Shan Morgan
Ysgrifennydd Parhaol
Permanent Secretary

Llywodraeth Cymru
Welsh Government

Mr N Ramsay
Chair, Public Accounts Committee
National Assembly for Wales
Cardiff Bay
CF99 1NA

05 March 2018

Dear Mr Ramsay

Welsh Governments Initial Funding of the Circuit of Wales Project

Following my attendance with the Public Accounts Committee on 05 February 2018, the Committee asked the following questions:

- Whether the general issue about the size of the guarantee and that any solution would only be achievable if the Welsh Government guarantee were to be reduced by at least 50 per cent was communicated to the company prior to the Cabinet decision.

- Was the fact that the guarantee only started when the project was completed, known and communicated, whether in a written form or not, by the treasury official providing advice to officials providing the Cabinet advice on 20 June?

- Consider whether the notes of the wash up meeting held between the Welsh Government and the company which was held on 30 June, can be shared with the Committee.

- Confirm whether Welsh Government officials confirmed to the Circuit of Wales principals that there were no outstanding issues the Friday prior to the Cabinet decision.

I have also agreed with the Cabinet Secretary for Finance and the Cabinet Secretary for Economy & Transport that I would copy Adam Price AM into this letter to respond to his questions that he raised in Plenary on the 7 February 2018 as they are closely linked to the above, these questions were:

- So, was the company told, in advance of the Cabinet's decision, about the assessment that the Permanent Secretary described in terms of the need to reduce the guarantee further?

- And, also, were they told on the preceding Friday, before the Cabinet decision, that there were no major problems?

- Specifically, again, can I ask the Cabinet Secretary if the official or officials in the Welsh Treasury that gave that classification advice on 20 June were aware, at that time that the guarantee only commenced when the project was completed?

Mr Adam Price AM has also asked a number of Welsh Assembly Questions based on the areas covered above, which have been answered through the normal WAQ process. The responses to these questions are included as Annex 1.

The responses to the Committee's follow up questions and those questions asked in Plenary by Mr Adam Price AM are given in Annex 2 to this letter.

Having reflected carefully on the transcript of the 5 February oral evidence session, I think it might be helpful to the Committee if I set out in this letter some further clarification and explanations that may help to allay some of the concerns expressed by members during that hearing.

While the classification issue, and the responsibility of the Welsh Government to manage risk prudently in what is a highly complex area, played a significant part in the assessment of whether to support the Circuit of Wales proposition, it was by no means the sole issue informing that assessment. Indeed, other issues of a more commercial nature gave cause for concern as detailed in the published due diligence reports on this project, such as job creation claims or the viability of the business model. Hence the Welsh Government's decision not to support this scheme did not come down to a narrow interpretation of accounting rules.

During the scrutiny session, the Permanent Secretary commented:

Ministers gave the project promoters a great deal of time and support to try and make this project work. There were a number of very different iterations of that project, which required different amounts of funding from the Welsh Government, which responded to concerns that were raised between 2011 and, in fact, last summer. So, we're talking about a period of more than six years of

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considering this project. Why was that? Because we felt that there was a potentially huge opportunity—a major private sector investment in a part of Wales that's received very little private sector investment in recent years—therefore, the Welsh Government was prepared to put a great deal of time into trying to develop a successful project. We applied very comprehensive due diligence to the final proposal. A summary of some of that due diligence has been published.27

It was assessed to be a very high-risk project with most of the risk, in fact, being borne by the Welsh Government. It was also assessed that the benefits of the project, in particular the estimate of jobs created by the initial circuit element of the proposal, were, at best, very uncertain. As Andrew has indicated, there was a very strong likelihood as well that the asset and the associated debt, which was around £370 million, would be classified to the Welsh Government.

The risks that would have fallen on Welsh Government were primarily financial in nature. In the event that at any time after completion of construction Circuit of Wales Ltd (CoW) had been unable to meet, in whole or in part, the cost of the finance provided by the key funder then Welsh Government would have been liable to meet that underpayment. Similarly there was a risk that CoW may have been unable to pay the fee payable to the Welsh Government for the provision of a guarantee. Any underpayment of this fee would also create an elevated risk of state aid challenge. This inability to pay the key funder or Welsh Government would most likely have been triggered by Circuit of Wales failing to generate the required income, or by the collapse into insolvency of the company.

