



Long Term Timber Sales Contracts


INTERNAL AUDIT REPORT

May 2017

Distribution of Report (as agreed with clients)

Name	Title
Peter Garson	Head of Operational Services South
Ian Sachs	Head of Harvesting
Jerry Pritchard	Head of Marketing
Emyr Roberts	Chief Executive
	Audit & Risk Assurance Committee
	Wales Audit Office

Engagement Opinion

Opinion	RAG
Moderate Some improvements are required to enhance the adequacy and effectiveness of the framework of governance, risk management and control. (For the range of opinions, see Annex C)	Yellow 

EXECUTIVE SUMMARY

Based on our review we are able to give a **moderate** audit opinion. This rating means that some improvements are required to enhance the effectiveness of the framework of governance, risk management and control around the Long Term Sales Contracts.

NRW inherited the 2011-16 Timber Marketing Strategy from Forestry Commission Wales (FCW). One aim of the Strategy was focussed on developing and sustaining a strong timber supply chain in Wales and encourage value adding. A proportion of the programme was therefore allocated to Long Term Contracts that were designed to encourage companies bidding for them to invest into infrastructure to enhance the supply chain capacity within Wales. This resulted in contractual responsibilities which added extra requirements into the sales contract. Ultimately, this also increased the risk exposure from those contracts for NRW, (because the supply chain investments were beyond NRW’s direct control).

Currently, one live contract remains, which was conditioned on the construction of a plant, financed by the company itself. We have been informed by the Head of Marketing that, at the time of letting the contract (by FCW), legal advice was sought to ensure the contract was legally compliant.

NRW also ring-fenced a small quantity of timber to be sold to specific customers, who therefore did not have to purchase it via a competitive sales process. These customers were in a receipt of a Wood Energy Business Scheme (WEBS) grant, which NRW did not want to see fail, but positively contribute to Welsh economy instead.

While we have not identified any significant issues with the existing contracts, NRW may wish to review its approach to long term timber sales, to ensure NRW is not building in unnecessary conditions into our sales contracts and all sales are conducted via a competitive process.

NRW’s new 5 year Timber Marketing Plan, which came into effect on the 1st April 2017, reduces the proportion of timber sales through Long Term Contracts and indicates that where we do enter into new LTCs, their focus will be to achieve outcomes that are more directly related to the management of the forest such as increasing the amount of thinning.

A full description of all findings and recommendations can be found below.

BACKGROUND

Timber sales contracts are an essential source of income for NRW. In 2015/16 this amounted to £16.5m. In addition, harvesting timber is an essential part of our sustainable management of the Welsh Government Woodland Estate.

The recent Wales Audit Office (WAO) review of one of NRW's long-term timber contracts identified a number of shortcomings, whereby NRW were not able to provide evidence to support the decisions and actions taken in letting and awarding the contract and appropriateness of the agreed terms and conditions.

The purpose of this consultancy assignment was to assess and provide reasonable assurance to the Accounting Officer and management that appropriate and sufficient evidence exists to support the other current NRW long-term timber sale contracts and that the contracts were drafted and awarded in accordance with NRW policies procedures.

We reviewed the following:

- NRW's understanding of the current (at the time) market conditions for timber,
- The process of identifying the sales marketing options to optimise the outcomes,
- The documentation around marketing the sales,
- The oversight of the shortlisting and selection of the contractors,
- Controls around contract negotiations and contract award process,
- Management oversight, escalation and consultations on the sales process (i.e. what controls/processes existed to help to identify contentious, novel, repercussive or state aid issues).

Outside scope (What we didn't look at):

- We did not look at whether the contracts represent value for money.

The full Terms of Reference for this audit are included as Annex B.

EXPLANATION OF OPINION, KEY FINDINGS AND RISKS

Understanding of market conditions for timber and marketing the sales opportunities

NRW produces Long Term Production forecasts within which annual volumes of timber that can be released to the market are specified. In addition, the UK timber market is being monitored on capacity, imports, and prices. This review did not explore the work that contributed to the above knowledge of the market.

In relation to the existing long term contracts (where applicable), we reviewed the process for identifying timber for sales and presenting it to the market in such way that reflects market demand, capacity, capability and found it to be satisfactory.

