £20million annual appropriations to the capital reserve to be absorbed by repayments on borrowing. These annual appropriations would remain available to fund capital projects of the future.

In total, our funding models would make available to the next four States no less than £106million and up to £145million more than the funding model proposed by Treasury & Resources.

The other sources of funding in our models are the additional 2008 operating surplus, agreed appropriations to the capital reserve from 2009 to 2013 or 2014, and other income which Treasury & Resources expects to accrue to the capital reserve during the term of this States.

Our funding models are inherently less risky, more prudent and more sustainable. We submit these proposals as a measured and pragmatic 'Guernsey solution' to a 'Guernsey problem'.

The contents of this report shall form the basis of composite amendments to be proposed against the department's propositions outlined on pages 680 and 681 of Billet d'Etat IX.

For clarification, the sources of funding in our models are outlined below. The total estimated cost of the priority one projects is £301million.

Model A

	£m
Balance of capital reserve at 31st December 2008	42
Appropriations 2009-14 (incl.)	150
2008 operating surplus	22
Other income to capital reserve by 2012	15
Int. borrowing (solid waste)	83
Additional income from Guernsey Airport	8
Total available for capital investment	320

Model B

	£m
Balance of capital reserve at 31st December 2008	42
Appropriations 2009-13 (incl.)	122
2008 operating surplus	22
Other income to capital reserve by 2012	22
Ext. borrowing (solid waste and part of airport)	113
(Less interest on bonds transferred to sink fund)	(5)
Total available for capital investment	316

2. Introduction

The Treasury & Resources Department has established an improved framework to enable the States to undertake a more thorough, co-ordinated process of planning and prioritising major capital projects.

In general, States members and departments appear to have welcomed the improved process, which is an example of where the island's unique consensus or collegiate political model is perfectly capable of providing effective and cohesive government in respect of major items of policy.

Although this report challenges Treasury & Resources' funding proposals, we wish to make it clear that we support the capital prioritisation process. We wish to place on record our view that the department's political board and officers have led the States through a transparent and thorough process.

The States agreed in December 2008 that the capital prioritisation debate would take place in March 2009. Treasury & Resources kindly agreed early in February to circulate its States Report several weeks earlier than the official release date in order to provide members with sufficient time to consider such a major item of policy.

However, at the request of Policy Council, the department announced in mid-February that the capital prioritisation debate would be deferred, in order that Policy Council could present proposals to establish an over-arching fiscal framework at the April meeting of the States of Deliberation.

Following announcement of the deferral of the debate, Treasury & Resources' States Report was made available to members on Tuesday 3rd March.

The authors of this report first met as a group of independent members on Friday 13th March to discuss concerns in respect of Treasury & Resources' proposed funding model for capital projects. A second meeting was held on Wednesday 18th March.

We wrote to members and departments on Wednesday 18th March to advise of our intention '…*to present for consideration an independent report which shall include alternative proposals relating to the States' fiscal framework and programme of investment in capital projects'.*

The Minister of Treasury & Resources, Deputy Charles Parkinson, wrote to members on 23rd March reiterating that his board was very happy to offer the assistance of its officers in the preparation of amendments. Deputy Parkinson's letter included the following paragraph: *'I am grateful to Deputy Fallaize and those colleagues he is working with for giving my department advance notice of* *their intentions to consider amending our proposals…The approach taken by Deputy Fallaize is a very open one and is to be commended.'*

States members will be aware that an earlier version of our alternative proposals was outlined in a report circulated in April, when it was expected that the capital prioritisation debate would take place in May. In the event, the debate was deferred again – until June – after Treasury & Resources announced that financial information contained within its States Report was inadvertently misleading.

The department's error had a material effect on our original proposals, which would have involved paying for this phase of capital investment by using funds available to the capital reserve and internally borrowing from the general revenue cash pool up to £113million to be allocated strictly against revenue-generating projects.

Following the department's error, we have revisited all other possible funding options, and we are pleased to present these pragmatic proposals as viable alternatives to the recommendations of Treasury & Resources. This report is based on the updated financial information made available by Treasury & Resources.

While we are disappointed that we can no longer propose our original funding model, we are confident that our revised proposals offer less risk, and are more prudent and more sustainable that the department's funding recommendations. We believe that they are capable of appealing to the consensus view of the Assembly when the matter of funding capital investment is debated later this month.

The proposals contained within this report have been written after considerable research and deliberation by the five members whose names appear on the front cover, and after discussion with several other States members. We wish to place on record our thanks for the very useful input of other deputies, which helped to shape our thoughts during the formulation of these funding models.

Throughout this process we have remained mindful of the need for any substantial amendments against such a major item of policy to be well-researched and coherent.

The technical advice of officers at Treasury & Resources has been invaluable, and we should like to extend our thanks to them.

3. States capital expenditure (up to 2008)

The past decade or so has seen a period of unprecedented capital expenditure on the island's infrastructure and public services. Successive States have spent around £350million on major capital projects since 2000, and during these years capital expenditure has been far above the island's long-run average.

The origins of this programme of unprecedented capital expenditure were multifarious, including: historical underinvestment in infrastructure necessitating a period of 'catch-up'; the ever-increasing expectations of the community; and the availability of significant budget surpluses generated by the island's successful economic performance dating back to the early 1980s.

The table below details capital expenditure in the years 1966, 1971, 1976 and 1981, and then in every year thereafter. In line with States accounting practices, the table excludes any capital expenditure related to the ports, which was funded from the ports holding account.

Year	Capital spend (£)	Capital spend (2008 values) (£)
1966	403,000	6,726,935
1971	2,208,000	28,143,129
1976	2,667,000	15,684,157
1981	4,184,000	13,706,994
1982	5,039,000	15,547,785
1983	7,388,000	21,809,481
1984	9,634,000	26,593,409
1985	10,826,000	28,181,201
1986	8,563,000	21,429,537
1987	12,205,000	28,880,078
1988	10,508,000	23,208,632
1989	14,614,000	29,413,659
1990	22,213,000	40,747,252
1991	28,843,000	50,149,630
1992	17,350,000	29,223,432
1993	8,057,000	13,393,726
1994	8,042,000	13,055,648
1995	8,978,000	14,064,218
1996	6,805,000	10,374,233
1997	10,278,000	14,967,819
1998	8,664,000	12,221,404
1999	10,390,000	14,308,512
2000	13,897,000	18,426,509
2001	34,965,000	45,505,570

Year	Capital spend (£)	Capital spend (2008 values) (£)
2002	32,820,000	40,918,644
2003	51,107,000	61,336,719
2004	44,365,000	50,779,196
2005	50,181,000	55,589,511
2006	41,752,000	44,306,038
2007	48,990,000	49,556,948
2008	57,647,000	57,647,000

Excluding the ports, the average annual capital expenditure of the States between 1981 and 2008 was around £30million – an average of just over £120million during each four-year period (at 2008 values).

Between 1981 and 2000, and before the very significant increases in capital investment over the life of the last two States, average annual capital expenditure was around £22million – an average of less than £90million during each four-year period (at 2008 values).

The programme of increased capital investment since the turn of the century has been economically and socially desirable, and in general the benefits of improved infrastructure and services have been welcomed by the community. The States, and the island generally, has every reason to celebrate the development of facilities in most areas of the public sector, including education, healthcare, housing, sports and the arts; and, in addition, there has been significant investment in the ports.

However, it must be recognised that the overwhelming net benefits of this programme of investment occurred at a time when, quite unsatisfactorily, there was no formal process of long-term planning and prioritisation of capital expenditure. In general, there existed a culture of approving projects on a 'first-come-first-served' basis rather than necessarily subjecting all projects to a rigorous and competitive process of technical and political prioritisation.

The need for a more structured approach was recognised by the previous Assembly (2004-08). At the request of Policy Council, the Treasury & Resources Department prepared a broad overview of capital expenditure priorities, presenting its report to the States in Billet d'Etat XVII of 2006. The process of capital prioritisation has been refined and improved further over the past 12 months.

In view of the enormous scope of capital investment now proposed by Treasury & Resources – circa £300million-worth of projects to be funded over just four years – and the controversial funding model it is recommending to pay for such an ambitious programme, it is perhaps worthwhile to reflect on the salient parts of reports presented by the department's predecessor.

After the years of unprecedented capital investment since the year 2000, Treasury & Resources' States Report of 2006 advised that '…*a period of measured consolidation is now required… Significant amounts will still need to be spent, albeit less than the amounts of recent years… It is clear that the unprecedented level of capital expenditure of recent years is unaffordable and unsustainable'*.

The advice proffered by Treasury & Resources in its 2006 capital prioritisation report appears consistent with the States Resolution of 2007 to invest around £20million per annum on capital projects.

In the last States, the sum of £20million per annum was assumed to include spending of several million pounds on the corporate housing programme and routine capital items, such as the replacement of essential equipment, IT, plant, vehicles, etc.

But in the Budget Report of 2009, the department advised of its intention to appropriate £20million per annum (maintained in real terms) from general revenue to the capital reserve, which would be made available for new capital projects and would explicitly exclude routine items of expenditure.

Nonetheless, the current balance on the capital reserve plus annual appropriations made to it from general revenue would not be sufficient to fund the list of projects Treasury & Resources is recommending for approval during this States term. Hence the department's proposal to enter into an arrangement to borrow £175million externally.

4. States borrowing – a historical perspective

Our detailed observations of Treasury & Resources' proposed funding model shall be explored later in the report. In this section, we are concerned with how the department's proposals relate to the historic and existing practices of the States in respect of borrowing.

A General Purposes Loan was issued by the States in 1947 for £550,040, much of which was used to fund basic revenue expenditure. At that time, much of Guernsey's infrastructure had been significantly damaged by the occupying forces during the Second World War; considerable numbers of local people were returning home over a very short period of time, placing the island's infrastructure and services under a great deal of stress; and debts had been incurred running up budget deficits during the years of occupation.

In the immediate post-war years, the island was forced to accept a succession of austerity budgets. The people of Guernsey, relieved simply to be living in a free society once again, understood that the need for severe financial constraint was not a matter of choice. The States had no cash reserves and very little income, and it owed considerable sums to banks which had found the resources to assist the island's government during the occupation.

It would be erroneous to compare the borrowing arrangement entered into by an island desperately recovering from years of war with the significantly larger issue of debt proposed today by Treasury & Resources, in some cases to pay for projects with little or no associated income stream. It is also worth noting that many Guernsey people emerged from the experience of the 1940s and 50s determined that their island would never again run up 'national debt'.