Additional risk existed in a number of non financial aspects. In the initial award of the guarantee contract and the subsequent operations there was risk of state aid challenge, though the financial impact of a state aid penalty would fall on the company not on the Welsh Government. Another key risk was the potential failure of the project to deliver anticipated economic benefits for Wales. Within the operational phase of the circuit, any underperformance of the business could also impact on the direct and supply chain jobs and the wider tourism economy if spectator numbers fell short of expectations. It should be noted that the bulk of the jobs and economic impact were expected to arise from the automotive technology park which did not form part of this phase of the project.

When assessing the risks associated with the classification of any debt, the risk associated with that debt needs to be considered. Subordinated debt, or junior debt, represents the obligations that rank lower than all other loans and securities with respect to the claim on a firm’s assets. If the borrower defaults, the creditors of subordinated debt will be compensated after all other debt holders are paid in full. Hence junior debt is a greater risk and, as such, commands a higher return.

The proposed Welsh Government support for the Circuit of Wales was junior to the other funding instruments apart from equity. The Manual of Government Debt and

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Deficit (2016) (MGDD) (published by Eurostat) requires that riskier debt instruments (such as junior or subordinated debt) be risk adjusted. Whilst this risk provision is in the Public-Private Partnerships (PPP) chapter of MGDD, and whilst the Circuit of Wales was not a PPP, HM Treasury cautioned Welsh Government to consider this principle in the analysis. Bearing this advice in mind, the Welsh Government did not judge it prudent to assume that Eurostat would not apply the provision to non-PPP schemes. After adjusting Welsh Government support to take relative debt risk into account, the guarantee would have been more than 49% of total project costs, even if a liberal attitude were taken to total project costs as presented by the company. There was therefore a significant risk that the borrowing would score to Welsh Government budgets.

While the ONS sets out a formal process for its taking of classification decisions, there is no mandatory requirement to consult the ONS on such matters. Indeed, it is right and proper for officials to make their own assessments based on the relevant guidance. Formal advice on the Circuit of Wales would only have been sought from the ONS if relevant documentation was in a near-final form and a decision in principle to offer Government support had been made.

Welsh Treasury officials were responsible for developing the classification advice, which was formulated with input from the HM Treasury classification team. While the Welsh Government is not required to consult HM Treasury, due to the complexity of the proposal, and in acknowledgement of HM Treasury's greater expertise in the specific subject matter, numerous exchanges with HM Treasury officials took place. The advice from Welsh Treasury and external due diligence reports were utilised to develop the Cabinet paper, which was subject to a formal scrutiny and an advanced assurance and approval process prior to submission to Cabinet.

I hope this additional information provides you with assurance that the processes undertaken to consider the proposal for the Circuit of Wales were thorough and robust. I would like to reiterate that whilst there has been a level of focus on the balance sheet treatment of the debt, this was only part of the rationale for rejecting the request for funding for this complex project.

Yours,

Shan Morgan

Shan Morgan
Ysgrifennydd Parhaol/ Permanent Secretary
Llywodraeth Cymru/ Welsh Government

Cc: Mr Adam Price AM

Annex 1

Relevant Welsh Assembly Questions Reponses

WAQ75888

Adam Price (Carmarthen East and Dinefwr): Will the Welsh Government publish its notes of the meeting with the Heads of the Valleys Development Company on 30 June 2017, if the company is not opposed to this? WAQ75888 Tabled in Welsh

Ken Skates: My officials are currently discussing this with the company. The notes will be published if the company agrees.

WAQ75889

Adam Price (Carmarthen East and Dinefwr): Was the Welsh Treasury official who gave advice on 20 June 2017 on the balance sheet classification issue regarding the Circuit of Wales aware at that time that the Welsh Government guarantee did not cover any element of the project revenue? WAQ75889

Ken Skates: Welsh Treasury officials who advised on the balance sheet classification issue regarding the Circuit of Wales were aware at that time of the information relevant to that issue.

WAQ75890

Adam Price (Carmarthen East and Dinefwr): Was the Welsh Treasury official who gave advice on the balance sheet classification issue regarding the Circuit of Wales on 20 June 2017 aware that 100 per cent of the construction risk was held by the private sector at the time the advice was given? WAQ75890

Ken Skates: Welsh Treasury officials who provided advice on classification were aware of the relevant details of the proposal at the time of providing that advice. Whether the guarantee only commenced after the construction was complete would not have made a difference to the assessment of classification risk.

WAQ75891

Adam Price (Carmarthen East and Dinefwr): Did the Welsh Treasury official who provided advice on the balance sheet classification issue on the Circuit of Wales on the 20 June 2017 apply weightings to the financial risk based on the subordination and not the risk of exposure? WAQ75891

Ken Skates: Weighting was applied to the share of costs guaranteed by Welsh Government, given its subordinate nature in the capital structure and hence greater exposure to risk.