NRW and FCW before it, as part of their long term Timber Marketing and Sales strategy, explicitly encouraged the bidders to invest in infrastructure and technology that would create and develop a strong Welsh timber market. This was used as one of the scoring criteria for evaluating bids. Consequently, FCW and NRW entered into some contracts which were conditioned on a construction of the agreed infrastructure. One of the current live contracts has this as a condition of sale. However, the company funded all costs associated with construction.

By entering into such contractual arrangements, NRW takes on a degree of risk by introducing complexity into the condition of sale. If the conditions of sale are not met, then potentially the contract would have to be terminated, additional costs incurred as a result of having to re-tendering the timber to market, cause financial loss to the supplier and reputational damage to NRW.

Shortlisting and selection of the companies

There are currently six live Long Term Timber Sales contracts. Regarding three of them that were awarded through an open market competition, we were satisfied that an appropriate marketing and tendering process took place, proportionate to the size of the sale.

The evaluation guidelines exist and the records of scoring tendering criteria appear to be consistent with the guidelines.

The other three current Long Term Contracts relate to a sale of timber to ring-fenced companies, which received a government grant to purchase machinery in order to establish a market for biomass in Wales. The sales were smaller (totalling approx. 48,000m³ timber to the value of £710k over a period of 5 years) and were made at market prices. These contracts were on a reducing sliding scale and will end in 2018.

The practice of ring-fencing, instead of competitive sale process, can expose NRW to risk of being accused of preferential treatment for some suppliers in the market. Going forward, this practice has been reviewed and will no longer be used, also the proportion of timber sold through long Term Contracts will be considerably reduced.

Contract negotiations and contract award process

We discussed with the Head of Marketing the process of reviewing tenders and selection of the successful bidder. Evidence for one of the contracts was reviewed and found to be sufficient.

We were assured by the Head of Marketing that there have been no significant changes between the terms and conditions advertised for the tendered contracts and what was subsequently awarded. However, we were unable to verify this as not all the information was not available.

Contract extensions and variations and management

The quantities and species of sold timber are regularly monitored and recorded against contracts. All contracts have a degree of variations between the quantities agreed to be harvested and the actual quantities - which are tolerated (both over and under the agreed

amounts). Overall, 25% variation is accepted on “child” contracts (which are sub parts of the full “parent” contract) but the overall volume of sales need not be affected by this. However, occasionally the overall quantity harvested differs substantially from the “parent” contracts (with no formal extensions in place).

No penalties are imposed in the events where the contract does not harvest the required amount.

The practices described above may have an impact on NRW’s ability to sell timber efficiently and competitively.

The practice of packaging purchase of services by NRW (e.g., clearance of low value timber) into a sales contract occurs on some Standing Sales Long Term Contracts. The practice of packaging purchase within a sales contract was reviewed by WAO last year and no recommendations were made. However, there is a risk that without the tendering for the service, as would be the case in a typical procurement process, the prices might not be competitive or market tested. Nevertheless, the Head of Marketing believes that the approach used secures best value for the reasons explained in Key Finding 4.

Management oversight

We have not reviewed how contracts are managed on a day to day basis, as this fell outside of the scope for this review.

We saw evidence of monitoring and dealing with performance against contract, specifically – haulage-related breaches and other Terms and Conditions.

The evidence of annual review of the contracts and performance against them is not always summarised on the contract files. There is a risk that, without this information, contract management may be less effective. However, the need for this regular appraisal has already been identified by the timber Marketing Manager who is putting measures in place to address this gap.

Long Term Timber Contracts Agreed Action Plan

The agreed actions have been categorised according to the level of importance we attach to them. They are defined as:

HIGH (H)	The action addresses critical weaknesses that would result in serious risks and/or an unacceptable level of risk to the delivery of objectives.
MEDIUM (M)	The action addresses control weaknesses that carry a risk of undesirable effects in loss, exposure, poor value for money or missed business opportunities and benefits in the context of the delivery of objectives.
LOW (L)	The action addresses minor control weaknesses and/or areas that would benefit from the introduction of improved working practices in the context of the delivery of objectives.