It has been the policy of the States for the past six decades to borrow only against projects with a secure, associated income stream, and then only sparingly – for example against the operation of quasi-commercial activities such as the ports. That policy has formed part of a generally prudent, cautious, 'balanced budget' approach to financial affairs upon which the island's relative prosperity is generally recognised to have been founded, at least in part, and which would seem to be entirely consistent with the values and ethos of many Guernsey people.

As recently as 2003 the States investigated the possibility of entering into borrowing arrangements to fund the Education Department's programme of capital investment, which consisted wholly of projects with no secure, associated income streams.

In Billet d'Etat XX of 2003, and in relation to options for funding a solid waste treatment plant, a Policy Letter from the Board of Administration noted that

'…two broad conclusions can be drawn from the resultant debate [on borrowing]. *Firstly, a number of members viewed the principle of third party borrowing as a retrograde step. Secondly, borrowing to fund capital projects would be more acceptable if the project involved a revenue stream that could be set to meet the repayments'.*

The island's position on borrowing was made very clear in the Advisory & Finance Committee's Budget Report of 2003, which warned of the consequences of ongoing real terms increases in spending: *'Unless checked, the States could be forced to borrow, thus encumbering future generations.'*

The Budget Report of 2003 comments on the underlying principles of the successful management of Guernsey's public finances: *'…low taxation, careful control of public expenditure, and avoidance of borrowing.'*

Alongside its Budget Report of 2003, the Advisory & Finance Committee published an outline of its intentions vis-à-vis corporation tax reform (the new regime, commonly referred to as 'zero-10' was, of course, introduced in 2008). The 2003 report stated: *'The very positive current position of the island's public finances means that the reforms can be envisaged without leading to an overall budget deficit. Prudent financial planning over many years has meant that the island will be able to significantly reform its fiscal system while still adhering to the key tenets of fairness and equity and without borrowing.'*

In its Budget Report of 2004, the Advisory & Finance Committee articulated the historic policy position in the following terms: *'One area where borrowing has been identified as a potential source of funding was for those major capital projects with an associated income stream sufficient to repay any borrowing and related interest. However, for the major capital projects of Health and Education, because of the absence of an income stream, direct States funding is the most appropriate and lowest-cost option.'*

The report explored the notion of internal borrowing thus: *'…one aspect of borrowing that has been occasionally used is borrowing from the States Treasury. This is the funding method that was recommended for the energy from waste facility…In these cases the loans were repayable over a defined period with interest accruing.'* The 2004 Budget Report advised of the *'…important principle that, in general, the lender of first resort for States entities should be the States Treasury (i.e. internal borrowings)…'*

The following four paragraphs are reproduced from the 2004 Budget Report. They are included in this report because they remain as relevant today as they were then.

'What is certain is that there is a cost to borrowing. Any lender will seek to reduce their risk, retrieve their money and make a profit. This needs to be

funded, and in the case of a government, the cost of servicing and repaying the loan will almost inevitably fall on the general taxpayer.

‘Given that there is no direct income stream generated from such public sector projects as schools, interest payments and loan repayments would need to be funded from general revenue. As a result, the amount of money available to fund ongoing general revenue expenditure, other capital projects, and to appropriate to reserves would be significantly reduced.

‘For many years the States has been in a fortunate and enviable financial position, partly due to the fact that the present States has no debt to service or repay.

‘The challenge for the States, as it is for all governments, is to maintain and improve capital infrastructure in an affordable and sustainable manner.’

For the record, the 2004 Budget Report stated that issuing bonds remained an option for the future in the event of a requirement to raise at least £100million. However it was noted that bond issues made available to the public tend to be *‘relatively expensive to administer in the long term’*.

The first capital prioritisation report presented to the States following the machinery of government reforms of 2004 expounded a similarly prudent message in respect of borrowing, demonstrated by the following paragraph of the report: *‘As has been endorsed on numerous previous occasions, including as part of the Future Economic & Taxation Strategy, the States of Guernsey have traditionally had a very prudent approach to borrowing and as a result the taxpayer has not had to bear the cost of interest charges.’*

The Corporate Agenda approved by the States in December 2004 included the following statement: *‘Take a cautious approach to public sector borrowing, only doing so where the debt can be serviced by a secure, associated income stream.’* In 2006, Treasury & Resources endorsed that statement as a *‘…sensible and prudent approach’*.

The 2006 capital prioritisation report continued thus: *‘In very simple terms, the money for capital expenditure comes from the annual operating surplus, which is the difference between income (taxes) and revenue expenditure…Because previous States have adopted a policy of building up reserves before committing expenditure (“save to spend”) considerable amounts of interest have been accumulated (£40million between 1998 and 2006).’*

It is important to note that the States debated that first capital prioritisation report after having resolved to introduce the zero-10 corporate tax changes. The States of 2004-08 endorsed the island’s historic, cautious policy on borrowing in the full knowledge that significant annual budget deficits were likely to arise in the years immediately after the introduction of the new corporate tax regime.

During the life of the previous States, the Commerce & Employment Department released a document entitled 'Building Confidence' which essentially outlined the department's philosophy and guiding principles. The document confidently asserted that *'…economic growth should deliver a legacy of tangible long-term benefits and be sufficient to enable the island to pay for and maintain a high standard of public services without recourse to borrowing'.*

In September 2005, on behalf of Policy Council's Fiscal & Economic Policy Steering Group, Deputies Laurie Morgan, Lyndon Trott and Stuart Falla issued a second consultation document as part of the process that resulted in the development of the Future Economic & Taxation Strategy. The consultation document contained the following comments in respect of borrowing:

'The States of Guernsey has traditionally had a very prudent approach to borrowing and as a result the taxpayer has not had to bear the cost of interest charges. In recent decades the States has not borrowed to fund either ongoing revenue or individual capital projects.

'The Corporate Agenda, as approved by the States in December 2004, includes the following statement on borrowing: Take a cautious approach to public sector borrowing, only doing so where the debt can be serviced by a secure, associated income stream.

'The [Fiscal & Economic Policy Steering Group] *continues to believe that this remains a sensible and prudent approach.'*

In June 2006, the States debated Billet d'Etat XI of 2006 – Policy Council: Future Economic and Taxation Strategy. In its States Report, and after outlining proposals to utilise part of the contingency reserve fund to address the revenue shortfalls predicted during the early years of the new corporate tax regime, Policy Council stated confidently and unambiguously: *'Furthermore, the States is, and will remain, free of debt.'*

Significantly, Treasury & Resources has recommended that the States should no longer restrict itself to borrowing only against capital projects with a secure, associated income stream. Instead, the department proposes to borrow against projects with little or no income stream and to use general revenue income, inter alia, to repay a substantial portion of those debts.

We disagree profoundly with that part of the department's States Report. Our proposals adhere in full to the historic policy commitment of the States to borrow (whether internally or externally) only against capital projects with a secure, associated income stream.

In addition to the alternative proposals for funding this phase of capital investment contained within this report, the amendments we intend to move at the June meeting of the States shall propose re-affirming the principle that borrowing should be considered only to fund capital projects with a secure, associated income stream sufficient to service the interest payments and repay the capital sums involved.

5. The capital programme proposed by Treasury & Resources

Departments were invited to submit proposals for capital projects carrying an indicative cost of more than £250,000.

Approximately 30 proposals with an estimated total cost of around £370million were subjected to strategic review, a process recently introduced by Treasury & Resources to assist in determining the potential risk and relative economic, environmental and social impact of capital projects.

Subsequently 19 projects with an estimated total cost of £301million were allocated priority one status. Treasury & Resources' States Report proposes that *'all projects that have been assessed as priority one should be progressed without delay'.*

For reference, the full list of priority one projects is reproduced below.

Proposal	**Best Estimate £'000**	**Cumulative Cost £'000**
PRIORITY 1		
Education – College of Further Education Phase 2b	2,700	2,700
Education – Les Beaucamps School	38,150	40,850
Environment - Cobo Bay Bunker/Sea Wall Repair	350	41,200
HSSD – Adult Acute Mental Health Facilities	25,400	66,600
HSSD – Homes for Adults with a Learning Disability	5,300	71,900
Home – eBorders IT system	1,000	72,900
Home – Police core IT system	1,200	74,100
Home – Tetra Radio	1,800	75,900
PSD – Belle Greve Wastewater Disposal Facility	15,500	91,400
PSD – Solid Waste Solution	83,000	174,400
Ports – Airport Pavements	84,500	258,900
Ports – Airport Radar	2,400	261,300
Ports – St Peter Port Harbour Crane Strategy	10,000	271,300
Ports – St Peter Port Harbour Pontoons	1,000	272,300
Ports – Sarnia Work Boat	1,000	273,300
Social Security/Income Tax IT System	5,500	278,800
T&R - Cabernet Limited Recapitalisation	6,000	284,800
T&R – Corporate Asset Management IT System	600	285,400
T&R – IT Wide Area Network	3,600	289,000
SUB-TOTAL (before Inflation Allowance)		**289,000**
Inflation Allowance	12,000	301,000
TOTAL		**301,000**

The table above is a reproduction of page 528 of Treasury & Resources' States Report, except in respect of two items of expenditure: the total cost of the solid waste solution and the overall inflation allowance. In the table above, we have added £3million to the cost of the solid waste solution and subtracted the same amount from the overall inflation allowance.

The department has advised us that £3million of its predicted inflation allowance of £15million is applicable to the solid waste solution. Therefore, we have assumed that the total indicative cost of the solid waste solution should become £83million, all of which is to be funded by a loan under the terms of our funding proposals.

The above alteration makes no material difference to the proposals or to the income streams required to repay any loan arrangements entered into. We have explained it here merely for the sake of completeness.

Whether to approve the full list of priority one projects, as recommended by Treasury & Resources, is a decision for the States. We are aware that another member has circulated an amendment which would require not approving the full list of priority one projects during this term of the States. The States must weigh up in due course the merits of reducing the list of priority capital projects.

The scope of this report is concerned with presenting alternative proposals that are capable of funding the full list of priority one projects, should the States resolve to approve that list of projects later this month. Consequently, this report is effectively neutral on proposition one of Treasury & Resources' States Report on page 680 of Billet d'Etat IX, which invites the States to approve the department's recommended programme of capital projects.

We believe that our proposals would be equally viable, and certainly preferable to the funding model proposed by Treasury & Resources, whether the States resolves to reduce, amend or approve the list of priority one projects.

The relevance of proposition two on page 680 of Billet d'Etat IX should also be noted. Proposition two reads as follows: *'To note that each project that is included within the capital programme will be the subject of a separate report before the project can commence unless the Treasury & Resources Department has delegated authority to approve a capital vote.'*

Essentially, the project list approved at the June meeting of the States as the recommended programme of investment will remain an 'in principle' list. All projects will then be the subject of separate States Reports to be debated in due course before being granted final approval.

