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Supplementary Memorandum of the Auditor General for Wales to the Public Accounts Committee

Timber Sales Contracts awarded by Natural Resources Wales

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I have prepared this memorandum for the Public Accounts Committee of the National Assembly for Wales to support its consideration of my report under the Natural Resources Body for Wales (Establishment) Order 2012 on the financial statements of Natural Resources Wales for the year ended 31 March 2018.

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Supplementary Memorandum – Timber Sales Contracts awarded by NRW

Summary

- 1 On 2 March 2017, I laid before the National Assembly for Wales a report on the accounts of Natural Resources Wales (NRW). The report set out my reasons for qualifying the 2015-16 regularity opinion on NRW's financial statements. At the same time, I provided a supplementary memorandum to the National Assembly for Wales' Public Accounts Committee (PAC) setting out further detail on my reasons for qualifying the regularity opinion. My report and memorandum related to NRW's decision to award eight high value timber sales long-term contracts to a Sawmill Operator in May 2014.
- 2 I found that in entering into the 2014 contracts, NRW:
 - did not comply with its framework of authority, in that it failed to refer the proposal to award the contracts to the Welsh Government as required by the Welsh Government's publication, Managing Welsh Public Money;
 - failed to demonstrate that it complied with public law principles in the decision-making process which resulted in the award of contracts to the Sawmill Operator; in that the decision-making process which led to the award of contracts to the Sawmill Operator was neither robust nor transparent and NRW was unable to provide me with sufficient contemporaneous documentation to adequately demonstrate the considerations it took into account in deciding to enter into these contracts with the Sawmill Operator; and
 - it was unclear whether NRW complied with State Aid rules when it entered into contracts with the Sawmill Operator. This uncertainty was created as a consequence of NRW's decision to award the contracts to the Sawmill Operator without conducting any relevant market testing, and NRW being unable to provide persuasive reasoning to support a conclusion that seeking alternative providers would have proved fruitless.
- 3 The PAC carried out its own inquiry into the matters contained within my audit report and published its report in June 2017. The report concluded 'we believe that NRW could and should have ensured that there were good governance arrangements in place in the contracting process, and in failing to establish effective governance arrangements, it is unable to demonstrate how it acted lawfully. We do not believe there is any evidence to demonstrate whether the contracts represent value for money'. The PAC's report recommended that NRW 'undertake a full evaluation of its governance arrangements relating to contracting processes, clearly setting out lessons learned with specific reference to the timber sales contracts referred to in this report'.

- 4 I subsequently qualified my regularity opinion on NRW's 2016-17 financial statements for the same reasons set out in paragraph 2. This was a consequence of the fact that the long-term contracts NRW entered into in May 2014 were still operating and the 2016-17 financial statements included income relating to these contracts.
- 5 A Memorandum of Agreement linked to the eight long-term contracts referred to in my previous report included a requirement for the Sawmill Operator to construct and commence operating a new saw line at its sawmill by 31 March 2016 (which was subsequently extended by agreement to 31 March 2017). Under the terms and conditions of the Memorandum of Agreement (which was also reflected in some but not all of the contracts), if the saw line was not constructed and operating by this date the Memorandum and contracts would terminate. In February 2017, the Sawmill Operator informed NRW that it did not intend to construct the saw line.
- 6 In March 2017, NRW entered into negotiations with the Sawmill Operator with the view to putting in place transitional contractual arrangements to take effect from 31 March 2017 when the long-term contracts terminated. The proposal was to offer the Sawmill Operator short-term contracts to cover the transitional period between the termination of the long-term contracts and NRW remarketing the timber volume in the terminated long-term contracts. These new contracts would be awarded without seeking competition from the market.
- 7 By 31 March 2017, NRW had reached an agreement in principle with the Sawmill Operator. However, on that date NRW was contacted by a timber harvesting company which had acted as the harvesting agent on the terminated long-term contracts (the Timber Harvesting Company). The Timber Harvesting Company, which is a completely separate organisation to the Sawmill Operator, asked to be included in the contractual arrangements to be put in place from 1 April 2017. NRW agreed to award some of the transitional contracts to the Timber Harvesting Company.
- 8 The long-term contracts terminated on 31 March 2017 and during 2017-18 NRW entered into 59 transitional contracts. Twenty one of the transitional contracts were awarded to the Sawmill Operator and a timber harvesting company owned by it, (the Sawmill Operator's timber harvesting company). The remaining 38 contracts were awarded to the Timber Harvesting Company.
- 9 NRW's 2017-18 financial statements record that NRW received timber income of £2.76 million in respect of the 59 transitional contracts. NRW anticipates that it will receive a further £0.18 million in 2018-19. These figures represent the net sales price of the timber after contractor deductions for harvesting and haulage.
- 10 As set out in paragraphs 19 to 21, as part of my report on NRW's accounts, I consider the regularity of transactions included within NRW's accounts. I therefore considered the regularity of the transactions included within NRW's 2017-18 financial statements relating to the transitional contracts. I was unable to satisfy myself of the regularity of these transactions and I have therefore qualified my

regularity opinion accordingly. Within this supplementary memorandum I have set out the reasons for my qualification. These are:

- a) NRW departed from its own policy as set out in its published Timber Marketing Plan 2017-22 when it entered into 59 timber sales contracts without openly marketing the timber. NRW has been unable to demonstrate that it had good reason to depart from its stated policy (see paragraphs 25 to 33).
- b) NRW's rationale for determining the volume of timber to be contracted under the transitional arrangements is not supported by the available contemporaneous documentation (see paragraphs 34 to 40).
- c) NRW is required to comply with its Framework Document and Managing Welsh Public Money, which together require NRW to refer novel, contentious and or repercussive proposals to the Welsh Government. I consider that the proposal to enter into the transitional contracts was novel, contentious and/or repercussive. Whilst NRW informed the Welsh Government of its intention to put in place transitional arrangements, it did not make a formal referral to the Welsh Government as it was required to do (see paragraphs 41 to 49).
- d) NRW's Board made a Scheme of Delegation under the provisions of the Natural Resources Body for Wales Establishment Order 2012 (the Order). This Scheme of Delegation grants delegated powers to specified NRW office holders to agree timber sales contracts on behalf of NRW. Thirteen of the transitional contracts were not authorised in accordance with the Scheme of Delegation, and I therefore consider that they were not entered into lawfully (see paragraphs 50 to 59).
- e) Article 8 of the Order states that NRW 'in considering whether or not to exercise any power conferred upon it by or under any enactment, NRW must take into account the likely costs and benefits of the exercise or non-exercise of that power'. I have seen no evidence that NRW took into account the market price of the timber being sold within the transitional contracts, when determining the contract prices. In consequence, I am not satisfied that NRW complied with Article 8 of the Order and that it took all relevant factors into account when making its decisions (see paragraphs 60 to 71).
- f) NRW is required to comply with State Aid rules. I consider that NRW did not follow proper procedures to satisfy itself that its actions complied with State aid rules when entering into the transitional contracts. It did not seek to ensure that the prices in the contracts were at market rates, and by NRW's own admission it did not consider its own legal advice which had highlighted the risk that the transitional arrangements could have State Aid implications (see paragraphs 72 to 75).

11 In consequence of the matters set out in paragraph 10, I have significant uncertainty as to whether NRW acted in accordance with its statutory duties, public law principles and State Aid rules.

- 12 Whilst my report on NRW's 2017-18 financial statements focusses on the regularity matters set out paragraph 10, in my view, there are wider lessons that NRW needs to learn.
- 13 In February 2017, NRW was facing a situation where very substantial timber contracts would terminate at the end of March 2017. Alternative arrangements were required to ensure that the ending of these contracts did not have an adverse effect on timber processors and customers, as well as NRW's own income. NRW had to act quickly, but in its haste it did not follow due process and disregarded principles of good governance. My audit found that:
- documentation of the decision-making process was wholly inadequate;
 - it was unclear who had made decisions and the rationale for those decisions;
 - contractual operations commenced in advance of written contracts being signed;
 - communications regarding the transitional arrangements, both internally and with the Welsh Government, were incomplete and on some occasions inaccurate; and
 - the proposal to enter into transitional arrangements was both significant and potentially contentious, but was not subjected to proper scrutiny. Furthermore, no written reports were made to NRW's Board or Audit and Risk Assurance Committee (ARAC) in respect of this matter prior to entering into the arrangements.
- 14 It is disappointing that the urgency of the situation arose because NRW failed to properly monitor the long-term contracts and plan for the eventuality that the contracts would terminate. NRW had already extended the requirement of the Sawmill Operator to construct the new saw line by a year to 31 March 2017, at which point, if the saw line had not been constructed and operating, the contracts would fall. A new saw line typically has a construction period of 12 to 18 months and therefore NRW should have been aware many months before March 2017 that the saw line was very unlikely to be constructed. The termination of the contracts was eminently foreseeable and NRW should have developed detailed plans which would have given the Sawmill Operator and Timber Harvesting Company time to source alternative timber supplies and NRW time to arrange to market the timber within the long-term contracts from 1 April 2017 thereby minimising market disruption.
- 15 When I reported on NRW's 2015-16 financial statements I was concerned that NRW did not appear to fully accept my criticisms of their actions and sought to downplay their significance. The fact that the issues raised in my report on NRW's 2017-18 financial statements are so similar to those included in my report on NRW's 2015-16 financial statements has confirmed that NRW did not treat the findings of my 2015-16 report sufficiently seriously.

- 16 I am, however, encouraged that when my auditors informed NRW of the provisional findings of this audit, NRW's response was constructive, there was an acceptance of the seriousness of the matters raised, and a commitment to ensure that rigorous action is taken to ensure both that policies and procedures are improved and that cultural and behavioural issues are addressed. NRW has told me that it intends to commission a full independent review of the issues raised in my report on NRW's 2017-18 financial statements. The scope of the planned review will include examining the breadth of the governance and contract management of timber sales and marketing. The findings of the review will be used to inform changes within NRW's timber sales and marketing arrangements to ensure the matters highlighted in my report are not repeated in the future. NRW is aiming to ensure that the independent review is completed in the autumn of 2018.
- 17 Included in Appendix 1 is a detailed chronology of events relating to the award of the contracts.