Key Finding 1	<p>FCW Sales Strategy, later adopted by NRW</p> <p>In response to one of the objectives in the Welsh Government’s Woodland Strategy, FCW aimed to help Wales to develop longer term capacity to process/utilise timber and timber products. The intention was to encourage investment in infrastructure which would create a permanent market within the region.</p> <p>This strategy was reflected in FCW approach to marketing and sales and consequently, in some of the sales contracts. This approach was continued by NRW, albeit that NRW has now developed the subsequent 5 year Timber Marketing plan.</p> <p>We identified one large (approx. £18m over 12 years) NRW long term timber sales contract which stated “this agreement is conditioned upon the execution of the construction contract”. The construction referred to the building of a wood fuel burning energy plant (financed entirely by the company itself).</p> <p>The contract was awarded in 2006 via a tendering exercise which attracted a high level of interest. Availability of and investment in infrastructure (capacity and technology) was one of the scoring criteria for this contract.</p> <p>Legal advice was sought on the construction of the contract to ensure it was legally compliant, however, copy of the advice has not been retained.</p>
Risk	<p>Introducing additional conditions within the sales contract adds to complexity of the transaction and loads the risk of the contract performance onto NRW. If the condition is not met, there is a risk that NRW can terminate the contract – which is likely to be detrimental to NRW as well as to the company.</p>

Agreed Actions:	Priority	Action owner:	Target date:
<p>1</p> <ul style="list-style-type: none"> • NRW has already implemented a new marketing plan which reduces the use of LTCs. We no longer use LTCs to encourage investments in the timber processing sector. • The lessons from this review will be adopted in NRW's future enterprises. <p>Additional comment: With reference to the specific LTC, the investment has taken place and therefore the risk to the contract is low.</p>	M	Peter Garson, Head of Operations, South	Immediate

<p>Key Finding 2</p>	<p>Ring-fencing timber for sales to specific buyers</p> <p>There are 3 small (totalling approx. 48,000m³ timber to the value of £710k over a period of 5 years) contracts that were awarded to companies without going through a competitive tendering and sales process.</p> <p>This was because NRW agreed to ring-fence a small quantity of timber (we have been told it was around 3% of available timber) for sale to companies that were successful in obtaining a Wood Energy Business Scheme (WEBS) grant for investment in timber processing machinery, but who needed security of supply in order to make the investment. FCW's intention was to help to ensure that these government-encouraged investments succeed.</p> <p>Two of the three contracts were with the same company. All 3 will end in within the next 2 years.</p> <p>We have been told by the Head of Marketing that the sale was at market value, (using open market values for equivalent timber.)</p> <p>No contracts of this sort have been awarded since then by NRW as the practice of ring fencing stopped when the WEBS grant scheme closed.</p>			
<p>Risk</p>	<p>Although the sale was at market rate, this could be construed as preferential treatment.</p>			
<p>Agreed Actions:</p>		<p>Priority</p>	<p>Action owner:</p>	<p>Target date:</p>
<p>2</p>	<ul style="list-style-type: none"> Practices of ring-fencing should not be re-introduced. The lessons from this review will be adopted in NRW's future enterprises. 	<p>M</p>	<p>Peter Garson, Head of Operations, South</p>	<p>Immediate</p>

<p>Key Finding 3</p>	<p>Dealing with under and over sales</p> <p>Long term contracts consist of an overarching “parent” contract and the sub-parts relating to specific coups – so called “child” contracts.</p> <p>We note that each “child” contract has some variations between the quantities offered for sale and actuals. Generally, 25% variance on the “child” contract is accepted, but we identified that occasionally there are larger variances. These variations can be - over and above agreed sales, below that quantity, or no timber was collected at all.</p> <p>On LTCs, the variances on the individual “child” contract are monitored and subsequent coups adjusted. It is expected that, cumulatively, this would prevent large variances at the overall “parent” contract level. However this is not always the case. We noted that one contract is forecasted to achieve a lower sales volume (29% under) and one higher (20% over).</p> <p>In the event where the total quantity significantly exceeds that which was agreed, there were no formally agreed contract extensions or variations (with 2 minor exceptions).</p> <p>There could be variety of genuine reasons why the company could not collect timber. Where the timber remains unsold it is offered back to the market, unless there is a good reason why it is not appropriate (such as protected species nesting).</p>			
<p>Risk</p>	<p>If the actual amount sold significantly exceeds the one the company tendered for, then this might be seen as a way of securing extra sale without having to compete for it in an open market.</p> <p>When the contractor fails to collect the timber there is a risk that NRW might be financially disadvantaged, if there are costs associated with re-presenting timber back to the market.</p>			
<p>Agreed Actions:</p>		<p>Priority</p>	<p>Action owner:</p>	<p>Target date:</p>
<p>3</p>	<p>Ensure that the variations on “child” contracts are managed to minimise the cumulative effect on the “parent” contract level.</p>	<p>L</p>	<p>Ian Sachs, Head of Sales and Marketing</p>	<p>30 April 2017</p>