6. The financial position of the States

In recent years, Guernsey has consistently recorded budget surpluses. Over the last two decades or so, very significant annual surpluses have become commonplace.

However, the financial position of the States is now very much more precarious. Treasury & Resources recently forecast the island's structural budget deficit to be around £35-40million annually, largely as a result of corporate tax reforms introduced in 2008. The department also forecasts additional cyclical deficits of £25-30million per annum over the next few years.

The Future Fiscal & Economic Strategy, approved by the States in 2006, directed that up to one half of the contingency reserve fund may be used to cover budget deficits arising out of the decision to reform corporation tax with effect from 1st January 2008. Treasury & Resources now estimates that, without considerably increasing the revenue of the States and/or significantly reducing public expenditure, using one half of the contingency reserve will make good the budget deficit only until 2011.

Treasury & Resources has advised that it could be necessary to raise an additional £52million a year (at 2009 values) in order to balance the States budget by 2017. It is expected that additional revenue-raising measures will be proposed in the 2010 Budget Report, to be debated by the States in November 2009, albeit that there is no guarantee that the Assembly will support the recommendations put forward, or even substitute alternatives.

This report primarily concerns capital expenditure. However, policies in respect of funding capital projects cannot be developed in isolation and must be considered in the context of the overall financial position of the States and the economic position of the island generally.

It may be possible to return the island to surplus sooner than 2017 by placing greater emphasis on tackling income and expenditure with more urgency, i.e. by embracing the scope to reduce expenditure uncovered by the Fundamental Spending Review, and by introducing more significant revenue-raising measures sooner than perhaps otherwise envisaged.

The 2008 accounts of the States show that the additional operating surplus was £22million.

We believe it would be regrettable to use the additional 2008 operating surplus generated by the people and businesses of Guernsey merely to assist in making good a budget deficit that is best addressed in ways other than utilising the island's reserves.

Our models propose transferring the additional 2008 operating surplus to the capital reserve in order for it to be available for use during this phase of capital investment.

It is essential that the budget of the States should be balanced as expeditiously as possible in order that the island can return to its historic practice of ‘living within its means’.

Insofar as the primary subject matter of this report is concerned, we believe that in the long-term the States should adhere to its historic practice of funding capital expenditure out of operating surpluses. That is the only responsible, prudent and sustainable way of paying for capital projects in the long-term.

Treasury & Resources’ proposals to enter into an arrangement to borrow £175million externally may not directly affect the size of the States budget deficit today. However, in respect of the urgent need to address the deficit, one crucial difference between the department’s proposals and our alternative proposals should be noted.

Under the department’s proposals, every year from 2013 £10million of general revenue income (hitherto earmarked for future capital investment) would be consumed in making payments to a sinking fund established to service £175million of debt issued by this States.

Under our proposals, no general revenue income is required to service internal or external loans, and from 2014/15 annual appropriations of £20million (at 2009 values) from general revenue to the capital reserve would remain available for capital projects of the future.

We are of the opinion that entering into excessive borrowing arrangements, in particular against projects with no associated income stream, would be particularly risky and imprudent while the island is in a period of suffering such significant and recurring budget deficits.

The Bank of England base rate is at an historic low. However, it is equally true that global economic conditions are more volatile and challenging than at any time since the Great Depression of the 1930s. The outlook is uncertain. The perception that rates of interest are relatively low may appear superficially attractive, but must be balanced against the island’s historic principle of not borrowing for projects without an income stream, against the risks of so doing in an era of such global economic uncertainty, in the context of the detailed proposals put forward by Treasury & Resources, and in the full knowledge that such levels of external borrowing are so unnecessary.

While the outlook for the global economy is uncertain, some of the challenges that lie ahead are largely predictable. We consider the timing of Treasury & Resources' proposals to borrow such large sums of money in a manner that is contrary to historic and fundamental fiscal policies of the States are particularly unattractive in view of the very considerable challenges the island shall face in the future, including the demographic timebomb and the effects of climate change and peak oil, while possibly coming under the ever-increasing scrutiny of the international community.

It is interesting to note that Guernsey has remained free of 'national debt' during its fairly recent years of unprecedented economic growth, a period during which, in theory, repayments on any borrowing arrangements entered into might have been manageable because of successive and significant States operating surpluses.

However, under Treasury & Resources' proposals, the States is now being encouraged to accumulate a very considerable level of debt – to be repaid by future general revenue income – at a time of significant budget deficits, which shall have to be addressed during an era when the global economic, social and environmental outlook is so uncertain.

On top of the challenges that our successors will face, we believe it would be wrong to burden them with a requirement to use general revenue to pay off debts accumulated unnecessarily by this Assembly.

7. Our alternative funding proposals – models A & B in summary

The table below summarises our funding model A.

Model A		£M
Balance of capital reserve		42
2009 Appropriation	20	
2010 Appropriation	24	
2011 Appropriation	25	
2012 Appropriation	26	
2013 Appropriation	27	
2014 Appropriation	28	
		150
2008 operating surplus		22
other income		15
Additional income from Guernsey Airport		8
Internal borrowing for solid waste plant		83
Total available for capital investment		320

Funding model A presents a viable option for the States to undertake the capital programme proposed by Treasury & Resources, but without recourse to external borrowing in any form.

The unallocated balance on the capital reserve account as at 31st December 2008 is £42million.

In accordance with States Resolution, Treasury & Resources has advised that appropriations from general revenue to the capital reserve shall total £95million during this States term (£20million in the year 2009, £24million in 2010, £25million in 2011, and £26million in 2012).

Our funding model A proposes that this phase of capital investment should take into account appropriations to the capital reserve over a period of six years, rather than the period of four years proposed by Treasury & Resources. The reasons behind this part of our proposal are explored in further depth in another section of our report. Here it is sufficient to state that their effect is to provide additional funds of £55million for this phase of capital investment (£27million in the year 2013, and £28million in 2014).

This brings the total amount available from appropriations to the capital reserve to £192million for the list of projects classified as priority one in the department's States Report.

We are also proposing that the additional States operating surplus for 2008 be transferred to the capital reserve and made available for this investment programme. The additional operating surplus is £22million.

In its States Report, Treasury & Resources advises that the capital reserve shall also have available £23million of other income, which includes receipts from property sales and accrued interest. Some items in this category relate to interest that is expected to accrue to the States, including on the principal sum of money (i.e. £175million) which the department is recommending that the States should borrow externally.

In our funding model A, which does not include external borrowing, we have adjusted the category of other income to the capital reserve accordingly – from £23million to £15million.

Section 12 and appendix one of this report demonstrate that one of the ports – Guernsey Airport – is capable of generating additional income of £1.775million per annum. This proposal is not included in Treasury & Resources' States Report and, therefore, is in addition to the assumed revenue surpluses of £3million that currently accrue to the ports holding account.

The additional income of £1.775million per annum (maintained in real terms) is transferred to the capital reserve in our funding model A, making available a further £8million for funding the priority one list of projects.

The final tranche of funds would be raised by borrowing up to £83million internally from the States Treasury to pay for the solid waste treatment plant, with the loan to be repaid in full from revenue generated by the plant during its operable life.

The two potential sources of internal borrowing are the general revenue cash pool and the contingency reserve fund. The concept of borrowing internally from either or both of these funds is explored in greater depth in sections nine and ten of this report. Whether to utilise the facility of internal borrowing is a matter of political judgement; suffice to say that clearly there exists sufficient liquidity in these two accounts to sustain borrowing from them of up to £83million for the solid waste treatment plant.

The total estimated cost of the capital programme proposed by Treasury & Resources is £301million, including inflation. Our funding model A provides a total of £320million.

The balance of circa £19million provided by funding model A could be used in various ways. The money could be retained in the capital reserve to provide a contingency for higher-than-estimated costs on any of the capital projects or for unanticipated expenditure over the next few years; or it could be carried forward to fund the capital investment requirements of future States, our preferred option.

The table below summarises our funding model B.

Model B		£M
Balance of capital reserve		42
2009 Appropriation	20	
2010 Appropriation	24	
2011 Appropriation	25	
2012 Appropriation	26	
2013 Appropriation	27	
		122
2008 operating surplus		22
other income		22
External borrowing for waste and airport		113
Less interest on bonds to sinking fund		-5
Total available for capital investment		316

There are many similarities between funding models A and B. However, there are key differences relating in particular to the method of undertaking borrowing that is necessary to fund the full list of priority one capital projects.

Where there are similarities, the information is repeated in this section merely for ease of reference.

Funding model B includes external borrowing rather than internal borrowing, but at a much reduced level from that proposed by Treasury & Resources. Unlike the department's States Report, funding model B, like model A, also strictly maintains the principles that any borrowing should be allocated only against income-generating capital projects, and that general revenue income should not be used to repay debt.

The unallocated balance on the capital reserve account as at 31st December 2008 is £42million.

In accordance with States Resolution, Treasury & Resources has advised that appropriations from general revenue to the capital reserve shall total £95million during this States term (£20million in the year 2009, £24million in 2010, £25million in 2011, and £26million in 2012).

Our funding model B proposes that this phase of capital investment should take into account appropriations to the capital reserve over a period of five years, rather than the period of four years proposed by Treasury & Resources. This would provide additional funds of £27million for this phase of capital investment.

This brings the total amount available from appropriations to the capital reserve to £164million for the list of projects classified as priority one in the department's States Report.

We are also proposing that the additional States operating surplus for 2008 be transferred to the capital reserve and made available for this investment programme. The additional operating surplus is £22million.

In its States Report, Treasury & Resources advises that the capital reserve shall also have available £23million of other income, which includes receipts from property sales and accrued interest. Some items in this category relate to interest that is expected to accrue to the States, including on the principal sum of money (i.e. £175million) which the department is recommending that the States should borrow externally.

In our funding model B, which includes external borrowing but at a considerably lower amount than that recommended by the department, we have adjusted the category of other income to the capital reserve accordingly – from £23million to £22million.

Borrowing externally up to £113million would provide the final tranche of funds under our alternative funding model B.

£83million of that borrowing would be allocated against the full cost of the solid waste treatment plant, with the loan to be repaid in full from revenue generated by the plant during its operable life.

The remainder of the money borrowed externally – £30million – would be used to part-fund the airport pavements rehabilitation project, with the loan to be repaid in full by generating additional revenue at Guernsey Airport, in accordance with the proposals outlined in section 12 of this report. Once again, this would maintain the existing policy that any borrowing should be allocated strictly against projects with a secure, associated income stream sufficient to service the interest payments and repay the capital sums involved.

