INDEPENDENT RESEARCH, ANALYSIS & ADVOCACY · 2

Capital Expenditure in Guernsey

An introduction

This is the second publication from the Guernsey Policy and Economics Group LBG (GPEG). It is intended to inform debate surrounding Capital Expenditure in the Bailiwick.

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Capital expenditure is simply expenditure that has a lasting effect.

This note is mostly about “hard” infrastructure such as buildings or power distribution or IT. “Soft” infrastructure is about the structure of the economy and its institutions.

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Capital expenditure comes in a range of flavours:

Stuff You Just Have to Do

Water supplies, power, schools, and basic medical facilities are examples of this. If we cannot afford this type of spending our living standards have to drop.

Stuff that Improves Life but is Optional

5G telecommunications rather than 4G, new school buildings, toilet facilities at beaches, arts facilities and environmental improvements are these sorts of things. In the past, these have often been regarded as "vanity" projects but their existence may make living in a society far more attractive & a more desirable place in which to invest.

Stuff with an Economic Purpose

Better port facilities, tourist attractions, longer runways, a new States IT system, cheaper power supplies are good examples.

Just to make things a little less simple, capital expenditure can span these categories. For example, a replacement hospital might be essential in the future, but putting in facilities that mean Islanders no longer have to travel to the UK to get treatment would be "nice to have". It might save money by doing treatment locally. Finally, having a first-class hospital might attract more wealthy people to move to, or stay in, the Bailiwick. It might even kickstart medical tourism for the Island.

New power supplies might be unavoidable but could also generate cheaper power, and even be greener.

The Stuff You Just Have to Do is easy – it needs doing and quickly. Government has often delayed this type of expenditure which has increased the cost as existing assets have deteriorated. For instance, it has been reported that the Grammar School was voted £17m for maintenance in 2013 but only £2.1m has been spent (GEP 30/12/20). Now the school needs extensive work to meet current standards or, indeed for whatever purpose the States decide to use it going forward. Government's role here is to minimise cost and delay (proper tendering, project management and cost control etc) and get the job done without pointless consultants and excessive decision time.

The second category, Optional Stuff, is a much more political area. What does the electorate want? And what is it willing to pay? There is never a shortage of possible projects and the choice between, say, a new sports facility and a new day care centre for senior citizens is a political decision. If the electorate will not allow taxes to be raised to pay for such things, then ultimately, they will not happen. The ballot box is central – though perhaps not in the short term.

The third category of Stuff with an Economic Purpose is the most technical and often needs numerous inputs to select and execute projects. In developed economies, it is generally the case that the available economic return on infrastructure spending, the return on investment, tends to decline over time. This simply reflects the human tendency to do the most attractive projects first. Consider the relative attractions of being the first to build a rail link between two cities as opposed to a second or third. So, the current possible universe of projects to drive the economy tend to be less remunerative and returns tend to be lower, even negative. But, while this is a tendency, the exceptions are far from rare, especially when new technologies are involved. Attractive projects are the exception! Caution is definitely appropriate before deploying funds.

The reasons for the all too frequent disappointment, or outright failure, of the most governments' capital spending to generate economic returns can be found at https://www.cps.org.uk/research/infrastructure-can-be-a-bad-investment/. Large megaprojects have diabolical tendencies to run over budget. Professor Bent Flybjerg of Oxford University lists the reasons for this as:

1. Technology – trying to build the longest, tallest, or fastest structures.

2. Political i.e., vanity projects.

3. Economic – the money made by contractors, lawyers, consultants and so on (not so bad if they're all on island).

4. Aesthetic – the buzz that designers get from designing something beautiful, however impractical.

You might reasonably think that this is all very obvious and yet this gentleman is widely viewed as the best academic in project management.

Another leading academic in project management, Albert Hirschman, came up with the memorably named concept of the "hiding hand" which is stated as "if people knew the real costs and difficulties from the start, nothing would ever be approved. Therefore, it is good if they don't know, because we need to get things going, to start digging." This is almost a religious view of the merits of large-scale projects. Essentially, we cannot know the benefits any more accurately than the risks.