Reasons for qualification of my regularity opinion

- 18 Under Article 23(5) of NRW's Establishment Order 2012 (the Order), I am required to:
- examine, certify and report on NRW's statement of accounts;
 - provide a copy of the certified statement of accounts together with my report on it to NRW; and
 - no later than four months after the statement of accounts is submitted, lay before the National Assembly for Wales a copy of the certified statement of accounts and my report.
- 19 In addition to certifying that the financial statements give a true and fair view of the state of Natural Resources Wales' affairs as at 31 March 2018, I provide a regularity opinion certifying that 'in all material respects, the expenditure and income in the financial statements have been applied to the purposes intended by the National Assembly for Wales and the financial transactions recorded in the financial statements conform to the authorities which govern them'.
- 20 In providing my regularity opinion, I form a view on whether in the exercise of its functions, NRW has:
- acted within its statutory remit;
 - complied with relevant legislation;
 - acted in accordance with principles of public law; and
 - complied with the framework of authority which governs it, eg the provisions of NRW's Framework Document and ministerial directions given under Article 11 of the Order.
- 21 My regularity opinion, takes the form of positive assurance, which means that I state whether transactions are in accordance with the authorities that govern them. Where there is significant uncertainty that transactions within NRW's accounts are

irregular and/or unlawful, I am unable to provide a clear regularity opinion on the accounts. This is because positive assurance cannot reasonably be given where there is significant uncertainty.

- 22 I have doubt as to whether NRW acted in accordance with its statutory duties, public law principles and State Aid rules in awarding 59 timber sales contracts to three contractors during 2017-18. In consequence, I am unable to positively affirm that the transactions in NRW's 2017-18 financial statements conform to the framework of authority governing them. I have therefore qualified my regularity opinion accordingly.
- 23 However, a decision is not unlawful unless and until declared so by a Court (or, in the case of State Aid, a Court or the European Commission). Therefore, in the absence of a legal challenge the contracts remain valid and enforceable.
- 24 I have set out in the following section the considerations I have taken into account in reaching my decision to qualify my regularity opinion on NRW's 2017-18 financial statements.

Failure to demonstrate good reason for departing from NRW policy

- 25 For a decision of a public body to be lawful it must be made in accordance with applicable legislation and with public law principles. Public bodies must (a) take into account and (b) follow relevant policies, unless they have a good reason to depart from them. At the very least they must have stated clear reasons for the departures. A failure to do so can render a decision, and in turn an item of account, contrary to law. Public law also requires that any reasons given are substantiated.
- 26 In January 2017, NRW published a Timber Marketing Plan 2017-2022 (the Plan). The plan is essentially a policy which sets out how NRW will market timber, which will generally be on the open market. The Plan includes the caveat that 'in exceptional circumstances only we may decide to negotiate the sale of timber to customers who are able to respond quickly to unexpected events'. This implies an urgency requirement insofar as the decision would be to negotiate with customers who are able to respond quickly.
- 27 I have considered whether NRW was faced with exceptional or unexpected and urgent circumstances which meant that it could rely on the caveat within the Plan to enter into timber sales contracts without seeking competition. It might be expected that the early termination of the long-term contracts, resulting from the decision of the Sawmill Operator not to construct a new saw line was an unexpected event.
- 28 However, as set out in paragraphs 13 to 14, this event should have been expected if NRW had managed the long-term contracts differently. I also note that on 15 March 2017, NRW's then acting Head of Commercial Operations (now permanent in post) wrote to the Sawmill Operator stating 'we believe that the action we need to take is to bring these [long-term contracts] to a close and re-market the

equivalent volume in accordance with the direction set out in our recently published five-year [Plan]’.

29 I consider that there was not an urgent or exceptional circumstance, and NRW was not entitled to rely on the caveat within the Plan. In my view, NRW departed from its policy when it decided not to openly market these timber contracts in 2017-18.

30 I acknowledge that public bodies may depart from their own policies where they first considered their policy and second, are able to demonstrate a good reason to do so, and I accept that NRW could have constructed a reasoned case and rationale for departing from the Plan. For example:

- On 16 February 2017, NRW’s then Chief Executive emailed the Welsh Government stating that NRW needed to be mindful of investment made by the Sawmill Operator and the role timber processing plays in the rural economy (see Appendix 1, paragraph 2.9). I accept that NRW has a legitimate role in maintaining the market and supporting businesses.
- In May 2017, NRW’s acting Head of Commercial Operations wrote to NRW’s then Chief Executive, (albeit after the implementation of the transitional arrangements) giving the following reasons for the contract awards:
 - to avoid damaging the timber supply chain. In the event that the long-term contracts ended with no transitional provision, contractors could be put out of work through no fault of their own; and
 - to avoid adversely affecting NRW’s timber income as the lead in time for marketing timber would have resulted in a major dip in NRW’s income (see Appendix 1, paragraph 3.24).

31 Whilst the above seem like good reasons, there is little documentary evidence to show that these reasons were being considered at the time the contracts were entered into. (I have found NRW’s failure to keep proper records of its decision-making process of particular concern, see paragraph 13.)

32 Furthermore, other evidence provided by NRW suggests that NRW may have had other and/or alternative reasons for entering into the transitional contracts. These include:

- NRW was seeking to implement a new timber management IT system in the period in question. Significant difficulties were experienced which hampered NRW’s ability to openly market timber. This could have been a good reason, although NRW has not sought to rely on it and there is no documentary evidence that it was relied upon.
- On 23 February 2017, NRW’s acting Head of Commercial Operations emailed NRW’s then Chief Executive discussing the volume which could be potentially awarded under transitional arrangements. The email states that the timber volume with the long contracts for roadside logs could be remarketed in April 2017 on short-term contracts and [the Sawmill Operator] would be able to bid for new contracts alongside any other customer (see Appendix 1, paragraph 2.19). However, on 28 March 2017, NRW offered the

Sawmill Operator 49,575 tonnes of roadside spruce and larch logs and bars as part of the transitional arrangements.

- NRW's current Head of Marketing, who supported NRW's then Head of Marketing in the negotiations with the Sawmill Operator, has told my auditors that he himself would have had a different negotiation strategy to the one actually employed. He would have offered a lower transitional volume than that agreed and would have sought to negotiate harder on price.

33 I therefore consider that NRW has been unable to demonstrate that it had good reason to depart from its Plan when it entered into 59 timber sales contracts without seeking competition from the market. I am therefore not satisfied that NRW complied with principles of public law when entering into the contracts, and that the resultant transactions are lawful.

Failure to demonstrate that only relevant considerations were taken into account when determining contract volumes

34 On 22 March 2017, NRW's then Head of Marketing emailed the Sawmill Operator with a proposal to sell 194,248m³ obs of timber¹ to the Sawmill Operator under transitional arrangements (Appendix 1, paragraph 2.25). Of this volume 8.1% was for roadside log and bars. The offer equated to 41.1% of the existing long-term contract volumes. On 28 March 2017, at a meeting with the Sawmill Operator, NRW increased the offer to 251,973m³ obs. Of this volume 24.4% was roadside log and bars. The revised offer represented 43.3% of the long-term contract volume (Appendix 1, paragraphs 2.32 to 2.36).

35 NRW told my auditors that the volume offered was determined by a combination of objectives, to:

- provide continuity of supply to timber processors to enable them to meet their contracted commitments;
- give the forestry contractors time to find alternative work; and
- give NRW the lead in times needed to re-market the timber over a phased period to avoid placing an excessive amount of timber on the market at any one time.

36 However, in my view, NRW's position on this matter is inconsistent with contemporaneous documentation which suggests that the volume was linked to the value of investment the Sawmill Operator maintained it had made to its premises, rather than the factors set out in paragraph 35 above:

¹ One tonne in weight of softwood timber is equivalent in volume to approximately 1.24 cubic metres obs

- An internal NRW briefing note dated 17 February 2017, setting out options for transitional arrangements set out the proposal that transitional volume would be proportionate to the amount of investment the Sawmill Operator had undertaken at its sawmill (see Appendix 1, paragraphs 2.10 to 2.11).
- In an email dated 20 February 2017, NRW's acting Head of Commercial Operations instructed NRW's then Head of Marketing 'refine your de-commitment profile based on reducing the total transitional volume to 40%' (see Appendix 1, paragraph 2.14).
- On 31 March 2017, NRW's then Head of Marketing emailed NRW's then Chief Executive, setting out the rationale used for determining the volume offered, 'we used a swings and roundabout approach to make the whole volume fit the ratio of the proportion of investment made by [the Sawmill Operator]' (see Appendix 1, paragraphs 2.52 to 2.53).

- 37 It is unclear why the transitional volume increased between 22 March 2017 and 28 March 2017. NRW's response to this question is that 'NRW quickly recognised that the setting up and tendering of those contracts would have risked NRW's ability to deliver its overall programme by missing the crucial Spring and early Summer 2017 market. In turn this would have caused disruption to the supply chain and the ability for contractors to find alternative work. Consequently, an increase in transitional volume was agreed.' Whilst I acknowledge that this may have been the reason for increasing the offer volume, NRW holds no contemporaneous documentation to support its position. Furthermore, NRW has been unable to provide me with any contemporaneous documentation that sets out the decision to significantly increase the proportion of roadside timber relative to standing timber within the offer to the Sawmill Operator.
- 38 NRW has acknowledged that 'the business rationale, risk appetite and documentation in support of the calculations of transitional volume should have been much clearer and subject to wider scrutiny.'
- 39 Public law requires public bodies to take into account all relevant considerations and disregard irrelevant considerations when reaching decisions. One way in which public bodies can demonstrate that they have complied with this principle is by fully documenting the considerations they have taken into account.
- 40 NRW's failure to properly document the decision-making process that led to the award of the transitional contracts in general, and the determination of the transitional volume in particular. This means that I now have significant uncertainty as to whether NRW took into account all relevant considerations, and disregarded irrelevant ones.

Failure to refer novel, contentious and/or repercussive activities and proposals to the Welsh Government

- 41 The principal document that provides authority for NRW transactions is the Framework Document. The Framework Document sets out that payment of grant-in-aid to NRW is conditional upon the satisfactory performance by NRW of all its obligations, which includes compliance with the Welsh Government publication, Managing Welsh Public Money. The requirement to comply with Managing Welsh Public Money relates to section 70 (2) of the Government of Wales Act 2006 (2) which states that 'the Welsh Ministers may attach conditions to the giving of financial assistance by them; and the conditions which may be attached include, in particular, conditions requiring the repayment of the whole or any part of a grant, or the making of any other payments, in any circumstances.'
- 42 Under the title 'Expenditure', paragraph 3.9.1 of the NRW Framework Document says that: 'NRW shall comply with the delegations set out in Annex 5'. Annex 5 sets out that approval of the relevant Welsh Government sponsor team is required for any novel, contentious or repercussive proposals.
- 43 Paragraph 3.9.8 of the Framework Document provides that NRW's income-generating activity must be undertaken in accordance with the terms of Managing Welsh Public Money and the Framework Document. In addition, paragraph 1.2.9 of the Framework Document states that the Chief Executive of NRW, as Accounting Officer, is personally responsible for ensuring compliance with the requirements of Managing Welsh Public Money.
- 44 I have considered the latest version of the Welsh Government's Managing Welsh Public Money (January 2016). This document says 'paragraph 3.8.2: The framework document (or equivalent) agreed between a public body and its sponsor Branch always provides for the sponsor Branch to exercise meaningful oversight of the public body's strategy and performance, pay arrangements and/or major financial transactions, eg by monthly returns, standard delegations, exception reporting. Public bodies should refer to their sponsor Branch any issues which appear novel, contentious or repercussive'.
- 45 The NRW Framework Document sets out in relation to expenditure that NRW must obtain written approval in advance of proceeding with any proposal which could be considered to be novel, contentious or repercussive. However, for income (including disposal proceeds from the Welsh Government Woodland Estate) it states 'NRW must seek as far as possible to maximise its income... where this is consistent with its functions and is in line with the agreed Corporate Plan'.
- 46 In my view, NRW was required to refer to the Welsh Government any novel, contentious or repercussive proposals relating to income. I consider that the transitional contracts were novel, contentious and/or repercussive because:
- the contracts were not advertised on the open market and were not awarded in accordance with NRW's Timber Marketing Plan (see paragraphs 25 to 33).