The total estimated cost of the capital programme proposed by Treasury & Resources is £301million, including inflation. Our funding model B provides a total of £316million – a buffer of £15million more than is strictly necessary.

Treasury & Resources States Report includes the following paragraph:

‘The Department is also recommending that a sinking fund be established in order to accumulate the principal for repayment over the term of any borrowings. This will mean that an amount will be transferred to the sinking fund each year, which will grow in real terms, to enable the bond or loan to be repaid at the end of the period without the States encountering any refinancing risk. This is a prudent way of saving for repayment and the fund will also accumulate interest over the period.’

We are content to adhere to the advice of the Treasury & Resources Department in respect of the establishment of a sinking fund in the event that the States resolves to borrow externally via a bond issue, albeit that the department is recommending the transfer to the sinking fund of £10million per annum of general revenue income, whereas our funding model B strictly avoids using general revenue income to fund the sinking fund, and proposes instead that contributions to the sinking fund be limited to revenue arising out of the two income-generating capital projects (the solid waste plant and Guernsey Airport).

However, there would be a requirement to contribute to the sinking fund before the two income-generating projects are complete and capable of returning surpluses. This requirement applies equally to Treasury & Resources proposals as it does to our funding model B.

Under the department’s proposals, £14million of the £175million borrowed externally would be absorbed by transfers to the sinking fund during its first few years. We are of the opinion that it is undesirable to borrow more than is strictly necessary purely in order to meet interest repayments on such borrowing.

Therefore, we are recommending that contributions to the sinking fund during its first few years should be made, inter alia, out of interest generated on the amount to be borrowed externally before it is spent.

It should be noted that, under our funding model B, in the final year of the sinking fund it will be necessary to transfer a small amount of money to the fund from the capital reserve in order to repay the bonds in full. This transfer would be temporary and repaid within a few months by ongoing revenue generated by the solid waste plant, the operable life of which is 25 years, longer than the life of the bonds to be issued.

The above provision allows funding model B strictly to maintain the historic principle of the States that borrowing should only be allocated against, and repaid by, revenue-generating capital projects.

The total estimated cost of the capital programme proposed by Treasury & Resources is £301million, including inflation. Our funding model B provides £316million.

This balance could be used in various ways. The money could be retained in the capital reserve to provide a contingency for higher-than-estimated costs on any of the capital projects or for unanticipated expenditure over the next few years; or it could be carried forward to fund the capital investment requirements of future States, our preferred option.

8. Length of investment programme

Treasury & Resources' States Report takes into account scheduled appropriations to the capital reserve in the years 2009-12. Our alternative funding model A also takes into account scheduled appropriations in the years 2013 and 2014. Our alternative funding model B takes into account the scheduled appropriation in year 2013.

In other words, our proposals have the effect of modifying the length of the capital investment programme proposed by the department – to six years under funding model A, and five years under funding model B.

Page 529 of Treasury & Resources' States Report outlines a proposed timeline for undertaking each of the priority one capital projects. We are advised that, in reality, some of the projects are already behind the indicative schedule outlined in the States Report. History suggests that there is the probability of further slippage on an ambitious programme of investment of some £301million.

In the event that further slippage does not occur ordinarily, it would be necessary under the proposals contained in our funding model A to accept a slight delay on the start date of one or more of the capital projects. This is because, of the total funding of £301million that is required, model A provides £55million in the latter years – 2013 and 2014.

Of course, there is an attraction to carrying out all priority one projects as expeditiously as possible. But approving £301million of projects in one States is exceedingly ambitious in any event; taking a further 12 months to complete one or two of them must be worthy of very serious consideration in order that Guernsey can continue to live within its means.

Our funding model B, however, is capable of funding all priority one projects within the indicative timescale proposed by Treasury & Resources. In other words, the funding in model B is provided over a period of five years rather than four, but so doing has no effect on the anticipated start date of any of the priority one projects.

In the event that the States is unprepared to approve of even a slight delay on any of the priority one projects, we submit our funding model B as the most responsible and sustainable means of providing funding to carry out the full list of projects as expeditiously as possible.

We are of the view that there is a compelling case for slightly extending the funding period for this phase of capital investment, either to five years as proposed in model B, or six years as proposed in model A.

It is clear that Treasury & Resources' proposals will significantly restrict the funds available for capital projects over the next several States terms because of the requirement to use half of the annual appropriations to the capital reserve to build up the sinking fund to repay the debts accumulated by this States. Essentially, this feature of the department's proposals arises because of the recommendation to undertake a very expensive and ambitious programme of capital investment part-funded by borrowing against future general revenue income.

Our objection to borrowing for projects with no associated income stream is made clear elsewhere in this report. But it is relevant to this section because Treasury & Resources' recommendation to borrow against general revenue income would undoubtedly restrict the funds available for capital projects of the future to a significantly greater extent than our alternative proposal to fund this phase of investment over five years (in model B) or six years (in model A) rather than four years.

States members were advised in March that the renewed Government Business Plan will *'set a seven-year horizon for capital spending'*. Meanwhile, as an attempt to provide what have become known as 'fuzzy budgets', the GBP will present revenue spending requirements over periods of three and five years.

The proposal as part of our funding models to consider capital investment over five or six years would appear to fit comfortably with the need identified by the revised GBP to consider financial planning over periods of longer than four years.

Meanwhile, the Fiscal Framework approved by the States in April included the following: *'…the assumed norms for permanent capital expenditure…to be 3%...of gross domestic product (GDP)…'*

Guernsey's GDP is around £1.67billion, 3% of which is £50million. In view of the States having resolved as recently as April that capital expenditure over the long-term should be around £50million a year, it may be regarded as overly-ambitious to fund a list of capital projects with a cost of £301million in the four-year term of this States, as proposed in Treasury & Resources' States Report.

The proposal in our alternative models to extend to five or six years the funding arrangements for this programme of £301million of capital spending is certainly more consistent with the Fiscal Framework.

In addition, it should be noted that the department's timeline states that work shall be ongoing on seven of the 19 projects on the priority one list into the year 2013, and two of those projects shall not be complete until 2014. The department forecasts that at least £21.5million of the overall cost of the priority one projects will not be spent until 2013 and 2014, further evidence that it is not unreasonable to consider using scheduled capital appropriations from 2013, and perhaps 2014 as well, to assist in funding this very ambitious programme of capital investment. Indeed, we submit that our proposals to do exactly that are responsible and prudent.

In considering the reasonableness of our proposal to fund the capital programme over five years (in alternative model B) or six years (in model A), it is also worth referring back to the following extract from section three of this report:

After the years of unprecedented capital investment since the turn of the century, Treasury & Resources' States Report of 2006 advised that '…a period of measured consolidation is now required… Significant amounts will still need to be spent, albeit less than the amounts of recent years… It is clear that the unprecedented level of capital expenditure of recent years is unaffordable and unsustainable'.

These warnings were issued against a background of the States having spent an average of £51million a year on capital projects in the preceding five years, which contrasted sharply with the long-run average of £22million a year up to the year 2000 (excluding expenditure funded by the ports holding account).

The total estimated cost of non-ports-related projects in the recommended priority one list is £190million (excluding any additional inflation allowance). Funding this programme over a period of four years, as proposed by Treasury & Resources, would amount to average expenditure of £47.5million, very close to the £51million average spend which the previous Treasury & Resources board suggested would be *'unaffordable'* and *'unsustainable'* during the current States term.

Extending the funding period for this programme of investment to six years, as proposed in our alternative funding model A, would amount to average expenditure of £32million. And extending the funding period to five years, as proposed in our alternative funding model B, would amount to average expenditure of £38million.

It is clear that the level of annual average capital investment proposed in both of our funding models is more consistent with the advice proffered consistently and strongly by past custodians of the public purse. Indeed, the need for a disciplined approach to the management of public finances is a principal feature of this report.

In summary, given the unprecedented programme of capital investment proposed by Treasury & Resources, we believe there is a compelling case to extend the funding period for that programme to five years (model B) or six years (model A), especially when not doing so, as proposed by Treasury & Resources, would require breaking the historic, prudent and disciplined principle of not borrowing for projects without a secure, associated income stream.

9. Internal and external borrowing

Internal borrowing requires the States Treasury to arrange a loan from central funds already held under the control of the States, for example from the general revenue cash pool or the contingency reserve fund. Our funding model A proposes that this phase of capital investment be part-funded by borrowing internally for the full cost of the solid waste treatment plant with all capital and interest payments to be repaid by revenue generated by the plant.

External borrowing requires the arrangement of a loan from a third party, for example a commercial bank or via a bond issue. Our funding model B proposes that this phase of capital investment be part-funded by borrowing externally (via a bond issue) for the full cost of the solid waste treatment plant and part of the cost of upgrading the airport pavements with all capital and interest payments to be repaid by revenue generated by those two projects.

This section addresses the mechanics of internal borrowing insofar as they apply to our funding model A.

Treasury & Resources' States Report originally included the following information:

'The department has also considered internal borrowing as part of the process. The States operates a general revenue cash pool…which has in the region of £250million and has been used in the past to finance internal borrowings and overdrafts…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.'

At the end of May, the department announced that this information was no longer correct.

The balance on the general revenue cash pool was £281million at 1st January 2009. The average balance on the account over the medium-term is around £250million. However, the department's recent financial modelling indicates that the balance of the cash pool could decline somewhat over the next few years, and is therefore unable to sustain the same amount of internal borrowing as originally envisaged.

On 22nd May, Deputy Parkinson wrote to States members on behalf of the department in the following terms:

'Originally, Treasury & Resources' States Report estimated that up to £100million could be used for internal borrowing. Closer examination of the figures persuaded us that only the cash representing our revenue reserves and

the notes and coins issue (a) belongs to the States and (b) is likely to be sufficiently long-term to support internal borrowing. On the Treasury & Resources' model this cash amounts to some £70million and on Deputy Fallaize's model it amounts to some £50million.'

Deputy Parkinson's letter is reproduced in full in Appendix Two of this report.

The amount of internal borrowing which it may be reasonable to undertake remains a matter of political judgement. However, we are certainly not minded to challenge the department's revised advice in respect of the liquidity of the cash pool. Indeed, throughout this report we have based our figures on the financial assumptions and projections provided by the department.

Therefore, as part of funding model A, which relies on internal borrowing only, we are proposing that as far as possible the general revenue cash pool should be used as the source of funds, but that a small portion of the contingency reserve fund should be made available for the purpose of internal borrowing in the event that the cash pool cannot provide in full the £83million required for the solid waste treatment plant.