At the same time, Hirschman holds that most cost benefit analyses overbake the benefits and undercook the costs

giving a falsely high cost-benefit ratio. Once a project is started and the spades are in the ground, it is really hard to stop it even when unforeseen but not unexpected problems arise. Historically, contingencies included in budgets for major projects supposedly cover this eventuality. In Guernsey, the local habit has been to create contingencies that are so generous that going over the final budget, as opposed to the much lower quote included in the very first policy paper on the project, is quite rare.

If you are interested in a more academic approach to managing these large projects typing either of these academics' names into Google will rapidly find you a great deal of content.

Eurotunnel came in 80% over the budget at the start of construction, the UK's (never really completed) NHS Connecting for Health IT project spent 800% of the original budget. The Sottish Parliament building came in at over 1000% of its budget and many years late.

It is perhaps fortunate that Guernsey has very limited opportunities for grandiose megaprojects!

The Calculation

Building a new tourist attraction, say, a multi-media Guernsey Occupation Experience or a Victor Hugo museum would clearly have the main aim of getting a return from the money involved in its construction. But to figure accurately the likely return on investment, you need good estimates of the cost of construction, related power and water infrastructure costs, the time for construction, estimates for operating costs, reasoned, and supported projections of the revenue from visitors, estimates of the spending on other things (hotels, meals, shopping etc) that people who decided to come to the Island lured by the attraction would spend and so on. There might be concerns over landscaping or environmental issues to consider too. You might also want to put a value on other benefits such as educational value or the "recycling" of an otherwise under-used facility.

To make it harder, you also need to consider if there could be negative economic effects from building any new attraction. Would revenues decline at other attractions, traffic issues and so on?

You then have to feed all these facts and estimates into a broad economic model to see if it makes sense.

Most of the currently proposed options for the development of the St Peter Port harbour areas are really complicated scenarios with relatively simple cost estimates and a multitude of issues including but not limited to estimates of the economic impact, housing and retail benefits and detriments, complex aesthetic issues, parking and traffic as well as the complications of tides and storms. Finding an optimal way through issues like this is a major and difficult task. Conveying the cases for and against each of the scenarios to the political decision makers is itself a task requiring considerable capabilities. It will not be easy!

Recent history

The Island has been very poor at the third category of spending for economic gain, probably because it is a complex activity and the complexity of internal process and miscommunication have defeated the States' capabilities to actually implement projects. Though clearly very arguable, the absence of a political majority on the Island is widely thought to have obstructed and delayed larger, more risky decisions.

An example of the complexities and inherent difficulty of these kinds of decision is the long running debate on a longer runway. A fairly detailed report on this, prepared by Frontier Economics, is available on the web. (https://www.gov.gg/CHttpHandler.ashx?id=125756&p=0).

Given the likelihood that Guernsey would be an early adopter of electric aircraft, no-one yet knows how long the runway would then need to be – this is an unexplored future concern. In addition, the report was issued before the virus came, which may well have some permanent negative effects on business travel.

This is not criticism of the analysis; merely pointing out that these sorts of decisions are inevitably uncertain and require a lot of thought. Some of the relevant information will change as time passes and one of the critical determinants of good spending on capital projects is to gather all the data and then decide rapidly whether to proceed or not. Much time and money can be wasted by delay due to repetitive reviews.

Spending Control

The structure of capital expenditure control used by the States of Guernsey is broadly the same fairly elaborate model as the English system. But lacking the kick of political majorities on the mainland, approvals here often take longer than the life of a States.

The remarkable thing is that the States' own Scrutiny Management Committee ("Scrutiny") report on capital allocation says "...the only capital spend over the period reviewed (10 years to 2018) has been to refurbish or replace existing assets."

(https://www.gov.gg/CHttpHandler.ashx?id=129416&p=0)
In short, only the Stuff You Just Have to Do has been done

and arguably not all of that given that the list of outstanding maintenance issues stood at some £60m at the end of the last States' term. A serious failure. It is extremely unlikely that viable economy-improving projects did not also exist.