<p>Key Finding 4</p>	<p>Packaging up purchase of service into sales contract</p> <p>Where there is a big variation in the value of products, it is common to set different prices for each product within the LTC sale. Sometimes the lowest price products can have a “negative value”. This means that the company that has purchased timber (and carries out harvesting itself), is also harvesting other - not valuable - materials at the same time.</p> <p>The “negative value” occurs when the harvesting costs exceed the value of the product. Effectively, NRW pays the contract-holder to remove these products. The “negative value” products typically comprise at least 20% of the crop (mainly tips and dead-wood).</p> <p>NRW provides an incentive to the contract holder to remove all products, rather than just remove the higher value products and leave an excessive to clear amount of waste timber on site (where it would make replanting hazardous and expensive.)</p> <p>It is regarded by the management as impracticable and very expensive to remove the low value products as a separate operation. In addition, this clearing process is important in maintaining a clean and healthy estate.</p> <p>As the price for each product relies on a negotiation of working costs, it is difficult to demonstrate “market testing” of this, albeit the Sales Team have considerable experience of working costs and timber values from open market sales.</p> <p>The approximate value of the “negative sales” is £100k per annum, which represents around 15% of the value of the LTCs involved.</p> <p>Recent WAO review of another long term timber contract which included “negative sales” did not raise this as an issue.</p> <p>Finally, the Operations Business Systems Manager said that she was satisfied that the risk of company clearing valuable timber and charging for “negative value” products is being well managed through NRW’s timber security controls. This assertion was noted but not tested, as outside the scope for this review.</p>			
<p>Risk</p>	<p>There is a risk that NRW may not be paying a competitive rate to clear the low value materials.</p>			
<p>Agreed Actions:</p>		<p>Priority</p>	<p>Action owner:</p>	<p>Target date:</p>
<p>4</p>	<p>Review the “negative sales” periodically, or as part of contract reviews, to confirm that negotiated prices reflect market value.</p>	<p>L</p>	<p>Ian Sachs, Head of Sales and Marketing</p>	<p>30 April 2017</p>

<p>Key Finding 5</p>	<p>Maintaining information</p> <p>In order to provide good continuity of service, various information about day-to-day performance of contracts needs to be brought together and documented.</p> <p>This information currently exists in numerous forms (paper/electronic or personal knowledge) and locations.</p> <p>In particular, annual summary of contract performance, including any contract breaches and H&S infringements, needs to be documented to demonstrate that contract is performing well. Although we have been informed that this information is considered when contracts are being reviewed, this isn't clearly evidenced.</p> <p>In addition, some of the reports and management information relating to contracts are not dated, it can be unclear who produced them (NRW or the company) and lack context.</p>			
<p>Risk</p>	<p>Incomplete management information may impact on NRW's ability to assess contracts effectively and may lead to sub-optimal decisions (e.g. granting an extension where contract is underperforming).</p>			
<p>Agreed Actions:</p>		<p>Priority</p>	<p>Action owner:</p>	<p>Target date:</p>
<p>5</p>	<ul style="list-style-type: none"> • Document each contact performance and carry out a formal annual review of each of them. • Ensure that the management information is dated, the author is known and the context (i.e. in header/title) is apparent. 	<p>L</p>	<p>Ian Sachs, Head of Sales and Marketing</p>	<p>30 April 2017</p>

LIMITATIONS

We have prepared this report solely for the use of the Natural Resources Wales and its Accounting Officer following an audit conducted at a point in time and it was not written for any other purpose. Therefore, we take no responsibility for any reliance that a third party (i.e. other than the Natural Resources Wales) may place on it. Where this report has been made available to a third party, it is on the understanding that the third party will use the report only for the purpose agreed and will not distribute it or any of the information contained in it outside of the third party.

Agreed Terms of Reference

INTERNAL AUDIT ENGAGEMENT - TERMS OF REFERENCE

Long Term Timber contracts – Terms of Reference**Background**

The recent Wales Audit Office (WAO) review of one of NRW's long-term timber contract identified a number of shortcomings, whereby NRW weren't able to provide evidence to support the decisions and actions taken in letting and awarding the contract and appropriateness of the agreed terms and conditions.