As an indicative guide, based on the department's recent financial modelling referred to above, approving that the solid waste plant should be funded by internal borrowing, as per our model A, may require a loan of up to £50million from the general revenue cash pool and a loan of up to £33million from the contingency reserve fund.

In 2003, the Board of Administration, with the approval of the Advisory & Finance Committee, proposed that two projects with a combined cost around £110million should be funded from States working balances, i.e. the general revenue cash pool, at a time when the average balance on the cash pool was, as stated above, around £250million with highs of about £330million depending on the timing of cash flows. In other words, Advisory & Finance was content to sanction that more than 40% of the cash pool be made available to sustain internal borrowing.

Our proposal, as part of funding model A, to borrow £50million from the general revenue cash pool represents less than 20% of its value as at the start of 2009.

On 29th May, Treasury & Resources advised States members that the balance on the cash pool could drop to around £150million by the end of 2012. The department stated 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'*.

Even under the department's *'…deliberately prudent estimates…'*, our proposal as part of funding model A – that the cash pool should loan £50million for the purpose of internal borrowing – represents only a third of the projected total value of the cash pool by the end of 2012.

Meanwhile, the value of the contingency reserve fund at 31st December 2008 was £224million. Up to £119.5million of the fund is available to address temporary budget deficits arising out of the States Fiscal and Economic Strategy. Therefore, even in the event that it is required to provide the maximum loan that would be necessary (i.e. £33million) under our model A, over £70million would remain available in the contingency reserve for any emergency expenditure that may arise.

The contingency reserve fund was established only in the mid-1980s. Over many decades, successive States saw no reason to borrow externally to fund basic capital projects, even with no contingency reserve available. We believe that there is even less reason to succumb to such temptation today, in view of the not insignificant buffer now provided by the contingency reserve.

It should also be noted that one of the purposes of the contingency reserve fund is to provide a means of ensuring that any economic downturn should not have a severe adverse effect on the island. One of the most frequent arguments put in favour of undertaking the ambitious programme of capital investment proposed by Treasury & Resources is the positive impact it will have on local industry at a time of not inconsiderable economic difficulty. Therefore, on balance, we consider that it would be appropriate to fund a small part of the capital programme by borrowing internally up to £33million from the contingency reserve.

Any risk of using the general revenue cash pool and the contingency reserve to fund internal borrowing is greatly mitigated by the fact that, under our funding model A, surplus cash of around £20million would be retained as a buffer in the capital reserve account during this phase of capital investment.

For the record, it should be noted that our funding model B, which relies on external rather than internal borrowing, does not require the use of any part of the general revenue cash pool or the contingency reserve fund.

We shall move an amendment based on funding model B in the event that our first amendment based on funding model A is rejected by the States.

10. The case for internal borrowing

The States may decide not to borrow at all – internally or externally – to assist in funding this phase of capital investment. Indeed, an amendment to be moved independently by another member proposes undertaking no borrowing at this time.

However, should the States be prepared to consider taking out a loan to fund any capital projects, our preference remain to borrow internally rather than externally, with the caveat that, whether internal or external, no borrowing should be undertaken for projects without a secure, associated income stream.

This section seeks to set the notion of internal borrowing in a broader context, and explores some of the reasons that our preference remains that the States should restrict itself to internal borrowing only.

The States, and therefore the people of Guernsey, currently have no external debt to service, something of which the island should be justifiably proud and, in our view, should seek to maintain as far as possible.

It has been claimed that Guernsey should consider external borrowing because much of the rest of the world has done so. This is an unconvincing argument, and we would far rather adopt a 'Guernsey solution' to a 'Guernsey problem'.

While there are examples of other jurisdictions that have entered into external borrowing arrangements that in some cases represent more than 100% of national output, or Gross Domestic Product (GDP), many such jurisdictions are far larger than Guernsey with significantly more powerful economies and economic levers, including control of money supply and interest rates, something which Guernsey clearly does not have.

It is also worth asking how many of these jurisdictions would seek to accumulate 'national debt' were they starting from the same base as Guernsey in having no recognisable 'national debt' today.

In any event, rather than seeking to justify any proposals to accumulate debt on the grounds of what may or may not happen in the UK, Europe or the United States of America, it is more relevant to explore the policies on borrowing adopted by the two jurisdictions with which we are perhaps most obviously comparable – Jersey and the Isle of Man, the other two British crown dependencies.

The States of Jersey retains a presumption against borrowing. In December 2008, in his final budget speech as Jersey's Treasury Minister before being elected Chief Minister, Senator Terry Le Sueur spoke in the following terms:

'The UK and America, already deep in debt, are going even further…In contrast, Jersey has none of these problems. We are in a far better position to weather the storms ahead than any of our neighbours. We have no debt. We have no deficits. We have substantial reserves.'

Senator's Le Sueur's successor as Treasury Minister, Senator Philip Ozouf, indicated very strongly in January 2009 that he wished to maintain the prudent approach of his predecessors to borrowing, or rather not borrowing. Senator Ozouf said: *'The States of Jersey has no plans to borrow money in the foreseeable future.* [Capital projects] *are paid for out of the existing balance of funds.'*

Meanwhile, the Isle of Man government has adopted an explicit, unambiguous policy against borrowing, permitting it only for quasi-commercial operations run as statutory trading boards, such as the Isle of Man Post Office, Isle of Man Water Authority, and the Manx Electricity Authority.

The Isle of Man does not engage in general government borrowing to finance revenue or capital expenditure.

In his budget speech of March 2007, the Isle of Man's Minister for the Treasury, Alan Bell M.H.K., spoke in the following terms: *'For the benefit of new members, I should explain that with the exception of the statutory boards, we do not borrow to finance capital expenditure. All the capital expenditure incurred by government departments has been financed through internal loan schemes.'*

Project Norman, written by N M Rothschild & Sons on behalf of Treasury & Resources and included as an appendix in the department's States Report, comments upon *'the outstanding bond issue of Isle of Man, which issued £75million of bonds in 2000'.*

It is important to re-emphasise that any external borrowing arrangements entered into by the Isle of Man have not been for general government revenue or capital expenditure. Therefore, any bond issue pursued by the Isle of Man cannot be compared with the proposals put before the States by Treasury & Resources to borrow externally to fund basic, and in many cases non-income-generating capital projects.

The Isle of Man budget report of February 2008 included the following statement: *'Government's long-term policy remains to seek to limit actual capital spending to a level that can be funded without external borrowing.'*

We suggest that it is no accident that Guernsey has hitherto shared with Jersey and the Isle of Man an historic policy not to borrow externally to fund revenue or capital expenditure. Indeed, the policy has been at the cornerstone of the generally successful fiscal and economic policies employed by all three crown dependencies over many decades.

Like Guernsey, the Isle of Man enjoys an AAA credit rating. However, whereas there have been claims in Guernsey that such a rating is a reason almost of itself to borrow externally, it would appear that the Isle of Man has preferred to use its AAA rating not as a reason to borrow externally, but rather as a tool of promotion in seeking to establish itself as a stable jurisdiction with robust and sustainable public finances, maintained partly because of the absence of any ‘national debt’.

It should also be noted that certain assumptions about Guernsey’s economic performance that were taken into account when issuing the AAA credit rating already appear to be somewhat optimistic.

Some members are of the view that borrowing externally today may be a ‘good deal’ because of the historically low rates of interest available. But we hope members shall place in context any transient attraction of issuing bonds ‘cheaply’ – because it is so obviously not the prime responsibility of government to use taxpayers’ money to bet on what may or may not happen some years hence in the capital markets.

Entering into an external borrowing arrangement on such a pretext would surely be contrary to the traditionally prudent and risk-averse management of public finances employed by the States over many decades.

In addition, while the Bank of England base rate is at an historic low, historical data indicates that the rate of interest attracting to 20-year bonds has tended to fluctuate very little. This is not especially surprising since the expectation of movements in interest rates over a period as long as 20 years is likely to remain quite steady. It does mean, however, that under closer analysis the interest rate that may be attached to Guernsey bonds should they be issued now is perhaps not quite so atypically attractive as certain anecdotal evidence may have implied.

We also reject the notion that issuing Guernsey bonds would be an almost guaranteed form of ‘cheap’ borrowing because of the possibility that the rate of inflation relative to the rate of interest may erode the return on the issued stock. That should not be allowed to provide false comfort. It must be remembered that purchasers of the bonds would be investing with the intention of making a return.

Hyperinflation would, of course, also increase the total cost of the programme of capital investment proposed by Treasury & Resources, potentially very substantially. We note that no such contingency has been included in the department’s States Report. Indeed, the contrary is true. The department has applied a carefully-calculated inflation allowance to the total cost of the list of priority one projects; and in Project Norman, N M Rothschild has assumed Guernsey RPI at 3.03% in 2009, 3.53% in 2010, and 4.03% from 2011 onwards.

The potential to erode the return on any bonds issued arises when the rate of inflation is consistently higher than expected. Such circumstances may arise; equally, periods of low inflation may be experienced during the life of any bonds issued by the States. For the record, over the past 15 years annual headline inflation in Guernsey has averaged slightly above 3.5%; in the UK, the average figure has been just under 3%.

The Bank of England forecasts possible ranges of inflation for periods of up to three years hence, essentially based on market interest rate expectations. In February 2009, the Bank forecast UK Consumer Price Inflation to range between -1% (i.e. deflation) and +3% up to 2012.

The repayment figures contained in Treasury & Resources' States Report assume that Guernsey bonds would attract an interest rate of 5.25%. In line with the department's advice, this report assumes that borrowing internally from the States Treasury would also attract an interest rate of 5.25%

At current rates of interest, borrowing internally would actually be considerably less expensive than pursuing a bond issue.

At the time of writing, the States Treasury interest rate is only 2%. That is the rate that would be payable on the internal borrowings proposed in our alternative funding model A. And that rate is well below UK benchmark 20-year gilt yields, which are indicative of the likely price of a Guernsey bond.

At present, borrowing internally against the very low prevailing States Treasury interest rate would effectively result in front-loading capital repayments during the early part of any internal loan repayment schedule, providing more scope for flexibility later in the life of the loan.

In any case, the argument that now could be a good time to borrow externally may be more persuasive if Guernsey had already accumulated 'national debt' and determined that there would be no choice but to borrow more, and accumulate even more debt, in the future.

Were Guernsey facing such circumstances, there may be every reason to borrow while interest rates are historically low. But Guernsey's circumstances could not be more different – the States carries no external debt whatsoever, and there appears little popular appetite to begin accumulating 'national debt' now.