- the contracts with the Timber Harvesting Company had a clause described as 'exceptional' by NRW (the clause required the Timber Harvesting Company to sell spruce and larch logs and bars to the Sawmill Operator, see Appendix 1, paragraph 3.8).
- NRW clearly regarded the termination of the long-term contracts and the introduction of transitional arrangements to be significant matters as it felt it necessary to communicate with the Welsh Government in relation to these matters.

47 I acknowledge that NRW did communicate with the Welsh Government regarding its intention to enter into transitional arrangements. Emails from NRW on 15 March 2017 and then on 3 April 2017 to the Welsh Government set out in broad terms NRW's intention to contract with the Sawmill Operator, and provided a schedule of the timber volumes NRW was seeking to contract with the Sawmill Operator (Appendix 1, Paragraphs 2.23 and 2.49). However,

- neither the Welsh Government nor NRW regard these communications as being framed as a referral of novel, contentious or repercussive proposals in accordance with Managing Welsh Public Money, and the Welsh Government did not treat it as such; and
- the communications did not provide full details of the proposals. As set out in Appendix 1, paragraph 2.50, they did not make mention of the proposal to contract with the Timber Harvesting Company and they did not accurately record the volume to be contracted under the transitional arrangements.

48 NRW now accepts that the proposals should have been referred to the Welsh Government as novel, contentious and/or repercussive and takes the view that approval should have been sought to enter into the transitional contracts.

49 I consider that NRW did not meet the requirements of the Framework Document and Managing Welsh Public Money to refer a novel, contentious and/or repercussive proposal to the Welsh Government. I consider that the transactions related to these contracts which are included within NRW's financial statements for 2017-18 were outside the framework of authority governing them and are therefore irregular. In consequence, I have qualified my regularity opinion on NRW's 2017-18 financial statements.

Failure to comply with NRW's Scheme of Delegation

50 The functions of NRW are set out in the Natural Resources Body for Wales Establishment Order 2012 (the Order). These functions include undertaking any devolved function of the Forestry Commissioners. NRW is therefore empowered to manage the publicly-owned forest estate and to make decisions necessary to effectively carry out that function. The 2012 Order sets out that NRW may delegate the exercise of its functions to a committee, sub-committee, member or employee of NRW. This includes entering into contracts with external suppliers and purchasers.

- 51 NRW's Board has approved a Financial Scheme of Delegation called 'Managing Our Money' under which all financial activities of NRW have been delegated to an agreed level of authority or specific post holder. It allows the Board to delegate decision-making responsibility for certain financial matters.
- 52 The Scheme of Delegation is the method by which NRW's Board delegates its function of entering into contracts to individual members of staff and is a mechanism for risk management and financial probity. If contract authorisations are non-compliant with the Scheme of Delegation transactions in respect of those contracts will be items of account contrary to law.
- 53 As set out in Appendix 1, paragraph 3.3 to 3.5, the Financial Scheme of Delegation sets out the office holders authorised to enter into timber sales contracts, and the contract values to which their delegations extend.
- 54 Each of the transitional contracts were authorised individually by NRW officers.
- 55 As set out in Appendix 1, paragraph 3.6, 13 of the 59 transitional contracts were not authorised in accordance with the Scheme of Delegation. NRW has been unable to provide evidence that five contracts were authorised and eight were authorised by NRW officers without the necessary delegation to authorise contracts awards of the value they signed off.
- 56 The estimated value of the contracts not properly authorised was £2,752,248 and NRW received income in respect of these contracts of £1,868,773 in 2017-18.
- 57 I further note, that NRW's Financial Scheme of Delegation 'requires some delegated actions to be reported at Board level, when they involve either significant sums of money or where they are potentially contentious, novel or sensitive'. As set out in paragraphs 41 to 49, I consider that the decision to award these 59 transitional contracts was novel and contentious. The decision to award the transitional contracts was not reported to NRW's Board, and therefore I consider this a further breach of NRW's Scheme of Delegation.
- 58 NRW has told my auditors that in hindsight it considers that it would have been better to have considered approving the contracts on a collective basis, in recognition of the fact that the contracts were negotiated collectively. As set out in Appendix 1, paragraph 2.15, I note that NRW's then Chief Executive stated that he needed to ratify any final agreement on the transitional arrangements, but for some reason, he did not formally authorise or ratify the arrangements. However, I acknowledge that the Scheme of Financial Delegation as drafted did not require multiple concurrent contracts awarded to a single supplier to be considered collectively for delegation purposes, nor did it give NRW's Chief Executive the power to authorise the contracts or amend the lines of delegation.
- 59 I consider that in those instances where NRW has failed to comply with its Scheme of Delegation, the transactions included within NRW's 2017-18 financial statements are contrary to law. In consequence, I have qualified my regularity opinion on NRW's financial statements.

Failure to demonstrate compliance with the requirements of NRW's Establishment Order and State Aid rules when setting contract prices

Contract Pricing

- 60 During the course of my audit of the transitional contracts my auditors experienced significant difficulty obtaining clarity from NRW in respect of
- how the prices being paid for timber sold by NRW under transitional contracts had been determined;
 - how the pricing mechanism contained within the contracts for the sale of standing trees to the Timber Harvesting Company and the Sawmill Operator's timber harvesting company was intended to operate in practice; and
 - the considerations NRW took into account when agreeing contract prices.
- 61 This lack of clarity was due to a failure of NRW to maintain adequate records of its pricing negotiations, and how rates it had agreed had been applied within the contracts themselves. In consequence, the audit was unnecessarily protracted and my auditors had to undertake considerably more work than would have been the case had NRW adequately documented its pricing negotiations.
- 62 The first reference to transitional contract pricing is set out in the notes of a meeting between NRW and the Sawmill Operator on 28 March 2017, in which NRW agreed to put forward a pricing proposal for the transitional contracts (see Appendix 1, paragraph 3.10). NRW has been unable to locate a copy of any pricing proposal it made to the Sawmill Operator.
- 63 On 31 March 2017, the Sawmill Operator emailed NRW confirming prices it would pay for spruce and larch logs and bars. The prices specified represented an increase on the larch prices in the terminated Long-Term Contracts, (Appendix 1, paragraph 3.10). An internal email sent by an NRW officer to colleagues on 21 April 2017, confirmed the prices that had apparently been agreed and also specified the amount that could be deducted from the sales price for haulage (Appendix 1, paragraph 3.13).
- 64 NRW initially told my auditors that the prices specified in the emails of 31 March 2017 and 21 April 2017 applied to all the transitional contracts, including the contracts for the sale of standing trees awarded to the Timber Harvesting Company and the Sawmill Operator's timber harvesting company.
- 65 However, my auditors found that the amounts specified in the haulage rates for standing sales contracts were in most cases higher than the rates set out in the email of 21 April 2017. The effect was that NRW received less income than would have been the case if the rates set out in the email of 21 April 2017 had been applied.

- 66 My auditors also found that 17 of the contracts with the Timber Harvesting Company (which NRW had classified as 'pipeline' contracts as the contracts related to forest areas where felling operations had commenced before 31 March 2017), applied the rates set out in the terminated long-term contracts. If the prices for spruce and larch logs and bars as set out in the emails of 31 March 2017 and 21 April 2017 had been applied to all the transitional contracts, I have calculated that NRW would have received £186,231 more in income during 2017-18 than was actually the case.
- 67 I accept that NRW was entitled to apply different haulage rates to the contracts with the Timber Harvesting Company and the Sawmill Operator's timber harvesting company than the ones agreed with the Sawmill Operator. I also accept that NRW was entitled to align the prices set within the pipeline contracts to those which had applied to the terminated long-term contracts. However, I find it unacceptable that NRW has kept no records setting out its reasons for applying the prices it did to the transitional contracts.
- 68 NRW may determine the price at which it sells timber, however, the market price is a relevant factor which NRW should take account in determining the contractual prices. Furthermore, the market price is relevant in terms of whether NRW is conferring a potentially unlawful advantage contrary to the State Aid rules (see paragraphs 72 to 75).
- 69 My auditors have compared the prices that NRW achieved for timber sales under the transitional contracts against:
- i. the Forestry Commission's Timber Price Indices Data to March 2017; and
 - ii. NRW's average sales prices for the first quarter of 2017-18.

Whilst this analysis does not take into account all potential variabilities, it indicates that there is serious doubt as to whether the transitional contracts were priced at market rates, (although I note that the Sawmill Operator contends that the transitional contracts it was awarded were priced at market rates). Furthermore, the prices contracted for the pipeline contracts awarded to the Timber Harvesting Company were set at the long-term contract rates. NRW had already acknowledged in an internal briefing note dated February 2017, that the income from the Sawmill Operator's long-term contracts was at that point £1m lower than could have been achieved on the open market (see Appendix 1, paragraph 2.2).

- 70 Article 8 of the NRW Establishment Order 2012 (the Order) states that 'in considering whether or not to exercise any power conferred upon it by or under any enactment, the Body must take into account the likely costs and benefits of the exercise or non-exercise of that power'. I have seen no evidence that NRW took into account the market price (and therefore, State Aid) when determining the price under the contracts. NRW has acknowledged that whilst its legal advisors advised that entering into transitional arrangements could have State Aid implications (see Appendix 1, paragraphs 2.16 to 2.17). NRW did not consider or address this risk.

71 In failing to consider whether the transitional contracts were priced at market rates, I am not satisfied that NRW complied with Article 8 of its Order and took all relevant considerations into account.

State Aid

72 The information I have considered in respect of the pricing of the transitional contracts also leaves me with doubt as to whether NRW complied with EU State Aid rules in its award of the transitional contracts.

73 State Aid is any aid granted by an EU Member State or through State resources in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, so far as it affects trade between Member States (Article 107 of the Treaty on the Functioning of the European Union). The provision of State Aid is unlawful unless authorised in advance, whether by an existing 'block exemption' or by individual authorisation granted by the European Commission in response to a notification from the relevant State.

74 NRW was advised by its legal advisors on 20 February 2017 that entering into transitional arrangements could have State Aid implications (see Appendix 1, paragraphs 2.16 and 2.17). However, NRW does not appear to have taken this advice into consideration when entering into the transitional contracts.