> ***Capital expenditure does not by itself grow the economy or increase gross domestic product (GDP).***

A strange thing is that the States have targeted a level of capital expenditure in the Fiscal Framework. This is through a process involving the establishment of a capital reserve to "save" for future capital projects. These amounts are not for projects "ready to go". No other jurisdiction seems to have or need to have this reserves concept.

It might well be justifiable to have a rough estimate of the future cash needs for capital expenditure but there is no satisfactory method of estimating the desired amount. If there are no good economically driven projects, then we shouldn't spend a penny on this third category. If some big project looks attractive (perhaps redevelopment of the Eastern seaboard) then it is worth funding without much regard to a percentage of GDP.

The capital allocation process, which is separate from the Capital Reserve concept, determines the amounts voted for capital projects even when implementation of those projects is not imminent. Often, the funds simply don't get spent, so little is gained from the allocation process.

The Impact of Capital Expenditure on the Economy

A myth needs nailing.

Capital expenditure does not by itself grow the economy or increase gross domestic product (GDP). Nor does spending 100% on island turn a useless project into a useful one. If you put £10m into digging a large hole at Cobo and then fill it in again then, yes, some of that money, perhaps a third will be paid in local salaries which will be spent locally to benefit the economy. The rest will go in expenditure that ends up outside the Island for fuel, equipment and even labour. The 2020 States Scrutiny report uses this one third "benefit" as a rationale for more capital expenditure.

You could, of course, avoid digging the wretched hole entirely. £10m would then flow into this economy (through lower taxes) and three times the benefit would flow into our economy as compared to executing the pointless project. If there is an economically attractive return from a project then, yes, capital expenditure will grow GDP. But it seems Guernsey has in recent years largely lost the will to pursue such developments.

In a Guernsey Press article, the leader of the Scrutiny Committee review is quoted as saying ".... So, by spending the (targeted) capital money you end up with more taxes.... What's not to like?". However, if money is spent on uneconomic projects, then tax revenue will eventually have to fund the cost whilst the tax generating capacity of the island will actually be reduced.

Choosing the Right Projects

Over the years, the States have approved, but not delivered, numerous projects. Policy & Resources have delegated authority for about 40 projects costing an aggregate of, at least, £295m. As at the date of publication, we haven't been able to find any evidence of a coherent framework used to decide on the priority of these projects.

> ***"Unprecedentedly low interest rates still don't turn bad expenditures into good ones."***

Do we do the Stuff that Drives the Economy or spend our funds on better maintaining what we already have? Should we prioritise projects where the most spending is on island rather than more technically complex projects which require off-island resource? Should we prioritise the projects that generate the best return on investment rather than those with the best environmental credentials? And what do we do when a project falls into more than one of those categories? Without some prioritisation, we just have a shopping list. Innovative new projects can really help the island attract talent with obvious economic benefits. But innovation is not the sole driver of a good project.

Infrastructure is by its nature for the community and therefore it is important to involve the community as much as possible

in the selection process. It may also be of great benefit to harness the wealth of skills & talent of the community.

Methods of Funding the Right Projects

Then there is the broader question of how projects are funded.

Unprecedentedly low interest rates still don't turn bad expenditures into good ones. Debt could rationally be used to fund big robust economic projects that will be able to service and repay their "own" debt, but we get into tricky territory here as there are troubling implications in taking on debt where the kids get to pay for the parents' spending. We have the odd situation here in Guernsey where the States simultaneously hold both large investment funds and substantial debt.

Guernsey has rarely tried the UK model of using private sector companies to construct (and often operate) infrastructure in some form of partnership. These projects are called Private Finance Initiatives (PFI) or Public/Private Partnerships (PPP). The UK general experience of these projects is that the private companies do well out of these deals and the Government ends up in a poor position.

(https://www.nao.org.uk/wp-content/uploads/2018/01/PFI-and-PF2.pdf)

Government often ends up providing guarantees for revenue streams or traffic flows or some other basic assumptions. If the private partner goes bust, then the public end up picking up the pieces – the collapse of Carillion is a major recent example. Disputes are normal!