In respect of our proposal to borrow internally, it should be noted that rates of interest charged on loans from the States Treasury are typically low relative to the market, but are variable rather than fixed.

However, in the event that the States commits to internal borrowing at variable rates of interest, albeit at very low rates relative to the market, it may not be unreasonable to expect any material increases in the rate of interest payable to occur in an environment of material increases in the rate of inflation.

Thus any material increases in the rate of interest payable on the internal loan may largely be offset by similar increases in the income stream upon which we would be reliant to service the internal loan – charges at the solid waste treatment plant – since they are to be maintained in real terms, i.e. increased in line with the rate of inflation.

We have also explored the possibility of using a facility known as an Interest Rate Swap (IRS), which would enable the variable rate usually applicable to internal borrowing from the States Treasury to be swapped for a fixed rate of interest.

Having considered this option in some detail, and taken professional advice, we are persuaded that employing the instrument of an Interest Rate Swap would not be prohibitively expensive, and is therefore worthy of further investigation.

Consequently, as part of our alternative funding model A, we are proposing that Treasury & Resources should investigate the merits or otherwise of an Interest Rate Swap, and subsequently enter into such an arrangement should it prove cost-effective and appropriate.

Furthermore, proposals to establish a repayment schedule over a period of 20 years in respect of the solid waste treatment plant represent particularly prudent and cautious terms on which to enter into an internal borrowing arrangement.

The long-standing assumption, dating back several States terms, was that internal borrowing against the solid waste treatment plant would be repaid over a period of 25 years. And, in accordance with the tender details agreed in June 2008 by this States, the treatment plant, whatever its final form, must have an operable life of 25 years.

Therefore, at any time it would be perfectly reasonable for the repayment period of any internal loan used to finance the cost of the plant to be extended from 20 years to 25 years, as originally intended and as in line with the operable life of the plant.

In this context, the flexibility with which repayment terms may be renegotiated against an ‘income-generating’ project such as the solid waste plant serves to mitigate any risk of borrowing internally from the States Treasury. Indeed, the general flexibility of loaning from the States Treasury is one advantage of internal borrowing.

In addition, it may be of some comfort that interest repayments attaching to internal borrowing are paid not to external investors (as may generally be the case with bonds) but remain within funds under the control of the States, and for the benefit of the States, other local organisations, and the people of Guernsey generally.

It should be noted that the propositions contained in Treasury & Resources' States Report are not prescriptive in respect of the details of the department's proposal to issue bonds to the value of £175million.

The States Report explains that a public bond issue *'…attracts loans of different amounts from institutional and substantial private investors.'* It explains that private placement bonds *'…operate in a similar way to a public bond issue except that the bonds are not generally offered to the public or traded in the secondary market…'*

There is no commitment explicit in the propositions contained in the States Report to enter into a public issue or a private issue, although there are words to the effect that a private issue may be considered more appropriate given that £175million is a relatively small amount in terms of the capital markets.

Even in the event that bonds are issued publicly, there is no suggestion that Guernsey residents would be given precedence in bidding for bonds issued. Therefore, they may be required to bid in the marketplace against institutional and substantial private investors from around the world.

It cannot be assumed that Treasury & Resources' proposals would result to any great extent in Guernsey becoming a population of local bond holders with thousands of islanders perceived to own a stake in the future infrastructure of their home. As such, comparisons with previous local bond issues of many decades ago may be quite erroneous.

Internal borrowing also avoids intermediary fees associated with arranging external borrowing. Under Treasury & Resources' proposals, external borrowing could cost the island a seven-figure sum in intermediary fees.

In summary, we are confident that internal borrowing should form part of our preferred alternative funding proposals, contained in model A of this report.

However, we wish to re-emphasise that, should the States not vote to restrict itself to internal borrowing only, we shall move a second amendment based on funding model B of this report, which includes external borrowing at a level considerably below that recommended by Treasury & Resources, and within a more prudent and sustainable framework which provides future States with more scope to fund capital projects of the future, while at the same time retaining the historic policy of the States to borrow only against projects with a secure, associated income stream.

11. Borrowing for the solid waste treatment plant

Our funding models assume that the solid waste treatment plant shall generate a secure, associated income stream of £5million per annum, maintained in real terms. This is identical to the assumption made in Treasury & Resources' proposals.

The term 'self-funding' has been used to describe the solid waste plant because any borrowing requirement (whether internal or external) to finance the initial capital cost and interest repayments thereon can be met in full by revenue arising from gate fees over the lifetime of the plant.

Both of our alternative funding models propose borrowing against this income stream generated by the waste plant. Over a period of 20 years, the revenue stream of £5million per annum would be sufficient to repay a loan of £83million, the estimated total cost of the facility, including inflation.

In our funding model A, the loan to pay for the waste plant is arranged via internal borrowing from the States Treasury. In our funding model B, the loan is arranged via external borrowing.

The repayment arrangements outlined in each of our funding models is based on an interest rate of 5.25%, identical to the rate used in Treasury & Resources' proposals.

It should be noted that our funding models include provision to cover the necessary interest payments on the capital sum of building the treatment plant during the period before the facility becomes fully operable, partly through the existing policy of levying surcharges on gate fees at Mont Cuet.

The long-standing assumption of the States was that the solid waste treatment plant would be financed by internal borrowing. Indeed, there is a States Resolution to that effect which arguably was not directly rescinded by the successful Requete of 2004 against the original plan to construct an energy from waste plant (the Board of Administration's Lurgi proposal) at Longue Hougue.

We are of the opinion that borrowing internally from the States Treasury remains the best option for funding the initial capital cost of the solid waste treatment plant, whatever form the States ultimately resolves such a plant should take. However, our funding model B demonstrates that it would be equally viable to meet the initial capital cost of the plant by borrowing externally.

12. Borrowing for the airport pavements project – in summary

Our funding model B envisages £30million of external borrowing being allocated against the rehabilitation of the airport pavements (the generic term for the project, which includes work on the runway, taxiways, aprons, navigational aids, lighting etc).

The total estimated cost of the airport pavements project is £84.5million. A requirement to borrow £30million represents 35% of the total estimated cost. The remaining £54.5million would be funded from the capital reserve.

We are proposing that this loan of £30million should be repaid over a period of 20 years, by very moderately increasing passenger taxes, by generating additional profit on the commercial activities carried out at Guernsey Airport, or via a combination of passenger taxes and commercial activities.

Repaying a loan of £30million over 20 years would require Guernsey Airport to generate an additional income stream of £1.775million per annum (maintained in real terms). This figure is based on an interest rate of 5.25%, in line with assumptions made in Treasury & Resources' States Report.

In model A, which recommends no external borrowing, we propose allocating £83million of internal borrowing against the solid waste treatment plant only, and not borrowing at all for the airport pavements project. Instead, model A recommends funding the airport pavements project in full from the capital reserve account.

However, Guernsey Airport would still be required to generate an additional income stream of £1.775million per annum. That surplus would be transferred annually to the capital reserve account, in addition to the existing amount of £3million per annum which currently accrues to the ports holding account but which Treasury & Resources proposes should be transferred to the capital reserve from 2010.

We are content that the airport authorities should determine which of the above options (passenger taxes and/or commercial activities) they wish to pursue in order to generate an additional income of £1.775million per annum.

The amendments to be moved against the recommendations in Treasury & Resources' States Report shall merely direct that such additional surplus shall be generated at Guernsey Airport, in order that repayments (in model B) or additional transfers to the capital reserve (in model A) may be commenced by 2011.

Not requiring additional revenue to be generated until 2011 will provide the airport authorities with sufficient time to consider the relative merits of the various options, to consult all stakeholders, and to avoid the levying of any extra charges at short notice or during the current period of relative economic difficulty.

Any credible analysis of Guernsey Airport proves that there exists considerable scope for it to generate additional revenue at the fairly modest levels proposed in this report.

Although we have no particular preference for which of the additional revenue-raising measures is favoured, we feel obliged to demonstrate in this report that very moderately increasingly passenger charges and/or generating additional profit through the airport's commercial activities are both viable and justifiable options. To this end, Appendix One contains a detailed assessment of these matters.

13. Effects on future States of our alternative models A & B

In 2007 the States resolved to invest £20million per annum in capital expenditure. Implicit in Treasury & Resources' interpretation of that States Resolution is the assumption of annual appropriations from general revenue to the capital reserve of £20million (at 2009 values), maintained in real terms. Our proposals are fully consistent with that policy.

However, the department's proposals to borrow £175million externally to fund this round of investment in capital projects would require a substantial proportion of these annual appropriations (£10million of the £20 million, or 50% at 2009 values) to be redirected to a sinking fund to repay the debt.

As Treasury & Resources' report makes clear, even taking into account the transferred surplus that currently accrues to the ports, the department's proposals would restrict capital expenditure of future States to a mere £13million per annum (at 2009 values), significantly below the island's long-run average annual capital expenditure (actually that is less than half the long-run average, and importantly less than 20% of the average annual expenditure the department is proposing over the next four years).

We believe it is clear that under the department's proposals, in order to prevent deterioration in the island's infrastructure in the long-term, annual appropriations from general revenue to the capital reserve would have to be substantially increased, or the States would have to undertake additional borrowing, albeit that the latter would then create even heavier repayment commitments.

Neither of our alternative funding models require any part of annual appropriations to the capital reserve to be absorbed by meeting repayment commitments on borrowing. Annual appropriations would remain available for to fund capital requirements of the future.

Our funding model A restricts the States to internal borrowing only, paid back by income generated by the solid waste treatment plant. Our funding model B proposes external borrowing, albeit a considerably lower amount than that proposed by Treasury & Resources, paid back by income generated by the solid waste treatment plant and Guernsey Airport.

We cannot emphasise strongly enough that both of our alternative funding models are consistent with the existing policy of the States to borrow only against capital projects with a secure, associated income stream. Therefore, under our models the repayments have no effect whatsoever on States general revenue.

Therefore, at the same time as limiting any exposure to borrowing, our alternative funding models would provide considerably more money to spend on essential capital projects of the future, or else contribute to eliminating the budget deficit sooner.

Below is a table that compares the effects on future States of Treasury & Resources' proposals and the funding models (A and B) that we have presented in this report.

It assumes that appropriations to the capital reserve increase at a rate of 4.03% from the year 2013, in line with the inflation assumption contained in N M Rothschild's Project Norman.

The department and our funding models propose retaining a balance on the capital reserve during this States term. The table below assumes that such balances are made available for capital investment in the next States.

T&R model A assumes that the additional 2008 operating surplus is transferred to the contingency reserve rather than the capital reserve.

