
Cynulliad Cenedlaethol Cymru
Y Pwyllgor Cyfrifon Cyhoeddus

National Assembly for Wales
Public Accounts Committee

Mr Michael Carrick
Heads of the Valley Development Company

By email:

michaelcarrick@aventacapital.co.uk

14 March 2018

Dear Mr Carrick,

As you may be aware the Public Accounts Committee has been considering issues arising out of the initial funding of the Circuit of Wales, as highlighted in the Auditor General for Wales 2017 report. Through the course of the inquiry we have also received evidence on the decision making process around the cabinet decision not to provide the support requested by the Heads of the Valley Development Company.

As part of this consideration, the Committee has been provided with a copy of the note of the meeting held between HODVC and the Welsh Government on 30 June 2017. The Committee notes that the Welsh Government advise that this note has not been agreed with you. I am therefore writing to clarify whether you consider this note to be a true and accurate record of the meeting.

I would be grateful for a response by 6 April 2018, to aid the Committee's deliberations on this matter.

Yours sincerely,



Nick Ramsay AM
Chair



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Nick Ramsay AM
Chair
Public Accounts Committee
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16 March 2018.

Dear Mr Ramsay

PAC – Circuit of Wales

Thank you for your letter of 14 March 2018 in which you sought our view on whether the file note produced by the Welsh Government of a telephone discussion on 30 June 2017 was a true and accurate record of the meeting.

The Welsh Government did reach out to us on 14 February 2018 with a file note of the phone call which I circulated to the other participants on the call : Richard Parry-Jones, Martin Whitaker and Gheev Changizi of Kleinwort Hambros.

We internally discussed the note and reverted back on the 20 February with our marked-up comments over areas where we disagreed with the position stated and seeking redaction of commercially sensitive identities of funding partners that had not consented for their disclosure. We were advised that the PAC would be provided with a copy of our agreed note. A series of iterations then occurred where:

- On 22 February Welsh Government advised that they would provide the file note as drafted by WG but would attach our detailed comments as an appendix; then
- On 5 March, Welsh Government advised that they would not be providing our detailed comments but provide a statement that HOTVDC was not provided with the note at the time and had requested changes to three areas; then
- On 7 March, Welsh Government advised that the file note that had been provided to the Public Accounts Committee did not contain any commentary regarding HOTVDC other than to inform that this had not been agreed with HOTVDC.

I would therefore advise that the note provided to the Public Accounts Committee was not an agreed position and in our opinion did not reflect a true and accurate reflection of the meeting. For completeness I attach a copy of the note that we marked up and sent to the Welsh Government.

I would also emphasise that unlike other meetings with Welsh Government over this period we were not provided with a file note of the conversation at the time.

Yours sincerely



Michael Carrick
CEO

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
Steve Davies (SD) – Treasury, Welsh Government
Tracey Mayes – Welsh Government
Richard Parry-Jones (RPJ) – HOVDC
Gheev Changizi (GC) – HOVDC
Martin Whittaker (MW) – HOVDC
Michael Carrick (MC) – HOVDC

1. AJ and SD introduced their roles within WG treasury. AJ was introduced as the Welsh Treasury expert on balance sheet treatment and had been instrumental in the assessment. AJ clarified he was not an expert but engaged with experts in UK 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, MW and Peter Thomas 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, specifically noted that the approach agreed would be to jointly engage with the company in presenting proposals to Treasury 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-acknowledged that the project costs for the CoW needed to be off the Welsh Government balance sheet. HOVDC, nor its range of experienced advisors still cannot see/did not understand how the

current proposal could be classified on the balance sheet. They need to understand what parts of the proposal in terms of contracts and the risks that means the financial 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). All parties recognised that this was not to be considered as a PPP transaction and would likely be assessed as a concession. Guidance on other types of transactions, such as concessions, 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. It was specifically noted that this weighted approach on concessions had not received support in Treasury and no examples were able to be provided. 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 combination with the removal of developer profit 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 ██████████-secured senior funders ██████████. 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 recognised that the developers profit was a normal cost of the project and retained within the capital structure as equity. This was as a result of restrictions on distribution and alignment with developers until the facilities were operational. It was theoretically possible therefore that the ONS would discount certain things remove the developers profit, possibly reducing the project costs to £373m, so £210m out of £373m is more than 50% (56%). Risk weighting would exacerbate this. The developers profit was acknowledged as being within normal limits and there were no examples of ONS or Treasury adopting this approach on other concession or PPP projects.~~

~~40.~~

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 by officials that there is a significant risk that CoW could be classified to the public sector as public corporation if a risk weighting were applied to a concession and the costs had the developers profit removed.

~~44.~~

12. HOVDC stated there was no governance or control by the WG, no risk of the delivery of construction and that the private sector were aiming to create profit to enable long term sustainable private investment to be attracted. There are lots of examples out there which are not on balance sheet. They were astonished that the PPP weighting guidance is being applied for ~~something a concession~~ 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. HOTVDC disagreed and stated that only the construction, external advisor and staff costs and WG finance charges were being funded by debt, the normal developers profit was not being distributed and therefore was retained in the company and could only be treated as shareholder equity—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 if the treatment of weighting and removing developers profit was adopted. 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 not 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 as 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 – ~~raised a question over what level of guarantee would be considered acceptable what would the impact be if the guarantee is reduced to £100m and equity was significantly increased?~~
33. WG – ~~WG thought that the guarantee would need to be closer to £100m 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