75 I consider that NRW did not follow proper procedures to satisfy itself that it was acting in compliance with State Aid rules when entering into the transitional contracts, as it did not seek to ensure that the prices in the contracts were at market rates, and by NRW's own admission it did not consider its own legal advice which had highlighted the risk that the transitional arrangements could have State Aid implications.

Appendix 1 – Timeline relating to the award by NRW of 59 timber sales contracts to a sawmill operator and two timber harvesting companies in 2017-18 as part of transitional arrangements

Part 1

1. Summary

- 1.1. On 2 March 2017, I laid a report on the accounts of Natural Resources Wales (NRW) before the National Assembly for Wales setting out my reasons for qualifying my regularity opinion on NRW's accounts for 2015-16. I also provided a supplementary memorandum to the National Assembly for Wales' Public Accounts Committee (PAC) setting out further detail on the matters contained within the report on NRW's accounts. These documents are available on the website of the National Assembly for Wales.
- 1.2. The report on the accounts related to the award by NRW of eight timber sales long-term contracts in May 2014 connected by a Memorandum of Agreement. Under the contractual terms, NRW agreed to sell both standing trees and pre-felled timber to a sawmill operator (the Sawmill Operator). The Sawmill Operator used a timber harvesting company (the Timber Harvesting Company) to harvest the standing trees. The Sawmill Operator agreed, as a condition of the Memorandum of Understanding and contracts, that it would construct and operate a new saw line at its Welsh premises by 31 March 2016. This deadline was subsequently extended by agreement of both parties to 31 March 2017.
- 1.3. I was unable to provide an unqualified regularity opinion on NRW's accounts for the following reasons:
 - NRW did not comply with its framework of authority in that it failed to refer the proposal to award the contracts to the Welsh Government (a proposal that was contentious and repercussive in several ways) as required by the Welsh Government's publication, Managing Welsh Public Money;
 - NRW failed to demonstrate that it complied with public law principles in the decision-making process which resulted in the award of contracts to the Sawmill Operator. I concluded that the decision-making process which led to the award of contracts to the Sawmill Operator was neither robust nor transparent and NRW was unable to provide me with sufficient contemporaneous documentation to adequately demonstrate the considerations it took into account in deciding to enter into these contracts with the Sawmill Operator. The degree of uncertainty was such that I was unable to positively conclude that the decision to award the contracts to the Sawmill Operator was regular; and
 - There was doubt as to whether NRW complied with State Aid rules when it entered into contracts with the Sawmill Operator. This uncertainty was created as a consequence of NRW's decision to award the contracts to the Sawmill Operator without conducting any relevant market testing, and NRW being unable to provide persuasive reasoning to support a conclusion that seeking alternative providers would inevitably have proved fruitless.

- 1.4. The PAC carried out its own inquiry into the matters I brought to its attention in respect of the long-term contracts and published its findings in June 2017, recommending that NRW:
- 'undertake a full evaluation of its governance arrangements relating to contracting processes, clearly setting out lessons learned with specific reference to the timber sales contracts referred to in [the] report;
 - review its delegation arrangements alongside its awareness raising of State Aid law, public law and the processes for awarding contracts. We recommend the findings of this evaluation are shared with the Public Accounts Committee to enable this Committee to monitor implementation and progress against identified changes; and
 - review its internal governance arrangements to ensure that its accounting officer, Executive Team and Board should have a much greater role in scrutinising contracting processes and the awarding of contracts. It is imperative that these processes are robust with a clear and demonstrable audit trail that decisions have been taken on a fair and sound basis'.
- 1.5. On 5 July 2017, NRW's then Chief Executive wrote to the PAC accepting in full the PAC's recommendations. I subsequently qualified my regularity opinion on NRW's 2016-17 financial statements for the same reasons set out in paragraph 1.3. This was a consequence of the fact that the long-term contracts NRW entered into in May 2014 were still operating and the 2016-17 financial statements included income relating to these contracts.
- 1.6. As set out in paragraph 1.2, a Memorandum of Agreement to the eight long-term contracts referred to in my previous report included a requirement for the Sawmill Operator to construct and commence operating a new saw line at its sawmill by 31 March 2016 (which was subsequently extended by agreement to 31 March 2017). Under the Memorandum of Agreement (which was also reflected in some but not all of the contracts), if the saw line was not constructed and operating by this date the contracts would terminate. In February 2017, the Sawmill Operator informed NRW that it did not intend to construct the saw line.
- 1.7. In March 2017, NRW entered into negotiations with the Sawmill Operator with the view to putting in place transitional contractual arrangements to take effect from 1 April 2017 when the long-term contracts terminated. The proposal was to offer the Sawmill Operator short-term contracts awarded to cover the transitional period between the termination of the long-term contracts and NRW remarketing the timber volume in the terminated long-term contracts. These contracts would be awarded without seeking competition from the market.

- 1.8. By 31 March 2017, NRW had reached an agreement in principle with the Sawmill Operator. However, on that date NRW was contacted by a timber harvesting company which had acted as the harvesting agent on the terminated long-term contracts (the Timber Harvesting Company). The Timber Harvesting Company, which is a completely separate organisation to the Sawmill Operator, asked to be included in the contractual arrangements to be put in place from 1 April 2017. NRW agreed to award some of the transitional contracts to the Timber Harvesting Company.
- 1.9. The long-term contracts terminated on 31 March 2017 and during 2017-18 NRW entered into 59 short-term contracts. Twenty one of the transitional contracts were awarded to the Sawmill Operator and a timber harvesting company owned by it, (the Sawmill Operator's timber harvesting company). The remaining 38 contracts were awarded to the Timber Harvesting Company. NRW's stated intention was to achieve 'an orderly wind down' of the long-term contracts.
- 1.10. NRW's 2017-18 financial statements record that NRW received timber income of £2.76 million in respect of the 59 transitional contracts. NRW anticipates that it will receive a further £0.18 million in 2018-19. These figures represent the net sales price of the timber after contractor deductions for harvesting and haulage.
- 1.11. Having considered the circumstances surrounding the award of these contracts, I have significant concerns regarding the regularity of the contract awards and of the transactions relating to these contracts. In consequence, I have qualified my regularity opinion on NRW's 2017-18 annual accounts. The reasons for my qualification are set out in paragraph 10 of the supplementary memorandum.
- 1.12. In this appendix, I set out the events that led to NRW entering into the transitional arrangements.

Part 2

2. Implementation of transitional arrangements

Termination of long-term contracts awarded to the Sawmill Operator in May 2014

- 2.1 On 17 January 2017, NRW's acting Head of Commercial Operations (who has since been permanently appointed to this role) emailed NRW's then Chief Executive setting out that 'our larch [Long Term Contracts] with [the Sawmill Operator] were linked to a timescale for investments at [the Sawmill Operator's premises]. The expectation was that the new line should be up and running by the end of March 2016. They were granted an extension last year to give them an additional 12 months to make the investment. [NRW's Head of Marketing] is requesting an update from [the Sawmill Operator] on progress with the investment [at its premises]. However, the indications are that there has been significant further slippage'. The email also notes that because timber prices had risen since the contracts had been awarded in 2014, they now offered poor value for money. The acting Head of Commercial Operations requested NRW's then Chief Executive's consent for him to 'take stock of the situation and options in order to brief you and to recommend a way forward'.
- 2.2 On 31 January 2017, in advance of a meeting that had been arranged with representatives of the Sawmill Operator, the then Chief Executive emailed NRW's acting Head of Commercial Operations requesting information regarding the performance of the contracts. NRW's acting Head of Commercial Operations responded on 3 February 2017 providing a draft briefing paper setting out concerns regarding the performance of the contracts which included:
- the Sawmill Operator had only made approximately £5m of the expected £17m capital investment expected at its Welsh premises and that the construction of a new saw line which was agreed in the Memorandum of Agreement had not taken place.
 - the Memorandum of Agreement required the Sawmill Operator to actively expand the market for larch products, increasing the overall value of the product base and concentrating on the development of larch timber in the construction market. The briefing paper noted that whilst the Sawmill Operator had made efforts to increase the amount of larch going to the construction market, much of the larch production at its sawmill had been used to provide sawn products for the fencing panel market, which was not a new market and did not represent either construction or a higher market value.
 - the Sawmill Operator had not been flexible in respect of the contractual pricing mechanism, and as the market value of larch had increased since the award of the contracts, NRW had received approximately £1m in income less than it would have achieved if the timber had been openly marketed.

- 2.3 The briefing paper concludes given the change in circumstances since the contracts were awarded it 'would make it extremely difficult to justify a further extension in the timetable for completing the investment'.
- 2.4 On 8 February 2017, NRW's Head of Legal Services emailed legal instructions to NRW's legal advisors seeking advice on 'the strength of our case for potentially not granting a further extension to the deadline for investments and instead terminating the contracts'.
- 2.5 On 13 February 2017, NRW legal advisors advised that if the Sawmill Operator could not comply with the deadline for construction and operation of the new site and NRW refused to agree to any request for a further extension of time, the contracts and the overarching Memorandum of Agreement which connected them would come to an end. They advised that the prospect of termination could be used as a means to renegotiate the terms of the Memorandum of Agreement and the contracts with a view to varying the agreements or entering into a new arrangement. However, any such negotiation should proceed on the basis that the negotiations were without prejudice to NRW's position that with effect from 31 March 2017 the Memorandum of Agreement and the contracts would terminate.
- 2.6 On 16 February 2017, NRW's then Chief Executive and NRW's acting Head of Commercial Operations met with representatives of the Sawmill Operator to review the contracts and to discuss the progress being made by the Sawmill Operator to construct the new saw line and commence its operation by 31 March 2017.
- 2.7 NRW's notes of this meeting record that NRW was informed by the Sawmill Operator that it was not commercially viable for it to construct the saw line it had been contracted to construct (a saw line to process small/short bars), but there was 'scope for an expansion in the capacity for larger logs' on the proviso that the long-term contracts were not terminated.
- 2.8 The notes also record that:
- the Sawmill Operator was told that if the new saw line was not constructed and operational by 31 March 2017 the contracts would be terminated; and
 - the Sawmill Operator threatened to sue NRW to recover the £4m the Sawmill Operator said it had already invested, to close its Welsh premises and that 'NRW would face some political difficulties given the employment that [the sawmill] supported and the economic contribution it makes'.
- 2.9 On 16 February 2017, NRW's then Chief Executive emailed the Welsh Government attaching a briefing document setting out an outline of what was discussed in the meeting held on 16 February 2017. The note stated that NRW would write to the Sawmill Operator setting out its position and that in drafting this letter NRW would 'be mindful of investments that [the Sawmill Operator has] already undertaken at its Welsh premises and the role that timber processing plays in the rural economy'.