T&R model B assumes that the additional 2008 operating surplus is transferred to the capital reserve rather than the contingency reserve, and therefore an additional sum of £22million becomes available for use in the next States.

	Amounts available to capital reserve in cash terms (£M)			
States terms	**Our model A**	**Our model B**	**T&R A**	**T&R B**
2012-16	83	102	94	116
2016-20	145	135	95	95
2020-24	170	158	118	118
2024-28	198	184	144	144
Total available over life of next four States terms	596	579	451	473

During the life of the next four States, our funding model A would provide the capital reserve with between £123million and £145million more than would be provided under Treasury & Resources' proposals.

Our funding model B would provide the capital reserve with between £106million and £128million more than would be provided under Treasury & Resources' proposals.

From 2014 or 2015, the States would have available an additional £10million per annum under our funding models than would be available under Treasury & Resources' proposals – because our model simply does not require any part of the annual appropriations from general revenue to the capital reserve to be absorbed repayments on any debt accumulated by this States.

Therefore, it is clear that our funding model is inherently more sustainable. Our proposals would also provide departments with greater certainty to assist in long-term planning of future projects, and would establish a platform for smoother periods of investment rather than the likely 'boom-and-bust' impact of Treasury & Resources' recommendation to spend £301million over this States term only to leave future States with just £13million a year to spend on capital investment (at 2009 values).

As a guiding principle, we firmly believe that the only responsible and sustainable way to fund capital projects of the future is for the States to return to the practice of raising more money than it spends annually, so that the resultant surpluses can be invested in the schools, hospitals and other essential services and facilities our community requires.

The sustainability of any funding models is of significance for many reasons, not least that the programme of capital investment proposed by Treasury & Resources is highly unlikely to have the effect of requiring considerably less investment in infrastructure (compared with long-run average capital expenditure) over the terms of the next few States.

Although it has been claimed that commissioning such an ambitious programme of investment today may result in a period of considerably less capital expenditure thereafter, we consider such claims to be unrealistic given the many calls on the capital reserve that can already be predicted over the life of the next few States. For example, the rebuilding of La Mare de Carteret Schools, the rebuilding and relocation of the College of Further Education, nine priority two projects costing a total of £72million submitted for consideration during this phase of capital investment but deemed capable of deferral, and a wastewater treatment plant, which the States has already agreed to construct as soon as practicable.

The comparative analyses above assume that, during the 20-year life of the bonds that Treasury & Resources wishes to issue, no additional external borrowing arrangements are entered into.

Many States members – on all sides of the borrowing debate – believe that it is unrealistic not to expect further external borrowing arrangements to become necessary should the department's proposals be approved.

It must be assumed that additional external borrowing would require the transfer to a sinking fund of even greater portions of the annual appropriations that would otherwise be available to the capital reserve. That would, of course, further limit the flexibility of future States, and future generations of islanders, to engage in their own programmes of essential capital investment. This is patently more likely under Treasury & Resources' proposals because they simply do not leave the States with sufficient funds to invest in essential capital projects of the future.

One of the reasons that we have written this alternative funding report is that we believe that Treasury & Resources' proposals to borrow £175million externally – and to require general revenue income to service a large part of that debt – would likely place Guernsey on an 'escalator of debt' from which it would be difficult, or virtually impossible, to step off in due course. This is the experience of many jurisdictions once they have begun to accumulate 'national debt'.

There is every reason to be concerned that Guernsey, like countless other jurisdictions, would come to develop a very unhealthy appetite for borrowing. Clearly, that is more likely once one Assembly has resolved to depart from the existing prudent practices of the States in respect of borrowing, or more accurately of not borrowing, and in particular not borrowing against future general revenue receipts and for projects with no associated revenue stream.

The department's proposals may have been considered more attractive had they been capable of raising sufficient funds to finance perhaps one or two generations' worth of capital projects; in other words, had the issue of one tranche of debt raised enough money to pay for all the island's capital requirements during the period in which it was planned to repay that debt (i.e. 20 years in the case of the department's current proposals).

However, this is far from the case. Instead, Treasury & Resources is recommending entering into a borrowing arrangement that would consume significant repayments from general revenue for the next 20 or so years while providing only four years' worth of capital projects.

Under Treasury & Resources' model, it is not unreasonable to wonder quite how future States, by then burdened by general revenue being consumed by repayments on debt accumulated by the current States, would be expected to meet their own capital investment requirements from the generation of operating surpluses if this Assembly cannot do so at a time when it has no debt to service whatsoever.

We are of the view that the answer to this question, regrettably, may be to borrow again and again and allow Guernsey's newly-accumulated 'national debt' to snowball. Indeed it is worth considering how few jurisdictions in modern times have managed to remove, or even greatly reduce, their burdens of 'national debt' once they have become accustomed to their existence.

We acknowledge fully that Treasury & Resources' States Report includes a proposition to enter into an external borrowing arrangement only once (possibly in two tranches), and furthermore concerns itself only with matters pertaining to the life of the present States. In no way would we wish to imply that the department is recommending further borrowing arrangements be entered into by future States. However, on balance, and as explored above, we submit that the department's recommendations would be far more likely than our alternative funding model to encourage future States to borrow again and again.

14. Ports holding account

Treasury & Resources is recommending the closure of the ports holding account and the annual transfer into the capital reserve of assumed revenue surpluses of £3million that currently accrue to the ports holding account.

Section 12 and appendix one of this report demonstrate that one of the ports – Guernsey Airport – is capable of generating additional income of £1.775million per annum. This proposal is not included in Treasury & Resources' States Report and, therefore, is in addition to the assumed revenue surpluses of £3million that currently accrue to the ports holding account.

The additional income of £1.775million per annum is transferred to the capital reserve in our alternative funding model A. In alternative funding model B, it is used to repay a loan of £30million allocated against the airport pavements rehabilitation project.

It is not the intention of this report to take a view one way or the other on the merits or otherwise of closing the ports holding account – although we note that in the course of our preparing this report, the proposal has generated support from several States members and quite significant misgivings from several others.

For practical purposes, in this report, and in the amendments to be moved in accordance with the alternative proposals in this report, we have assumed that Treasury & Resources' recommendation to close the ports holding account will be approved by the States.

The department is proposing that henceforth ports-related projects should be funded from the capital reserve, pending the outcome of feasibility studies intended to assess the merits of commercialising one or more of the ports.

Treasury & Resources intends to use its annual Budget Report to recommend short- and long-term accounting arrangements in respect of the ports.

We respect that the States shall have to determine separately its intentions in respect of the ports holding account. Therefore, the amendments to be moved in accordance with the alternative proposals in this report shall make provision for Treasury & Resources to return to the States with revised funding proposals (as far as possible in accordance with our alternative funding models but modified so as to respect the will of the Assembly) in the event that members vote in favour of one of our amendments and then vote to negative Treasury & Resources' proposition to close the ports holding account.

Index of appendices

Appendix 1 – Analysis of revenue-generating opportunities at Guernsey Airport

Funding £30million of borrowing entirely through an increase in passenger taxes would require the levying of an additional charge of £1.95 per passenger movement, i.e. £1.95 for a single fare, or £3.90 for a return ticket.

These figures are based on a flat passenger movement charge applied equally on all routes, whether inter-island, UK or European. If desirable, it would be possible to weight any increases disproportionately on routes that are less price sensitive, in order to levy smaller increases, or even no increase at all, on routes that are more price sensitive, should it be possible to demonstrate such a distinction in respect of routes in and out of Guernsey Airport.

For example, should the airport authorities apply an increase on inter-island routes of half the increase on other routes, the additional 'passenger charge' on UK and European routes would be £2.19 per movement, and on inter-island routes £1.09 per movement.

It is important to emphasise that the additional charges would be borne by passengers flying in and out of Guernsey Airport, and not by airline operators.

By the time the proposed rehabilitation of the pavements is complete, the States will have made capital investments at the airport in excess of £110million over a period of 10 years.

Under our alternative funding models, the capital reserve, funded by general revenue, would contribute significant investment in the airport over the next two-and-a-half years – between £57million and £87million of taxpayers' money in total. And we firmly believe that the States must commit to ongoing capital investment at the airport, given the strategic importance of the facility.

However, we are convinced that it would not be unreasonable to require users of the airport, a quasi-commercial operation, to contribute an additional £1.95 per passenger movement in view of the significant investment already made, or about to be made, by general taxpayers in upgrading the terminal building, runway and radar.

Introducing a charge of up to £1.95 per passenger movement would add a fraction to the cost of departure and arrival at Guernsey Airport.

In any event, there is significant volatility in the price of airline tickets. The price of a seat on the same flight travelling to or from the same place and at the same time of the day often fluctuates by considerably more than £1.95 depending on what time of the day or week a ticket is booked. It is inconceivable that air travel is so price sensitive that passengers would be persuaded not to use Guernsey Airport at all on account of adding no more than £1.95 to the cost of a ticket.

At present, the charges levied on a passenger departing or arriving at Guernsey Airport on an inter-island route are as follows: 80p passenger fee + £1.14 security fee + 50p airport development charge. The total fee levied per passenger movement is £2.44.

At present, the charges levied on a passenger departing or arriving at Guernsey Airport on a UK or European route are as follows: £1.76 passenger fee + £1.14 security fee + £1 airport development charge. The total fee levied per passenger movement is £3.90.

In comparison, the charges levied on a passenger departing or arriving at Jersey Airport (irrespective of the route) are as follows: £4.28 passenger service charge + £1.80 aviation security levy. The total fee levied per passenger movement at Jersey Airport is £6.08.

We make no comment on the landing fees levied on aircraft operators, other than to note recent and very credible documentary evidence that Guernsey's fees and charges are quite favourable when measured against those of comparable airports, albeit that at times some airports are generally more disposed than Guernsey towards negotiating discounts and subsidies with airlines serving certain routes, particularly non-core routes.

The published charges applied per passenger on domestic (i.e. UK) routes at various airports are set out below.