WAQ75892

Adam Price (Carmarthen East and Dinefwr): What was the reason for the removal of the developer's equity in the calculations of the balance sheet classification risk relating to the Circuit of Wales by the Welsh Treasury official who gave advice on 20 June 2017? WAQ75892

Ken Skates: Developers' equity was not removed in the calculations of the balance sheet classification risk.

WAQ75893

Adam Price (Carmarthen East and Dinefwr): Did Welsh Government share with UK Treasury the paper produced for it showing all the mitigating steps available to Circuit of Wales such as capex deferral, asset sales, operational cost reduction, refinancing, commercial renegotiation and lifecycle cost deferral that would preserve earnings to satisfy the loan exposed to the guarantee? WAQ75893

Ken Skates: Officials shared relevant information with UK Treasury on this matter. However, officials do not recognise the paper you refer to in your question.

Annex 2

Welsh Government Response to Questions from PAC and Adam Price

Question 1

Whether the general issue about the size of the guarantee and that any solution would only be achievable if the Welsh Government guarantee were to be reduced by at least 50 per cent was communicated to the company prior to the Cabinet decision.

Adam Price AM
So, was the company told, in advance of the Cabinet's decision, about the assessment that the Permanent Secretary described in terms of the need to reduce the guarantee further?

Welsh Government response
The Welsh Government did not arrive at a formal conclusion as to what level of guarantee would not give rise to a significant classification risk. Given the scale of investment and the commercial risk to which the Welsh Government would have been exposed in the proposed structure, a much smaller guarantee would have been needed to mitigate the risk of an adverse classification ruling – a reduction potentially of more than 50%. However, no definitive number could be established in the abstract.

Hence HOVDC was not made aware by the Welsh Government, prior to the Cabinet decision, that a reduction of at least 50% in the requested government guarantee would be needed. Furthermore, reducing the classification risk would not necessarily have made the project suitable for Welsh Government support. Classification risk is not the same as commercial risk. Mitigation of the classification risk by reducing significantly the level of the guarantee would have foreseen a project with a very different risk and reward profile than that which the Welsh Government was asked to consider.

Question 2

Was the fact that the guarantee only started when the project was completed, known and communicated, whether in a written form or not, by the treasury official providing advice to officials providing the Cabinet advice on 20 June?

Adam Price AM
Specifically, again, can I ask the Cabinet Secretary if the official or officials in the Welsh Treasury that gave that classification advice on 20 June were aware, at that time that the guarantee only commenced when the project was completed?

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Welsh Government response
The Welsh Treasury officials who provided advice on classification to the ESNR officials drafting the paper for Cabinet were aware of the relevant details of the proposal when they provided the advice on 20 June. Whether or not the guarantee only commenced when the project was completed was not relevant as the key criterion in the assessment was the proportion of total costs covered by the guarantee, not the point at which the guarantee could be called. As such the timing of the guarantee would not have made a difference to the assessment of classification risk.

Question 3

Consider whether the notes of the wash up meeting held between the Welsh Government and the company which was held on 30 June, can be shared with the Committee.

Welsh Government response
A note of the meeting on the 30 June was produced by officials to be retained as part of Welsh Government's internal record on the project. In line with standard practice for internal documentation, the notes were not shared externally at the time. However the notes were circulated shortly after the meeting to Welsh Government officials in attendance and it was agreed that the note was a fair record of the meeting.

In light of the possible disclosure of the Welsh Government's internal note of the meeting, it has been shared with representatives from HOVDC in attendance.
The original notes of the meeting approved by Welsh Government officials for internal use only are provided as Annex 3. The redactions are the identity of junior officials and the identity of the key funders for the project due to commercial sensitivity. The note has not been agreed with HOVDC.

Question 4

Confirm whether Welsh Government officials confirmed to the Circuit of Wales principals that there were no outstanding issues the Friday prior to the Cabinet decision.

Adam Price AM
And, also, were they told on the preceding Friday, before the Cabinet decision, that there were no major problems?
Welsh Government response
An informal meeting was held with HOVDC on Friday 23 June, as part of the programme of pre-arranged regular progress meetings. Officials did not confirm to HOVDC that there were no major problems or outstanding issues. However, officials did confirm that there was no additional information being sought from HOVDC prior to Cabinet considering their decision.