2.10 On 17 February 2017, NRW's acting Head of Commercial Operations sent a draft briefing paper, (addressed to the Welsh Government) to NRW's then Chief Executive setting out the history of the long-term contracts and outlining four options for managing the timber volumes currently within the contracts with the Sawmill Operator after 31 March 2017. Against each option were set out perceived risks and benefits. The options were as follows:

Exhibit 1: options for managing the timber volumes

Option 1 – Allow the contracts to terminate at the end of March 2017 on the basis that the new saw line would not be constructed.

Option 2 – Renegotiate the long-term contracts by terminating some contracts and allowing some contracts to run for a further period or until the end of their contracted duration. The reduced volume to be calculated at 40% of the original long-term contract volume, ie proportionate to the amount of the expected capital investment (£10m) as against that actually made by the Sawmill Operator (£4m).

Option 3 – Renegotiate long-term contracts and reset the baseline unit price of timber to reflect open market timber values.

Option 4 – Agree a further extension of time for the investment and/or negotiate alternative capital investment by the Sawmill Operator to increase processing ability.

2.11 The briefing note sets out some of NRW's considerations in developing the options. These included:

- the threat of job losses could 'be expected to generate some political controversy'; and
- the Sawmill Operator would 'face a difficult position if NRW terminates the [long-term contracts]. The company has indicated that it is unable to secure finance for investments, without there being the guarantee of a significant part of the volume needed. Meanwhile other timber processors have been making significant investments without the [long-term contracts] with NRW'.

2.12 The briefing paper invited 'the Welsh Government's view on the options and recommendations'. In the event, NRW has told my auditors that its then Chief Executive decided not to send the briefing paper to the Welsh Government on the basis that it decided that the matters in the briefing paper were matters for NRW to determine. NRW did verbally brief the Welsh Government on developments but did not communicate the options it was considering to the Welsh Government.

2.13 On 17 February 2017, NRW's Head of Legal Services emailed NRW's legal advisors attaching the notes of the meeting of NRW and the Sawmill Operator on 16 February 2017) and a copy of the draft briefing note addressed to the Welsh Government (paragraph 2.2). The Head of Legal Services requested further legal

advice on the contractual issues which existed between NRW and the Sawmill Operator.

- 2.14 On 20 February 2017, NRW's acting Head of Commercial Operations emailed NRW's Head of Marketing, then Chief Executive and Head of Legal Services stating, 'I think that Option 2 is probably the most appropriate as it focusses on reduction in contracted volume, in proportion to incomplete investments, but without introducing the complication of imposing price change' and asked the Head of Marketing 'can you refine your de-commitment profile based on reducing the total [long-term contract] volume to 40%'.
- 2.15 On 20 February 2017, NRW's Head of Legal Services emailed NRW's legal advisors updating his instructions of 17 February 2017 and attaching a copy of the email from the acting Head of Commercial Operations (see paragraph 2.14). The legal instruction states that NRW's then Chief Executive 'takes the view that it is for the NRW team to deal with the negotiations with the caveat that he, as Accounting Officer, would need to ratify any final agreement (and he adds that in light of [my then draft report on NRW's 2015-16 accounts], NRW would need to consider Welsh Government and Board scrutiny)'. He also expresses the view that 'it is too early to seek Welsh Government "approval" as we don't know how the negotiations might go'.
- 2.16 On 20 February 2017, NRW's legal advisors advised that:
- as the saw line had not been constructed the contracts would terminate on 31 March 2017;
 - the fact that the Sawmill Operator had made some £4m investment was in their view irrelevant as a new saw line had not been constructed and was not operating, and they could see no possible basis of a claim against NRW by the Sawmill Operator;
 - in respect of the options outlined, there was no provisions for the original contracts to be varied and it would be preferable for NRW to negotiate new contracts; and
 - that options 2, 3 and 4 had potential State Aid implications.
- 2.17 NRW's legal advisors also returned a copy of NRW's options matrix contained within the draft briefing paper referred to in paragraph 2.10 with suggested tracked amendments in red. These amendments drew attention to the fact that renegotiating contracts with the Sawmill Operator could have procurement and/or State Aid implications.
- 2.18 On 21 February 2017, NRW's acting Head of Commercial Operations emailed a draft letter addressed to the Sawmill Operator to NRW's Head of Legal Services, copied to other NRW colleagues recording what had been discussed in the meeting of 16 February 2017 and setting out NRW's position in respect of the existing long-term contracts. The draft letter was shared with NRW's legal advisors who suggested a number of amendments to the draft.

- 2.19 On 23 February 2017, NRW's acting Head of Commercial Operations emailed the amended letter addressed to the Sawmill Operator to NRW's then Chief Executive. The covering email stated 'the final paragraph [of the letter] with the invitation to propose a wind down of the Standing Sales contracts is the avenue which [the Sawmill Operator] can negotiate a solution. About 65% of the contracted volume is Standing Sales and there are operational reasons why these should not be terminated on 31 March. The same does not apply to the roadside log contracts, where we can continue to manage the harvesting operations while we remarket the volume from April on short-term contracts which [the Sawmill Operator] would be able to bid for alongside any other customer'.
- 2.20 On 24 February 2017, NRW's acting Head of Commercial Operations wrote to the Sawmill Operator. The finalised letter states that at the meeting of 16 February 2017:
- the Sawmill Operator had been informed that if the new saw line was not operating by 31 March 2017 the contracts would terminate;
 - the Sawmill Operator threatened legal action against NRW if the contracts were terminated; and
 - the Sawmill Operator maintained that it had made £4m of capital investment at its Welsh premises.
- 2.21 In the letter of 24 February 2017, NRW's acting Head of Commercial Services also requested details of the basis of any claim the Sawmill Operator had against NRW and requested evidence of the investments that the Sawmill Operator had claimed to have already undertaken (said to be around £4m). NRW forwarded a copy of its letter to the Sawmill Operator to the Welsh Government for information.
- 2.22 On 7 March 2017, the Sawmill Operator responding to NRW's letter reiterating its threat of a legal claim. Whilst the letter listed investments made, no evidence was provided to support the amount of capital investment the Sawmill Operator maintained had been made at its premises.

Offer of future timber volume to the Sawmill Operator

- 2.23 Following receipt of the letter from the Sawmill Operator dated 7 March 2017, NRW's Head of Commercial Operations drafted a letter to the Sawmill Operator setting out NRW's position and reflecting the advice NRW had received from its external legal advisors. The letter, which was sent to the Sawmill Operator on 15 March 2017 states 'we value the role that [the sawmill] plays in the timber supply chain in Wales and wish to ensure that before the [long-term contracts] end, you have the opportunity to purchase alternative volume. We also think that in order to do this and to ensure that we secure best value for timber, we need to phase the purchasing opportunities over a period. We therefore propose to meet with you on a without prejudice basis, to discuss a profile for staggering the end dates of the [long-term contracts] in a sequence that would enable us to market the volume and provide scope for you to purchase equivalent volume. I must stress however, that the buying opportunities would be on the open market and that they are likely to be

mainly in the form of short-term contracts in line with the current Marketing Plan. If [you wish] to take up the phased closure of the [long-term contracts], we would need to enter into a new Memorandum of Agreement to cover the period as the existing Memorandum will end at the end of March'. NRW forwarded a copy of the letter to the Welsh Government to keep it informed of developments.

2.24 NRW's acting Head of Commercial Services has told my auditors that he received a phone call from a representative of the Sawmill Operator on 17 March 2017 who told him that the Sawmill Operator would like to take up the offer of discussing a 'transitional plan'. NRW's Head of Commercial Operations has told my auditors that he notified NRW's then Chief Executive and then Head of Legal Services by email and asked the then Head of Marketing to prepare a supply profile for transitional volume that could be put to the Sawmill Operator by the middle of the following week.

2.25 On 22 March 2017, NRW's acting Head of Commercial Operations emailed NRW's then Head of Legal Services asking him to prepare a revised memorandum of agreement to 'cover the period in which we are phasing out the contracts'. The email states that NRW's then Head of Marketing had produced a schedule that he would be sharing with the Sawmill Operator. Later that day, NRW's Head of Marketing emailed the Sawmill Operator attaching a spreadsheet setting out a proposed transition plan which would take effect on the termination of the long-term contracts on 31 March 2017. The spreadsheet indicated that NRW was prepared to sell the following volume of timber to the Sawmill Operator post the termination date as part of transitional arrangements.

Table 1: Transitional volume proposed to be offered to the Sawmill Operator as set out in an email from NRW's Head of Marketing to the Sawmill Operator on 22 March 2017

| | Committed pipeline | Additional volume | Total volume |
|------------------------------|---------------------------|---------------------------|---------------------------|
| Roadside timber | 7,700 tonnes | 5,000 tonnes | 12,700 tonnes |
| Standing timber | 49,500m ³ obs | 129,000m ³ obs | 178,500m ³ obs |
| Total units of supply | 57,200 | 134,000 | 191,200 |

2.26 The 'committed pipeline' volume related to completion of felling in forest areas where operations had commenced before 31 March 2017. The total transitional volume that NRW's then Head of Marketing was proposing to provide to the Sawmill Operator equated to approximately 22.9% of the timber NRW had set out in its Timber Marketing Strategy it would sell to the market in 2017-18.

2.27 The spreadsheet records that the transitional volume, when added to the volume the Sawmill Operator had already received under the long-term contracts before 31 March 2017, meant that the Sawmill Operator would have received 41.1% of the volume that had been contracted in 2014.

- 2.28 The spreadsheet also sets out NRW's plans for releasing timber (which had been part of the long-term contracts) to the market for sale by open tender during 2017-18. It states that 90,685 tonnes of timber would be released in competitive sales between 31 May 2017 and 28 February 2018.
- 2.29 On 24 March 2017, NRW's then Head of Legal Services emailed NRW's acting Head of Commercial Operations and then Head of Marketing stating that it was essential that a phone meeting took place with NRW's legal advisors to finalise the revised Memorandum of Agreement and for him and NRW's legal advisors 'to understand the emerging negotiation picture here. In particular, [has the Sawmill Operator] now indicated that [it] will go quietly and agree an orderly wind down of the [long-term contracts]?'
- 2.30 On 27 March 2017, NRW's then Head of Legal Services emailed the acting Head of Commercial Operations and then Head of Marketing reminding them that the long-term contracts would expire on 31 March 2017 without any further action from NRW and setting out further advice he had received from NRW's legal advisors referring to the need for NRW to comply with the post-termination clauses contained within the long-term contracts, namely to enable the Sawmill Operator to remove upon payment any timber felled prior to the termination date and to remove their own buildings, equipment, etc from NRW's land. He stressed that 'it is important that NRW act in accordance with all the post termination provisions in the contract and as if the contract has expired as otherwise [the Sawmill Operator] might be able to maintain that the contract has continued on the same terms and NRW has waived the termination provisions'.
- 2.31 Later that day, NRW's acting Head of Commercial Operations wrote to NRW's then Head of Legal Services stating that 'I am not sure that the post termination provisions will suffice as we are seeking to ensure a smooth transition from supply on these contracts to the commencement on new contracts (which may or may not be purchased by [the Sawmill Operator]). We aim to agree a set of staggered end dates for the various contracts with [the Sawmill Operator] tomorrow (29th). Although some contracts will end immediately and the post termination clauses may apply, others will continue for some weeks or months'. On 28 March 2017, NRW's then Head of Legal Services replied to the acting Head of Commercial Operations, 'we may be at cross purposes. I, and [our legal advisors] are not suggesting that we rely on the post termination provisions as a negotiating position'.