(https://www.nao.org.uk/wp-content/uploads/2020/06/Managing-PFI-assets-and-services-as-contracts-end-Summary.pdf)

The rationale for these kinds of structures in the UK was largely to keep debt off the national balance sheet and to diminish the short term reported economic deficit of the UK. Economically, most of these projects were effectively structured with unreported public debt.

There are situations where PPP structures make good sense. A developing nation might not have the money or the expertise to develop relatively essential infrastructure. However, it is hard to see any significant role for these complex and dangerous structures in a Guernsey setting. Of course, public and private capital can work together and should be encouraged to do so. This might be the private sector putting retail or residential units on top of a new harbour quay that the States fund. This is a similar approach to the current version of the Leale's Yard project. Done well these projects can make sense all round There has been considerable discussion of a Guernsey Bond. This would be a faint echo of UK War Bonds where residents would invest at sub-market terms in order for there to be some good done. The loan might be repayable in say 30 years and carry a 1% interest rate. Perhaps you could use the proceeds to construct something that might not quite make the list of things you have to do or things that have an economic return. Again, it must be something that the Community agrees is worthwhile and not just a vanity project, bearing in mind that the funding would be repayable at some point.

Is it Sustainable?

In modern times, there is clearly a concern about "sustainability" and, more generally, environmental issues. These will attach to most types of capital expenditure and somehow, they must be priced in any appraisal. Sadly, the most sustainable option is rarely the financially cheapest. An example of the issues is the potential for wind power in Guernsey. Onshore wind is cheaper than offshore but the lack of enthusiasm for it (it wrecks the views, noise etc) here means that the much more expensive offshore wind option is more favourably viewed. (See the very good review of Guernsey electricity supply issues on https://www.gov.gg/CHttpHandler.ashx?id=121754&p=0).

Conclusion

Creative and well executed capital spending is capable of improving both the economy and living standards in Guernsey. It can help in generating an attractive and modern image.

We hope that this paper illustrates the key features of choosing and implementing good capital expenditure programmes. It is not, and makes no claims to being, comprehensive.

One issue shines through – even the best analysis does not eliminate the fact that future events are not capable of accurate estimation.

However not attempting that prediction mostly works out a lot worse.

Recommendations

This paper does not seek to promote or campaign against any particular projects. In due course we may well review individual projects where we think believe that further insight and analysis can add value.

Our politicians have a difficult and important role in optimising capital expenditure. We wish them success and have some recommendations which we hope will assist:

1. Reduce the complexity of the approval and procurement processes – batting inordinately long papers between Committees, Deputies and the civil servants is clearly too ponderous, slow, and expensive.

2. Dispense with the notions of capital reserves and allocations within the States Accounts to demystify them.

3. There appear to be steps being taken to centralise project management in the States. This is an opportunity to control costs and get things done more quickly. Prioritisation should be a key focus.

4. Consider rapid reduction of the maintenance backlog. Nothing will help the island economy recover from the COVID-19 hit quicker than using local resources to do this.

5. Use local expertise and contractors as much as possible. Whenever we don't do this, we effectively export our wealth.

6. The vein of free advice on projects, which is unusually thick on Guernsey, from people who have had senior roles in industry and many large projects, should be harvested. Ad hoc single project committees designed to use this pool of talent and knowledge, subject to appropriate conflict of interest procedures, must be worth considering.

7. For larger projects there should be regular public reporting of progress – or not. The ongoing Agilisys IT contract is exceptionally large (£200m or around £3,000 per head of population), expensive and complex. There is a great deal of history (in most jurisdictions) of government IT contracts of this extensive scope going off the rails and there are a few issues already apparent. Making issues visible will help reduce their impact and encourage reducing repetitive mistakes.

8. Encourage public participation. Acknowledging that the States don't have a monopoly on good ideas would be welcomed by those who end up paying for it.

9. Whatever is done MUST be done quickly. There will never be a better time given the alignment of cheap money, #Guernsey Together, a new Administration and clear & present, visible needs.