2009 fees and charges per passenger (£)

Airport	**Standard**	**Security**	**Other**	**Total charge**
Guernsey currently				
Inter-island	0.80	1.14	0.50	2.44
UK/Euro	1.76	1.14	1.00	3.90
Guernsey (assumed 50% of additional income is by increasing passenger taxes)				
Inter-island	1.77	1.14	0.50	3.41
UK/Euro	2.73	1.14	1.00	4.87
Guernsey (assumed 100% of additional income is by increasing passenger taxes)				
Inter-island	2.75	1.14	0.50	4.39
UK/Euro	3.71	1.14	1.00	5.85
Jersey	4.28	1.80		6.08
Isle of Man	17.15			17.15

2009 fees and charges per passenger (£)

Airport	Standard	Security	Other	Total charge
Leeds Bradford	5.97	3.33	0.95	10.25
Durham Tees Valley	7.85	3.00		10.85
Bournemouth	5.39	5.93	0.05	11.37
Plymouth	6.93	4.62		11.55
Exeter	6.00	5.84		11.84
Bristol	13.90	4.25	0.42	18.57
Norwich	8.62	5.98	5.00	19.60

It should be noted that UK airports tend to levy passenger charges on one leg of a route only, i.e. only on passengers departing or only on passengers arriving; whereas the charges at Guernsey and Jersey Airports refer to each passenger movement, i.e. on passengers departing and passengers arriving.

In addition to the above, the UK government levies an air passenger duty of £10 (in the lowest class of travel) or £20 (in other classes of travel) per passenger movement at UK airports. Air passenger duty shall be increased to £12 or £24 in 2010.

No additional air passenger duty is levied at Guernsey Airport. Any valid analysis of fees and charges must take into account that Guernsey Airport does not levy this not insignificant additional cost borne by passengers departing UK airports.

A credible analysis has been undertaken which largely reflects actual passenger charges – after taking into account various airport discounts and adjusting fees at Guernsey Airport on the basis of it not levying air passenger duty that applies in the UK.

The analysis demonstrates that, in reality, fees and charges at Guernsey Airport are comparable with many of the cheaper UK airports, and significantly cheaper than the more expensive UK airports.

In February 2007, the UK Government doubled air passenger duty from £5 to £10 per passenger on departures from all UK airports. This move had no negative effects whatsoever on the number of passengers using Guernsey Airport.

In 2006, when UK air passenger duty was £5, the total number of passenger movements on UK routes at Guernsey Airport was 683,777, which was a decrease of nearly 1% on the previous year. But in 2007, once air passenger duty had been doubled to £10, the total number of passenger movements on UK routes at Guernsey Airport was 691,187.

Significantly, in the first year that the rate of air passenger duty was doubled to £10, the number of passengers using Guernsey Airport from and to the UK actually increased by 1%.

Clearly, there are no rational grounds on which to believe that our proposals would in any way compromise the competitiveness or viability of Guernsey Airport, even in the event that the airport authorities determined that the additional income should be serviced wholly via an increase in passenger taxes.

Therefore, we submit that there is no reason not to suggest a measure which may result in such modest increases in passenger taxes at Guernsey Airport, especially in the context and wider interest of proposing a generally more prudent, sustainable alternative funding models for capital projects.

It should be noted that any decision to levy very modest increases on charges per passenger movement would not in any way constrain the relationship between the States, Guernsey Airport and airline operators.

It may be the wish of the States in the future to introduce additional support, financial or otherwise, for air travel – for example, in order to assist in the development of new routes or the expansion of services on existing routes. Equally, the States may wish to explore the possibility of commercialising Guernsey Airport, or put in place other measures to generate additional revenue via the facility.

The possibility of levying a charge of up to £1.95 per movement concerns the narrow issue of passenger taxes only. It cannot possibly affect strategic or operational matters between the various stakeholders – now or in the future. Nor could it possibly affect any decisions future States may or may not wish to take in respect of lengthening the runway.

At present, the Commerce & Employment Department pays airline operators on key routes a subsidy of £1.05 per passenger movement (i.e. per arriving and departing passenger). The department recently announced that the policy was under review.

In 2006, a report produced by the National Audit Office on behalf of the Public Accounts Committee was critical of the key routes subsidy after finding that the objectives of the policy were unclear and that its effectiveness was highly questionable.

More recently, the purpose of the key routes subsidy has been challenged following several events, including: a decision by Blue Islands to give away to charity its share of the payout, having originally attempted to decline the money; comments attributed to a prominent local hotelier, who described the policy as ‘ludicrous’; and an interview with Deputy Parkinson in which he said the following:

‘It is wrong…The benefit is trivial and insignificant and I cannot see the point in principle as to why the taxpayer should subsidise mainland airfares. That [Mr Coates] *actually asked not to receive the money illustrates just how stupid it is.’*

The experience of the key routes subsidy may be further evidence that air travel on routes served by Guernsey Airport (in terms of charges paid directly by travelling passengers) is not so price sensitive as to believe that demand would be greatly affected by very modest changes to fee structures or passenger charges, such as the possible increase of up to £1.95 per passenger explored in our alternative funding models.

It is relevant to note that Guernsey Airport, unlike many regional airports in the UK, and to an extent unlike even Jersey Airport, is not nearly so reliant on the low-cost model of air travel pioneered by so-called budget airlines, such as Easyjet. Whereas increasing passenger fees in the order of up to £1.95 per movement may contribute not insignificant percentage increases in the cost of a ticket on such budget airlines, it would have a much smaller percentage effect on the average cost of a ticket on routes typically served by airlines operating at Guernsey Airport.

We wish to re-emphasise that our alternative funding models makes no provision for any additional surplus, or any borrowing allocated against the airport pavements rehabilitation project, to be repaid until 2011. We are firmly of the view that all stakeholders must have sufficient time to engage constructively and plan for any possible changes in passenger fees or the commercial income generated at the airport, even at the very modest levels we are proposing.

The alternative to a very modest increase in passenger taxes is to generate additional profit through Guernsey Airport’s commercial activities.

There is considerable evidence that Guernsey Airport is capable of generating additional revenue from its commercial activities.

Prior to the redevelopment of the airport terminal, BAA, the world’s leading airport operator, carried out a major financial and operational review of Guernsey Airport, on behalf of the Board of Administration. The review found that, in terms of revenue and profitability, Guernsey Airport was *‘…underperforming compared with airports of a similar size’*.

BAA’s report stated: ‘*The explanation for the lower profitability of Guernsey Airport lies in considerably lower income per passenger…Guernsey Airport’s* *operating profit and returns are small… there is a clear underperformance. However, this is not due to high costs, but rather a low level of charges and commercial income.'*

Although the report was written some time ago, many of its conclusions remain valid and are worth pursuing further.

Income per passenger is certainly higher at Jersey Airport than at Guernsey Airport. In the last year for which published accounts are available (2007), income at Jersey Airport was around £22.6million on a total of 1,563,000 passenger movements; whereas income at Guernsey Airport was around £8.9million on a total of 892,360 passenger movements.

Therefore, in 2007, average income per passenger was as follows:
Guernsey – £10.00
Jersey - £14.46

It is possible to break down the above figures so as to analyse the revenue per passenger at the two airports in respect of commercial income only – for example, concessions, rentals, car park fees and other commercial services.

In 2007, the average income per passenger generated by commercial activities only was as follows:
Guernsey – £2.65
Jersey – £3.96

These figures demonstrate that commercial income per passenger is 50% higher at Jersey Airport than at Guernsey Airport. It is, therefore, difficult to make a case that there is no headroom to generate additional income from existing or new commercial activities at Guernsey Airport.

Businesses are, of course, one of the most significant user groups of Guernsey Airport. It is not uncommon for local business representative organisations to express the view that Guernsey Airport should be generating additional income from commercial activities. For example, in 2008, the President of the Chamber of Commerce said: *'Chamber calls for a development programme of commercial initiatives at the airport to increase income streams from this key asset.'*

Airline representatives have also claimed that there exists considerable scope for Guernsey Airport to increase its revenue from commercial activities. For example, in 2006, a spokesman for Flybe said: *'The amount of money that people spend during their time at the airport is significantly below the UK average and there are so many missed opportunities.'*

The harbour authorities charge per unit of freight. However, Guernsey Airport does not – there is simply no charge made for the cargo onboard. This is another area which the airport authorities may wish to review in order to ensure that the airport is as commercial viable as possible.

In addition, in its submission to Treasury & Resources' capital prioritisation review process, Public Services stated: *'There remains the possibility, once the* [pavements] *work is completed, of attracting both new routes through existing operators and new operators to the island. This would lead… to enhanced revenue growth of the airport. As a minimum, this development could accommodate the reintroduction of a jet service to London…'*

Of course, as explored above, the airport authorities may choose to employ a combination of passenger taxes and additional commercial revenue in order to generate an additional £1.775million per annum to repay the £30million of borrowing that we are proposing should be allocated against the airport pavements rehabilitation project (in model B), or to transfer to the capital reserve (in model A).

As an illustration, a 50/50 split between passenger taxes and commercial income streams would require the following: levying a charge of 97p per passenger movement, and generating additional profit of around £890,553 per annum (the equivalent of 98p per passenger) from commercial activities.

Under this illustrative 50/50 split, passenger taxes at Guernsey Airport would remain lower than at Jersey Airport, and commercial income per passenger would also remain lower than at Jersey Airport.

Appendix 2 – Letter to States members dated 22nd May 2009

TREASURY AND RESOURCES
A STATES OF GUERNSEY GOVERNMENT DEPARTMENT

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To all States Members

BY E-MAIL

22nd May 2009

Dear Colleague

Capital Prioritisation Report

You will all be aware of the coverage in today's edition of the Guernsey Press which I feel I must respond to robustly given the inaccurate portrayal of the facts.

The facts are as follows:

1. Nothing has gone missing from the cash pool. The cash pool contains £265 million and we can account for every penny.
2. The issue is "how much of this money can be safely borrowed to fund States capital projects, bearing in mind that large parts of the pool consist of sums deposited with T & R by Guernsey Electricity Limited (GEL), Guernsey Post Limited (GPL) and other States Departments?"
3. Originally, T & R's States Report estimated that up to £100 million could be used for 'internal borrowing'.
4. Closer examination of the figures persuaded us that only the cash representing our revenue reserves and the notes and coins issue (a) belongs to the States and (b) is likely to be sufficiently long-term to support internal borrowing.
5. On the T & R model this cash amounts to some £70 million and on Deputy Fallaize's model it amounts to some £50 million.
6. The essential point is that neither of these figures includes ANY money from GEL.
7. The figures would therefore not change if the balances deposited with T & R by GEL (or anyone else) fell to zero.
8. It is totally wrong to say that if GEL's cash is withdrawn from the cash pool to fund its capital expenditure programme (or indeed for any other purposes) that £75 million would have "gone missing". (GEL has £16 million on deposit with us but this is not included in our estimate of the sums that could be "loaned" with a low risk to the States.)

9. T & R accepts that GEL’s reserves for capital expenditure are an issue which will need to be addressed at some stage but this issue has nothing to do with the capital prioritisation debate.

If you have any further questions please contact me.

Yours sincerely

C N K Parkinson
Minister