Negotiations with the Sawmill Operator

- 2.32 On 28 March 2017, NRW's acting Head of Commercial Operations, the then Head of Marketing and the then Head of Harvesting met with a representative of the Sawmill Operator to discuss a future agreement between the Sawmill Operator and NRW. The notes of the meeting record that the purpose of the proposal was held 'with the intention of making an agreement on volumes to be offered and worked during 2017-18 to facilitate an orderly closure of the [long-term contracts]. The proposal seeks to allow a smooth transformation of timber to market, give time for supply chain to adjust as there are hauliers and timber contractors who are attached to these contracts, some making substantial investments in labour/equipment and to allow the company time to adjust its buying profile to supply the saw mill'.
- 2.33 The notes also record that NRW offered the Sawmill Operator 41,875 tonnes of felled timber and 141,000m³ obs of standing timber over a period of one year (182,875 units of supply in total), with the volume being phased out over the four quarters of the financial year with 97.7% of the transitional volume being sold by 31 December 2017 as shown in table 2.

Table 2: Planned phasing out of transitional contract volume as per meeting between NRW and the Sawmill Operator on 28 March 2018 (excludes pipeline volume)

| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Total |
|------------------------------|--------------------------|--------------------------|--------------------------|--------------|---------------------------|
| Roadside timber | 16,750 tonnes | 12,561 tonnes | 8,375 tonnes | 4,189 tonnes | 41,875 tonnes |
| Standing timber | 78,000m ³ obs | 51,000m ³ obs | 12,000m ³ obs | - | 141,000m ³ obs |
| Total units of supply | 94,750 | 63,561 | 20,375 | 4,189 | 182,875 |
| % of transitional volume | 51.8% | 34.8% | 11.1% | 2.3% | 100% |

- 2.34 The notes of the meeting state that 'the standing sales volumes will be provided through new coupes and coupes that are currently being worked will be treated as pipeline volume. It is anticipated that the final total across all contracts will be 928,000 units of sale. This equates to 43.3% of the original offer', ie the transitional and pipeline volume, when added to the volume the Sawmill Operator had already received under the long-term contracts before 31 March 2017, meant that the Sawmill Operator would have received 43.3% of the volume that had been contracted in 2014.

2.35 The notes of the meeting refer to 'pipeline volume' but do not explicitly state whether the 182,875 units of supply offered at the meeting include 'pipeline volume' the statement that 'this equates to 43.3% of the original offer'. The statement indicates that the Sawmill Operator was offered 57,200 units of pipeline volume in addition to the 182,875 units. The offer therefore amounted to 240,075 units of supply. This represented a 29.7% increase (in m³ obs) to the proposal emailed to the Sawmill Operator on 22 March 2017.

Table 3: Comparison of transitional volume proposed to be offered to the Sawmill Operator by NRW's Head of Marketing on 22 March 2017 and the volume offered to the Sawmill Operator at a meeting of 28 March 2017

| Proposal 22 March 2017 | Committed pipeline | Additional volume | Total volume |
|-----------------------------------|---------------------------|---------------------------|---------------------------|
| Roadside timber | 7,700 tonnes | 5,000 tonnes | 12,700 tonnes |
| Standing timber | 49,500m ³ obs | 129,000m ³ obs | 178,500m ³ obs |
| Total units of supply | 57,200 | 134,000 | 191,200 |

| Proposal 28 March 2017 | Committed pipeline | Additional volume | Total volume |
|-----------------------------------|---------------------------|---------------------------|---------------------------|
| Roadside timber | 7,700 tonnes | 41,875 tonnes | 49,575 tonnes |
| Standing timber | 49,500m ³ obs | 141,000m ³ obs | 190,500m ³ obs |
| Total units of supply | 57,200 | 182,875 | 240,075 |

2.36 As well as the change in the overall volume of timber offered by NRW, as shown in Table 3, there was a significant change in the ratio of roadside timber to standing timber, resulting in the Sawmill Operator being offered a far higher volume of roadside timber than had been originally proposed on 22 March 2017.

2.37 NRW's Head of Commercial Operations has told my auditors that the offer volume was increased because the Sawmill Operator expressed major concerns that the level of supply initially offered, particularly of roadside logs, was too low to sustain the current number of shifts being operated at its sawmill. In addition, by 28 March 2017 NRW had realised that if its supply of roadside timber to the Sawmill Operator ended on 31 March 2017, it would need to remarket the equivalent log volume very quickly if it was to meet its overall sales programme. This would have proved very difficult as NRW was introducing a new timber marketing ICT system on 1 April 2017 which would have prevented NRW from setting up and tendering contracts quickly.

- 2.38 However, NRW does not hold any contemporaneous documentation setting out why the offer was increased, and the notes of the meeting of 28 March 2017 do not record the comment attributed to the Sawmill Operator in paragraph 2.37. Furthermore, NRW has been unable to provide my auditors with any evidence that the increase in the offer volume was reported internally.
- 2.39 The increase in the offer of roadside timber as part of transitional arrangements came shortly after NRW had announced in its Timber Marketing Plan 2017-2022 (January 2017) its intention to decrease its direct production working (which results in roadside sales) from 380,000m³ obs to 280,000m³ obs in 2017-18.
- 2.40 The offer made to the Sawmill Operator at the meeting of 28 March 2017 represented 29.6% of NRW's planned timber supply to the market during 2017-18. It also equated to 74% of the annual volume of roadside timber and 106% of the standing timber that had been contracted to the Sawmill Operator under the terminating long-term contracts.
- 2.41 On 29 March 2017, NRW's acting Head of Commercial Operations emailed NRW's then Head of Legal Services setting out his understanding of the meeting with the Sawmill Operator on 28 March 2017. The email indicates that the acting Head of Commercial Operations' understanding was that the transitional arrangements would 'stagger the closure of the [long-term contracts]' and 'this will include a price adjustment for the larch timber on some of the contracts to be extended'. The email refers to the need for a new Memorandum of Agreement to be agreed with the Sawmill Operator and a request that the Head of Legal Services draft this document.

Introduction of an additional contractor

- 2.42 On the morning of 31 March 2017, NRW's then Head of Marketing emailed NRW's acting Head of Commercial Operations regarding the proposed transitional arrangements. In this email he set out:
- he would that day inform the Sawmill Operator and the Timber Harvesting Company, (which had been subcontracted by the Sawmill Operator to harvest standing timber under the long-term contracts) that the long-term contracts would terminate at the end of the day;
 - existing arrangements would transfer to new contracts and new contracts would also be drawn up for the new volume within the transitional plan; and
 - a proposal that new roadside agreements would be set up each quarter.

- 2.43 In the afternoon of 31 March 2017, NRW's then Head of Marketing received an email from the Timber Harvesting Company. The email states 'can you contact [the Sawmill Operator] and ask them to get in touch with us as they seem to be studiously avoiding us at the moment. We find ourselves in a pernicious position, we in good faith negotiated with [the Sawmill Operator] to support the investment at [its premises], we all know what has happened there. We have done everything that has been asked of us and essentially been hung out to dry. I have no idea how [the Sawmill Operator] will conduct themselves going forward but my suspicion is that they will look to take the harvesting back in house unless you can provide some context in your new contractual arrangements to protect our interests. The [long-term contract] states that we are the nominated harvesting agents; as you are completely in the driving seat in this arrangement can we not be offered the same arrangement in the [new] contracts? It is surely a case of adding that line in the contract that applies to the remaining volume An alternative is to simply reassign our original contract back to ourselves as the original basis for the arrangement was to support the investment. Can we arrange a conference call for Monday to discuss this?'
- 2.44 NRW's then Head of Marketing replied stating that NRW was available for a conference call on 3 April 2017 and that he would alert the Sawmill Operator of the need to call the Timber Harvesting Company.
- 2.45 Later that afternoon, the Sawmill Operator emailed NRW's then Head of Marketing and the then Head of Harvesting thanking them for their call earlier that day and confirming prices it agreed to pay to purchase spruce and larch timber logs and bars.
- 2.46 NRW's acting Head of Commercial Operations emailed the Sawmill Operator 20 minutes later attaching a letter notifying it that the long-term contracts would expire that day and the post termination provisions of the long-term contracts would take effect. In addition, proposing that NRW and the Sawmill Operator negotiate in good faith to enter into new arrangements, reflecting terms to be agreed between the parties, including (but not limited to) an attached matrix and otherwise with a view to achieving an orderly wind down of operations. The letter sent to the Sawmill Operator had been prepared by NRW's then Head of Legal Services with input from NRW's legal advisors.
- 2.47 The Sawmill Operator was asked to confirm by signing a copy of the letter that it agreed to the terms set out in that letter. The email from NRW states that 'just to be clear the existing contract numbers will end today with no further authorisation of uplift of timber against the contract numbers. On receipt of your confirmation, we will set up new contract numbers with the revised larch prices to cover the winding down period'. The attached supply schedule records the intention to offer the Sawmill Operator 41,875 tonnes of roadside timber and 141,000m³ of standing timber, 182,875 units of supply in total. Whilst the schedule is consistent with the notes of the meeting between NRW and the Sawmill Operator on 28 March 2017 (paragraphs 2.32 to 2.35), it does not include the additional 'pipeline volume' of

57,200 units that had been offered to the Sawmill Operator in the email sent by NRW's Head of Marketing to the Sawmill Operator on 22 March 2017 (see table 3).

- 2.48 On the morning of 3 April 2017, NRW's acting Head of Commercial Operations emailed the Sawmill Operator. The email was in response to a telephone call received by the Head of Commercial Operations from the Sawmill Operator on 31 March 2017 in which the Sawmill Operator had requested an increase in the proposed timber volumes. The email from NRW's Head of Commercial Operations stated that 'I have reviewed with [NRW's then Head of Marketing] the supply schedule and it would not be appropriate to add additional volume, including spruce and we feel the profile is reasonable and proportionate The reason for the supply schedule is not just to enable [you] to adapt to the ending of the [long-term contracts], but to enable the supply chain to plan and adapt. We therefore expect [you] to engage with the affected contractors and provide them with at least the level of protection afforded by the supply schedule provides for'.
- 2.49 The same morning, NRW's acting Head of Commercial Operations wrote to the Welsh Government setting out that the long-term contracts with the Sawmill Operator had terminated on 31 March 2017 and that the Sawmill Operator had 'chosen not to challenge this and to instead enter into discussion with us about how to wind down the contracts. Our legal advice was to use the post-termination contract provisions and accept that the contracts would expire on 31 March'. This statement was incorrect. NRW's legal advisors had advised that the long-term contract post-termination provisions could not be used to offer the Sawmill Operator future volume as part of winding down arrangements. The email to the Welsh Government included attachments including the post termination letter and a schedule showing the timber NRW proposed to sell to the Sawmill Operator under the transitional arrangements (Table 4).