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Annex 3

Notes of meeting with HOVDC to discuss Balance sheet issue re Circuit of Wales 30 June 2017

Attendees: Mick McGuire (MMcG) – Welsh Government
Andrew Jeffreys (AJ) - Welsh Government
[redacted] (XX) – Treasury, Welsh Government
[redacted] – Welsh Government
Richard Parry-Jones (RPJ) – HOVDC
Gheeve Changizi (GC) – HOVDC
Martin Whittaker (MW) – HOVDC
Michael Carrick (MC) – HOVDC

1. AJ and XX introduced their roles within WG treasury.

2. MMcG stated that the primary reason of the meeting is to discuss issues arising from the likely classification of the Circuit of Wales (CoW) project. The discussions at the meeting are to be treated as confidential.

3. HOVDC stated that they were disappointed and disenchanted in the decision not to support the project. They had previously worked with Treasury on balance sheet treatment of similar projects. They had asked for the meeting to better understand the WG decision and to discuss if this can be taken forward. They also stated their disappointment in the lack of communication on the way forward.

4. WG – Economic activity is recorded and classified in the national accounts based on rules provided by Eurostat. The budgetary treatment flows from whether this activity is classified to the public or private sector. ONS would classify the company. Its debt would be classified to the public or private sector accordingly. WG have had concerns on whether the debt would be classified to the public sector for some time. AJ has been aware of the project for some time and of potential issues with classification since around spring 2016. AJ met with MC at that time, when classification was discussed. At that time the guarantee was bigger than the recent proposal. Classification was not therefore a new concern. MC acknowledged their earlier meeting and said he was confident then that it would not be classified on balance sheet and he remains bullish today.

5. MW – In July 16 there was a meeting where HOVDC talked about the balance sheet concerns and shared examples of projects underwritten by government where the debt was not on the balance sheet. HOVDC have always understood that the project costs for the CoW needed to be off the Welsh Government balance sheet. HOVDC still cannot see how the current proposal could be on the balance sheet. They need to understand what parts of the proposal in terms of contracts and the risks that means the debt will end up on the Welsh Government balance sheet. HOVDC needs to understand that if they have different views on this than WG what can be done to take the project forward.

6. WG – There has been no ONS decision at this time as they will only give a classification decision on an actual contractual proposition. This process could take

between two or three months. It would take longer if a decision were referred to Eurostat, which AJ thought was possible given the novel nature of the proposition, and its high public profile. AJ said that advice had been sought by Ministers on whether there was a risk that CoW would be classified to the public sector; and that advice had been given, i.e., that there is significant risk that CoW and its debt would be classified to the public sector and hence hit the Welsh Government budget.

7. WG confirmed that advice had been sought from UK Treasury, and that discussions around the relevant guidance had been taking place with the ONS and Eurostat for some time. The UK Treasury's view is that elements of the proposal did give rise to a risk that the debt will be classified to the public sector.

8. Eurostat has recently reissued the PPP guidance on classification as set out in the Manual on Government Deficit and Debt (MGDD, 2016). Guidance on other types of transactions is not as comprehensive, although Eurostat will now begin the work of revising other chapters in the MGDD. Advice has been received that the guidelines on PPP classification can to some extent be used as a benchmark for classifying other types of transaction – applying a relevant risk weighting to debt that is exposed to a higher level of risk being a case in point. Whilst the WG guarantee can be seen as technically less than 50% applying a risk weighting to reflect the junior nature of this debt in the capital structure would increase the percentage to over 50%.

9. Whilst the equity is the riskiest bit of the capital structure, the WG guaranteed tranche of £210m is riskier than the [redacted] and non-guaranteed [redacted] funding. As the guarantee is more junior to this latter funding, this will increase the risk weighting. It doesn't need to be weighted very heavily to get the risk-weighted percentage funding over the 50% limit.

10. Furthermore, there were concerns that, even without applying a risk weighting, the guarantee was over 50% of the project costs. The project costs appeared to double count certain elements of funding as the equity appeared to be sourced from the senior debt, rather than being additional. It was possible therefore that the ONS would discount certain things, possibly reducing the project costs to £373m, so £210m out of £373m is more than 50% (56%). Risk weighting would exacerbate this.

11. WG stated that the MGDD has different sections within it eg guarantees, PPP. Eurostat have updated the guidance on PPP, and whilst CoW is not a PPP some of the key principles can be applied to an assessment of the classification of its debt. It is believed that there is a significant risk that CoW could be classified to the public sector as public corporation.