Review Objective – Purpose

The purpose of this assignment is to assess and provide reasonable assurance to the Accounting Officer and management that appropriate and sufficient evidence exists to support the other NRW long-term timber sale contracts and that the contracts were drafted and awarded in accordance with NRW policies procedures. In addition, we will review whether an audit trail of decision-making process exists.

Business Objectives (of Activity)

Timber sales contract are an essential source of income for NRW. In 2015/16 this amounted to £16.5m. In addition, harvesting timber is an essential part of our management of the Welsh Government Woodland Estate.

Review Scope (What we look at)

We will examine long term timber sales contracts and evidence to support decisions made that led to letting/awarding the contracts.

We will look at:

- NRW understanding of the current (at the time) market conditions for timber,
- The process of identifying the sales marketing options to optimise the outcomes,
- The documentation around marketing the sales
- The oversight of the shortlisting and selection of the contractors,
- Controls around contract negotiations and contract award process,
- Management oversight, escalation and consultations on the sales process (i.e. what controls/processes existed to help to identify contentious, novel, repercussive or state aid issues).

Outside scope (What we won't look at)

- We will not look at whether the contracts represented value for money.

Business Risks (Factors which would impact on the achievement of the activity objectives)

- If NRW cannot demonstrate that the contracts have been let following a competitive process, then we can be exposed to the risk of challenge from WAO, Welsh Government or the market.

- If we are unable to demonstrate that we have safeguarded NRW against the risk of state aid or that we have given adequate consideration to issues that can be seen as novel, contentious or repercussive, we might be challenged on validity and probity of our decision making.

Audit approach (How we will do it)

As with all of our audit work, we will adopt a risk-based approach where possible. Files, records and other forms of evidence will be examined, both manual and electronic, and relevant staff will be interviewed to identify and assess risks, document systems and evaluate controls.

By reference to documentation and consultation with staff we will determine what controls have been established to help ensure that risks are managed appropriately. We will then assess both the adequacy of the design and the effectiveness of these controls.

Following our initial evaluation, appropriate testing will be undertaken as considered necessary to establish the adequacy of management controls and whether they have been implemented an embedded effectively across the organisation.

Any emerging thoughts will be discussed with management during the audit. At the end of fieldwork, an exit meeting will be held to present our findings, confirm factual accuracy and agree corrective actions. Following this meeting, a draft report will be issued for final comments prior to issuing the final report.

Contacts

Assignment Sponsor	Emyr Roberts, Chief Executive
Assignment contacts	Peter Garson – Head of Operational Service South Jerry Pritchard – Head of Marketing Ian Sachs - Head of Harvesting Claire Evans - Harvesting Team -Operational Business Systems Manager
Report Distribution (to be confirmed)	Emyr Roberts - Chief Executive Peter Garson – Head of Operational Service South Kevin Ingram – Executive Director for Finance and Corporate Services David Cavell – Head of Legal Members of the Audit and Risk Assurance Committee Wales Audit Office




Proposed timetable of events is (provisional dates)*

Draft report date	April 2017
Response from Management	April 2017
Final report	May 2017

*: Dates are indicative. The planning, scope, approach and timetable for this audit may change in the light of preliminary findings. We will advise you of any significant changes to the timetable.

Agreed by Audit	Dorota Lee, IA Manager (HIA)	Date: 10/03/2017
Agreed by Audit client	Emyr Roberts, Chief Executive	Date: 10/03/ 2017

Overall Opinion Key

Coverage	Core Definitions for Annual and Engagement Opinions	Optional RAG	Factors influencing choice of opinion
Governance, risk management and control framework Assurance Opinion on mitigating controls over the risk to the delivery of objectives	Substantial The framework of governance, risk management and control is adequate and effective.	Green 	<ul style="list-style-type: none"> • Adequacy and Effectiveness of the governance, risk management and control framework • Impact of any weakness on delivery of objectives • Extent of risk exposure • Materiality: by value to the entity, by value in the engagement context and by nature (e.g. irregularity and reputational risk) • We may also take account of Management responses to recommendations/ management actions
	Moderate Some improvements are required to enhance the adequacy and effectiveness of the framework of governance, risk management and control.	Yellow 	
	Limited There are significant weaknesses in the framework of governance, risk management and control such that it could be or could become inadequate and ineffective.	Amber 	
	Unsatisfactory There are fundamental weaknesses in the framework of governance, risk management and control such that it is inadequate and ineffective or is likely to fail.	Red 