Table 4: NRW's summary of transitional timber volume offered to the Sawmill Operator as notified to the Welsh Government on 3 April 2017.

| | Offer Q1 Apr – Jun 2017 | Offer Q2 Jul – Sep 2017 | Offer Q3 Oct – Dec 2017 | Offer Q4 Jan – Mar 2018 | Total to be Offered 2017/2018 |
|----------------------------------|--|--|--|--|--|
| Road side Timber | 16,750 tonnes | 12,563 tonnes | 8,367 tonnes | 4,189 tonnes | 41,877 tonnes |
| Standing Timber | 78,000 m ³ obs | 51,000 m ³ obs | 12,000 m ³ obs | | 141,000 m ³ obs |
| Total units of supply | 94,750 | 63,563 | 20,367 | | 182,877 |

- 2.50 Whilst the schedule provided to the Welsh Government indicated that the Sawmill Operator had been offered 182,877 units of supply, as shown in Table 3, the Sawmill Operator had been offered 240,075 units of supply. The volume set out in the information provided to the Welsh Government was understated by 30.6% because it did not include the pipeline volume which had also been offered under the proposal for transitional arrangements. NRW has told my auditors that it accepts that 'all the volume should have been stated in the schedule'. The email to the Welsh Government did not set out that earlier the same morning NRW had agreed to contract with the Timber Harvesting Company for transitional standing timber (see paragraphs 2.43 and 2.54).
- 2.51 Later that morning, the Sawmill Operator emailed NRW its signed letter agreeing to 'negotiate in good faith' and a signed copy of the supply schedule NRW had sent to it on 31 March 2017. On receipt of this email, NRW's acting Head of Commercial Operations wrote to NRW's then Chief Executive and Head of Legal Services stating that the Sawmill Operator had agreed to the post-termination arrangements for the long-term contracts. He also wrote to the Welsh Government informing it that the Sawmill Operator had agreed to the winding up of the long-term contracts and that 'the reason for phasing out the supply over a period of months is not just to enable [the Sawmill Operator] to adapt to the ending of these [long-term contracts], but to enable the supply chain to plan and adapt to the ending of these [contracts]. It will also avoid adverse impact on NRW's timber income which would be an inevitable consequence of the disruption associated with complete cessation of all supply'.
- 2.52 NRW's then Chief Executive responded to the acting Head of Commercial Operations stating that 'the termination seems to have gone very smoothly and I'm pleased that we were able to reach agreement before the end of March'. He went on to state 'I am, though, likely to be pressed at the next PAC as to why these volumes were selected and how they compare with the previous contracts. In particular, I note that [the contract volume for one forest district] is for a higher volume than the original contract. I'd also be grateful for an explanation on the price differences which [the Head of Marketing] mentions. Could I have a briefing note please to cover these points?'
- 2.53 The then Head of Marketing emailed the then Chief Executive with responses to his queries. In answer to the question about 'why these volumes were selected', the Head of Marketing stated 'we used a swings and roundabouts approach to make the whole volume fit the ratio of the proportion of investment made by [the Sawmill Operator], we have only offered 12,000 out of 30,000 [40%] on the mid Wales standing spruce contract for example'. The Head of Marketing also set out the increases (from the long-term contracts) in larch sale prices that had been negotiated at the meeting of 28 March 2017.

- 2.54 At just before 5pm on 3 April 2017, the Head of Marketing emailed the Timber Harvesting Company confirming that the following had been discussed in a telephone call that morning and setting out:
- The long-term contracts had terminated on midnight on 31 March 2017.
 - There would be 'no uplift of timber' until new contracts had been put in place with the [Timber Harvesting Company].
 - There would be a 'presumption' that log and bar suitable for the Sawmill Operator from the current work sites and 'those offered in the step out arrangement' would be sold to the Sawmill Operator.
 - All new coupes were to be sold on the new larch prices that were agreed with [the Sawmill Operator] on 31 March 2017.
 - All contracts that have been partly worked would be reissued to [the Timber Harvesting Company] directly under new contracts.
 - All new coupes would also be issued to [the Timber Harvesting Company] directly under new contracts.
 - It was sensible to agree a contractual clause that stated that [the Sawmill Operator] is given the suitable log and bar.
 - 'The volume to be offered this year is 42,000m³ obs on the Llandovery arrangement and [72,000m³ obs] on the [Coed y Cymoedd] arrangement..... NRW intended getting all the volume contracted by end of [Quarter 3]'
- 2.55 On 6 April 2017, the Timber Harvesting Company emailed NRW's Head of Marketing asking for the new contracts to be speeded up and asking for confirmation that 'NRW will negotiate all the remaining volume on the [standing larch long-term contracts] with ourselves? In effect that there is nothing in the NRW/[Sawmill Operator] agreement that gives them the right to negotiate the remaining volume going forward, they only have the right to receive the log and bar element of the standing crops.'
- 2.56 NRW's Head of Marketing replied later that day stating: 'The agreement is that we will make available the volumes that we have stated. They have agreed that you will remain the agents to harvest the remaining volume? They cannot purchase the timber directly so you by default will have the contracts. As far as I am concerned, they will have access to the larch and spruce of the sites, minor species were not discussed nor prices adjusted so it is better if they are marketed locally, best value if they are willing to meet that price all well and good. [The Sawmill Operator has] never negotiated the individual parcels in the past so why would they want to do that now? I would expect that the matrix for harvesting rates will still be used. Our contract managers are working on this as quickly as they can but this is additional work and has to be shoehorned in, they have other sale deadlines to meet as well. If they don't get that done there will be no June offers'.

Part 3

3. Award of transitional contracts

Contract Authorisations

- 3.1. Between April 2017 and March 2018, NRW entered in 59 transitional contracts.
- 3.2. Eleven of these contracts were contracts for the roadside sale of timber to the Sawmill Operator, 11 were for the sale of standing trees to the Sawmill Operator's timber harvesting company and 38 were for the sale of standing trees to the Timber Harvesting Company. NRW subsequently withdrew three of the contracts it had awarded to the Timber Harvesting Company and have told my auditors that this was due to delays by the Timber Harvesting Company commencing harvesting operations.
- 3.3. NRW's Board has adopted a Scheme of Delegation called 'Managing Our Money' under which all financial activities of NRW have been delegated to an agreed level of authority or specific post holder. It allows the Board to delegate decision-making responsibility for certain financial matters.
- 3.4. The Scheme of Delegation is the method by which NRW's Board delegates its function of entering into contracts to individual members of staff and is a mechanism for risk management and financial probity.
- 3.5. Table 5 sets out the NRW office holders who have been specified in the Scheme of Delegation as having been granted authority to enter into timber sales contracts on behalf of NRW.

Table 5: Delegated Authority for approving timber sales: Managing Our Money

| Limit | Authorised Body or Person(s) |
|-------------------|---|
| £250,000 and over | Head of Enterprise |
| Up to £250,000 | Head of Marketing or Head of Harvesting |
| Up to £100,000 | Sales Manager North or Sales Manager South or Operations Business Systems Manager |

- 3.6. During the course of the audit my auditors found that 13 of the transitional contracts were not approved in accordance with NRW's Scheme of Delegation, and in five of these cases NRW was unable to demonstrate that the contracts had been authorised by any NRW officer. Table 6 provides a summary of the contract authorisations.

Table 6: Summary of contract authorisations against requirements of Managing Our Money

| Contractor | Number of contracts | Authorised in accordance with Scheme of Financial Delegation | Value of contract above delegation limit of authorising officer | Not authorised by NRW |
|--|---------------------|--|---|-----------------------|
| Sawmill Operator | 11 | 5 | 6 | 0 |
| Timber Harvesting Company | 38 | 34 | 1 | 3 |
| Sawmill Operator's timber harvesting company | 10 | 7 | 1 | 2 |
| Total | 59 | 46 | 8 | 5 |

3.7. The estimated value of the contracts not properly authorised was £2,752,248 and NRW received income in respect of these contracts of £1,868,773 in 2017-18.

Contract Terms and Pricing

3.8. The transitional contracts NRW entered into during 2017-18 were generic timber sales contracts. However, into each contract with the Timber Harvesting Company NRW inserted a non-standard contract term stating, 'the purchaser shall in the first instance, offer all larch logs, larch bars and spruce bars arising from this contract to [the Sawmill Operator]. All other species/products may be marketed to achieve best value. All gate prices realised, including changes, shall be notified to NRW'. NRW's acting Head of Commercial Operations told my auditors that the inclusion of the non-standard contract term was 'exceptional' and no comparable term had been included in other NRW timber sales contracts.

3.9. The contracts do not specify the gross price to be paid by the Sawmill Operator to purchase larch logs, larch bars and spruce bars harvested by the Timber Harvesting Company.

3.10. The notes of the meeting between NRW officers and the Sawmill Operator on 28 March 2017 state that the Sawmill Operator 'agreed to look at increasing the price of the larch material that goes to [its Welsh] sawmill; NRW to put forward a pricing proposal'. NRW has not been able to provide my auditors with a copy of any pricing proposal it put to the Sawmill Operator. However, as set out in paragraph 2.45, on 31 March 2017 a representative of the Sawmill Operator emailed NRW's then Head of Marketing and the then Head of Harvesting, 'to confirm the prices as

discussed'. The spruce prices were stated to be as per the [long-term contract] mechanism and the larch prices 'for the coming 12 months'. The prices set out in the email were as follows:

Spruce prices per the mechanism:

Log £46.05 at roadside²

Bar £42.94 at roadside

Larch prices for the coming 12 months:

Log £46.46 delivered³

Bar £38.50 delivered.

- 3.11. Whilst not explicitly stated in the email, it is clear from the contracts entered into that the above prices were per tonne.
- 3.12. An internal email from the then Head of Marketing to the acting Head of Commercial Operations on 3 April 2017 states that 'the larch increase is as follows, logs are increased by £4.46 a tonne, bars are increased by £6.50 a tonne'. The increases related to the prices for larch which had applied within the terminated long-term contracts.
- 3.13. On 21 April, NRW's Timber Sales Manager South emailed other members of NRW's timber sales team following a discussion she had held with a representative of the Sawmill Operator. In the email she set out the prices that she considered had been agreed in respect of the pricing of the transitional contracts. The prices set out were consistent with those set out in paragraph 3.10. However, the email provides some additional information:
 - the haulage rate to be applied for larch had been agreed at £11 per tonne and therefore the roadside price for larch logs per tonne was £35.46 (£46.46 - £11.00) and larch bars £27.50 (£38.50 - £11.00); and
 - the haulage rate to be applied for spruce had been agreed as £8.50 per tonne and therefore the delivered price for spruce logs was £54.55 per tonne (£46.05 + £8.50) and for spruce bars £51.44 (£42.94 + £8.50).
- 3.14. NRW told my auditors that the above rates had been applied to all the 59 transitional contracts regardless of whether those contracts were with the Sawmill Operator, the Sawmill Operator's timber harvesting company or the Timber Harvesting Company.