12. HOVDC stated there was no governance or control by the WG, no risk of the delivery of construction. There are lots of examples out there which are not on balance sheet. They were astonished that the PPP guidance is being applied for something that is very different. There are lots of projects where this treatment does not apply. The key criteria is that it's less than 50%.

13. WG stated that a guarantee equating to less than 50% could mean, other things equal, that it would not be classified to the public sector as a public corporation. But this was not a question where the WG or the UK had discretion. The approach was rules based. Officials’ role is to provide advice to Ministers on risk in the context of those rules. HOVDC could reduce the classification risk by reducing the amount being guaranteed or by increasing the ranking of the debt such as it was genuinely pari passu with the most senior debt, or a combination of the two.

14. RPJ – HOVDC have calculated the percentage as 49.8%

15. WG – The numbers aren’t necessarily approached in this manner for reasons already cited. Equity is funded by the debt so it is arguably double counted – borrowing is recycled back into the funding package, so the equity element appears to give an inflated figure for the cost of the project. Need to focus on the capital cost of the project primarily. But even if the value of equity were included in the project cost, f the risk weighting of the guaranteed tranche still will make the total percentage greater than 50%.

16. The due diligence work on the project enabled WG to see the figures in some detail for the purposes of classification for the first time – a reliable assessment could not be made until the DD process was completed. The assessment made on the basis of these figures, for the reasons already cited, is that there is a significant risk that CoW would be classified to the public sector. However ONS is the ultimate arbiter of these decisions, and a formal decision cannot be taken unless the relevant documents are submitted to the ONS for assessment.

17. HOVDC stated their exposure to the funding and the return on the equity should not be discounted. The level of security is an issue.

18. WG stated the only element of the funding considered is the value of the guarantee and not the likelihood of it being called.

19. RPJ stated that if the guarantee is called then the repayment is over a long period of time.

20. WG stated the assessment is on what the guidelines state. No discounting process is required under the guidelines for the purposes of establishing the relevant percentage of government financing in the form of a guarantee.

21. HOVDC stated that the Ernst and Young report states that the process being discounted is key.

22. WG restated that discounting is not a factor for the classification assessment. This was more about the treatment of the debt covered by the guarantee in the national accounts.

23. RPJ said in the worse case scenario and the guarantee is called on the day after the construction is completed. Is the classification based on the DCF value or the nominal value?

24. WG stated it doesn't matter if the guarantee is called – ONS is only working out whether the debt is in the private or public sector. As the debt is repaid the debt on the Government's balance sheet would reduce.

25. HOVDC stated that this is an inflexible process. If the project is a success and the guarantee is not called or the guarantee is bought out are WG still saying that the guarantee would still be on the balance sheet?

26. WG – the UK government is very compliant with the Eurostat rules. The purpose of the rules is to make sure it is clear whether Government is liable for the debt or not. The classification is not a permanent arrangement – if there is a significant change in the capital structure then it would be possible to seek to change a classification decision. It was reiterated that ONS could only take a decision at a point in time on the contractual conditions agreed at that point in time – if contracts are varied then reclassification would be required. The ONS cannot make a decision based on outcomes that might or might no come about.

27. WG – our assessment is that there is a risk that CoW debt would go on the balance sheet with a real opportunity cost for WG.

28. HOVDC stated the guarantee does not contractually start for 27 months. So why do we need to worry about the classification now and why can't we wait until then?

29. WG stated that it is not a simple as that. The fact that WG was obliged to guarantee the debt associated with the company would still need to be considered now. The fact that the guarantee is a contingent liability in terms of its being called did not mean it was not also a contractual obligation which means it needs to be dealt with at the start. It is not up to WG how the debt is classified – ONS would need to make the decision.

30. HOVDC stated they need to sit down with their advisors to work this through. HOVDC are still on a different page on this and believe this is not consistent with how other projects are being classified.

31. WG disagreed with this comment.

32. HOVDC – what would the impact be if the guarantee is reduced to £100m and equity was significantly increased?

33. WG – WG would need to consider the impact on classification if such a proposition were made.

34. HOVDC stated that this process has taken 7 years but without a steer on this point. There have been massive costs and they don't understand why this opinion was not provided previously. HOVDC appreciated the additional insight to the decisions made – whilst they did not agree at least they understood the rationale. The issues identified need to be addressed and a way forward needs to be found. HOVDC asked for another meeting, face 2 face, to take this forward.

35. MMcG would discuss this request with the Minister and will come back once a decision has been made

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