² Roadside price is the price the purchaser will pay if they buy at roadside, ie the gross sale price less the cost of haulage borne by the purchaser equals the roadside price.

³ Delivered prices are the prices the purchaser will pay if the product is delivered to its premises. However, if the purchaser has to transport to its premises, the delivered price will be offset for haulage costs.

- 3.15. However, my auditors found that whilst the prices set out above had been applied to the roadside contracts agreed with the Sawmill Operator, they had not been fully applied to the contracts made with the Sawmill Operator's timber harvesting company and the Timber Harvesting Company.
- 3.16. My auditors found that the amounts specified in the haulage rates for standing sales contracts with the Sawmill Operator's timber harvesting company and the Timber Harvesting Company were in most cases higher than the rates set out in the email of 21 April 2017. The effect was that NRW received less income than would have been the case if the rates set out in the email of 21 April 2017 had been applied.
- 3.17. My auditors also found that the 17 contracts with the Timber Harvesting Company (which NRW had classified as 'pipeline' contracts) had been priced at the same rates as those within the terminated long-term contracts. NRW had recognised in January 2017 that the prices within the long-term contracts were below market rates (see paragraph 2.2). As set out in Table 7, if the rates set out in the emails of 31 March 2017 and 21 April 2017 had been applied in full to all the transitional contracts, NRW would have received £186,232 more income in 2017-18 than was actually the case.

Table 7: Difference in income receivable by NRW in 2017-18 as a consequence of not applying the prices set out on 31 March 2017 and 21 April 2017

| Sawmill Operator: Roadside Contracts | £0 |
|--|------------------|
| Sawmill Operator's timber harvesting company: Standing Contracts | -£58,898 |
| Timber Harvesting Company: Standing Sales, Non-Pipeline | -£110,494 |
| Timber Harvesting Company: Standing Sales, Non-Pipeline | -£16,840 |
| Total | -£186,232 |

- 3.18. NRW has not been able to provide my auditors with any contemporaneous documentation setting out the basis on which the prices within the transitional contracts were set or that it took steps to ensure that the prices were at market rates. The contemporaneous documentation, which does exist, indicates that the Sawmill Operator notified NRW of the prices (see Paragraphs 2.45 and 3.10).

Contract volumes

3.19. The timber volumes contracted for sale within the transitional arrangements, and how this compared to the amounts offered to the Sawmill Operator on 22 March 2017 and 28 March 2018 is set out in Table 8.

Table 8: Changes to the volume of timber offered under transitional arrangements.

| Proposal 22 March 2017 | Committed pipeline | Additional volume | Total volume |
|------------------------------|--------------------------|---------------------------|---------------------------|
| Roadside timber | 7,700 tonnes | 5,000 tonnes | 12,700 tonnes |
| Standing timber | 49,500m ³ obs | 129,000m ³ obs | 178,500m ³ obs |
| Total units of supply | 57,200 | 134,000 | 191,200 |

| Proposal 28 March 2017 | Committed pipeline | Additional volume | Total volume |
|------------------------------|--------------------------|---------------------------|---------------------------|
| Roadside timber | 7,700 tonnes | 41,875 tonnes | 49,575 tonnes |
| Standing timber | 49,500m ³ obs | 141,000m ³ obs | 190,500m ³ obs |
| Total units of supply | 57,200 | 182,875 | 240,075 |

| Contractual volumes awarded 2017-18 | Sawmill Operator and its timber harvesting company | Timber Harvesting Company | Total volume |
|-------------------------------------|--|---------------------------|---------------------------|
| Roadside timber | 65,377 tonnes | 0 tonnes | 65,377 tonnes |
| Standing timber | 43,321m ³ obs | 210,287m ³ obs | 253,608m ³ obs |
| Total units of supply | 108,698 | 264,991 | 318,985 |

3.20. As shown in Table 8, the total volume of timber contracted to be sold to the Sawmill Operator and its timber harvesting company and the Timber Harvesting Company under transitional arrangements amounted to 318,985 units of supply. This was 72% higher than the volume in m³ obs offered to the Sawmill Operator on 22 March 2017 and 33% higher than that negotiated with the Sawmill Operator on 28 March 2017.

- 3.21. NRW has told my auditors that the volumes included in the transitional contracts awarded in 2017-18 'were not the volumes intended for supply' and that the contracted volumes have been inflated because the contracted volume in the pipeline contracts includes a significant amount of timber that had been harvested prior to 1 April 2017. I am unclear why NRW entered into new contracts to sell timber that had already been harvested and sold under contracts that had terminated. NRW has told my auditors that whilst it accepts it should have only included 'remaining volume' in the contracts, it never intended to provide higher volumes than those agreed at the meeting with the Sawmill Operator of 28 March and it continued to work to the volumes agreed at that meeting.
- 3.22. The volume contracted with the Sawmill Operator and its timber harvesting company and the Timber Harvesting Company amounted to 39.4% of the total timber volume that NRW had said in its Timber Marketing Plan it would make available to all purchasers in 2017-18. The contracted volume represented 97.6% of the annual volume of roadside sales and 141% of the annual volume of standing sales within the terminated long-term contracts.
- 3.23. On 4 May 2017, NRW's then Chief Executive emailed NRW's acting Head of Commercial Operations requesting information regarding the 'transitional arrangements'. One of the pieces of information he requested was 'a reconciliation between what was agreed in the original contracts and what the company will actually be getting – both in terms of volume and in value'.
- 3.24. On 11 May 2017, the acting Head of Commercial Operations responded by email to the then Chief Executive setting out a rationale for entering into the transitional arrangements. The email states that: 'The decision to wind down the supplies, as shown in the phasing out volumes, was made to avoid damaging the timber supply chain and to avoid adversely affecting NRW's timber income in 2017-18. Immediate cessation of supply on 31 March would have created a huge impact, with harvesting operations being stopped and contractors being put out of work through no fault of their own. Some harvesting contractors and hauliers would inevitably have gone out of business. The lead in time for remarketing the volume would have resulted in a major dip in NRW's timber income which would have been very difficult to catch up on as the spring is the time of year with the greatest demand for timber'. Attached to the email was a spreadsheet which was purported to represent the volume of timber provided to be sold under the transitional arrangements, and the percentage of the original long-term contract volume that would be supplied to the Sawmill Operator by the end of the transitional arrangements. Neither the email nor the spreadsheet referred to the involvement of the Timber Harvesting Company in the transitional arrangements.
- 3.25. A summary of the information provided to the then Chief Executive is set out in Table 9.

Table 9: Volume of timber offered under transitional arrangements as per email from NRW's acting Head of Commercial Operations to NRW's then Chief Executive of 11 May 2017.

| | Original LTC volume | Supplied to 31/3/17 under the LTCs | Transitional volume 2017-18 | Total supply volume | % of LTC volume to be supplied by 31/3/18 |
|------------------------------|-----------------------------|------------------------------------|-----------------------------|---------------------------|---|
| Roadside timber | 670,000 tonnes | 191,300 tonnes | 41,875 tonnes | 233,175 tonnes | 34.8% |
| Standing timber | 1,475,000m ³ obs | 498,200m ³ obs | 141,000m ³ obs | 639,200m ³ obs | 43.3% |
| Total units of supply | 2,145,000 units | 689,000 units | 182,875 units | 872,375 units | 40.7% |

- 3.26. The transitional volume of 182,875 units of supply set out in the attachment to NRW's acting Head of Commercial Operations email to NRW's then Chief Executive of 11 May 2017 was understated. As shown in Table 3, NRW had agreed at its meeting with the Sawmill Operator on 28 March 2017 to provide transitional volume of 240,075 units of supply.
- 3.27. The covering email from the acting Head of Commercial Operations to NRW's Chief Executive states that 'I have arranged for figures on values to be provided and hope that we can get these to you tomorrow [12 May 2017]'.
- 3.28. On 19 May 2017, NRW's newly appointed Head of Marketing emailed NRW's then Chief Executive attaching an updated version of the spreadsheet provided to the Chief Executive on 11 May 2017. The updated spreadsheet recorded that the estimated sale value of the timber sold to the Sawmill Operator from the commencement of the long-term contracts in 2014 up to 21 March 2017 was £11,013,286. The spreadsheet does not record the estimated sales value of timber contained within the transitional contracts, although this information was requested by the Chief Executive in his email to NRW's acting Head of Commercial Operations on 4 May 2017.

Part 4

4. Contractual sales

- 4.1. NRW set out in its transitional plan that it would phase the sale of the transitional timber (see Table 4) so that 90% of the roadside volume and all the standing transitional volume would be sold by 31 December 2017. In the event 9 of the 11 roadside contracts had contract periods running until 31 March 2018 and sales continued on these contracts into March 2018. Of the 48 standing sales contracts, 26 had contract periods extending beyond 31 December 2017, and 10 of these extended into 2018-19. NRW does not hold any documentation setting out the rationale for its deviation from the transition plan.
- 4.2. Table 10 summarises the volume of timber sold in 2017-18 under the transitional contracts.

Table 10: Timber sold under transitional contracts during 2017-18 compared to total volume agreed with the Sawmill Operator and contracted volume

| | Proposal 22/03/2017 | Proposal 31/03/2017 | Contracted volume | Transitional sales to 31/03/2018 |
|----------------------------------|---------------------------|---------------------------|---------------------------|--|
| Roadside timber | 12,700 tonnes | 49,575 tonnes | 65,377 tonnes | 45,453 tonnes |
| Standing timber | 178,500m ³ obs | 190,500m ³ obs | 253,608m ³ obs | 132,439 m ³ obs |
| Total units of supply | 191,200 | 240,075 | 318,985 | 177,892 |

- 4.3. In December 2017, my auditors commenced an audit of the transitional arrangements, and since then NRW has sought to minimise the volume of timber being sold under the transitional contracts. This has involved suspending operations on some contracts and resolving not to extend the contract period on other contracts where the contracted volume had not been delivered by the end of the contracted period. NRW estimates that a further 40,300m³ obs of standing timber will be sold to the Timber Harvesting Company in 2018-19 under the terms of the transitional contracts.
- 4.4. The income value to NRW of the timber sold under the transitional contracts in 2017-18 is 2.76 million and is estimated to be 0.18 million in 2018-19.

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