

Mr Llyr Gruffydd AM
Chair, Finance Committee
National Assembly for Wales
Cardiff Bay
Cardiff
CF99 1NA

24 Cathedral Road / 24 Heol y Gadeirlan
Cardiff / Caerdydd
CF11 9LJ
Tel / Ffôn: 029 2032 0500
Fax / Ffacs: 029 2032 0600
Textphone / Ffôn testun: 029 2032 0660
info@audit.wales / post@archwilio.cymru
www.audit.wales / www.archwilio.cymru

Reference: AC/130/caf
Date issued: 23 April 2019

Dear Llyr

Finance Committee inquiry – Welsh Government capital funding sources

To assist the Finance Committee in its inquiry into Welsh Government capital funding sources, I am pleased to provide written evidence to the Committee. The enclosed paper has been prepared on my behalf by staff of the Wales Audit Office.

The paper summarises evidence that may be of interest to the Committee arising from previously published Wales Audit Office material. It also provides signposts to some highly relevant work already published, or currently being undertaken, by other organisations including Audit Scotland and the National Audit Office.

As experience in Wales and elsewhere shows, all public-private finance programmes carry the challenge of balancing good value for money for the public sector with providing enough incentives to make the model attractive for private investment.

I am aware that the Committee has a particular interest in the Welsh Government's new Mutual Investment Model. In that regard, we are planning to undertake some follow-up audit work on the 21st Century Schools programme once Band B is further progressed, and so this is likely to take place in 2021-22. In undertaking that work we would expect to consider the extent to which, and how, the Mutual Investment Model has been applied in practice.

More generally, there is an extensive body of previous audit work (most notably by the National Audit Office) which highlights some of the potential challenges and pitfalls presented by alternative capital funding models. The lessons of experience show that when it comes to securing value-for-money, the devil is in the detail of how relevant contracts for projects are established and managed.

The balance of risk transfer is particularly important and it is vital that officials have a good grasp of this – not only in understanding the position at the outset of a long-term contract, but also as that balance of risk sharing evolves during the life of the contract. Too often in the past, the public sector has found to its cost that risks supposedly transferred at the outset to an external funder or contractor in fact reverted back to the taxpayer when a project later ran into significant difficulties. Ensuring that contractual provisions are sufficiently watertight to stand up to challenge when those risks materialise has also often proven to be problematic.

I and my colleagues stand ready to continue to support the Committee in its inquiry, and I hope that this written evidence is of assistance to you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Adrian Crompton', with a long horizontal stroke underneath.

ADRIAN CROMPTON
Auditor General for Wales

Enc: Finance Committee inquiry: Welsh Government Capital Funding Sources paper



Date issued: 23 April 2019

Finance Committee inquiry

Welsh Government Capital Funding Sources

Introduction

- 1 In the context of the terms of reference for its inquiry, this paper highlights evidence that may be of interest to the Committee arising from published Wales Audit Office material. It also signposts to some relevant work published or being undertaken by other organisations. In addition, we are aware that Audit Scotland has an audit underway looking at revenue financing of assets, specifically the Non-Profit Distributing and Hub models. Details about the plans and timing for this work are available on the [Audit Scotland website](#).
- 2 Our work in auditing public bodies' financial statements would seek to ensure that different capital funding arrangements are properly accounted for, with appropriate disclosures of assets, liabilities and contingencies so that their annual accounts give a 'true and fair view'. Nevertheless, our audit coverage of the practical application of different funding models has, to date, been limited. This is because some of these models (including the Mutual Investment Model) are new/emerging, and the fact that Wales has only made very limited use of the Public Finance Initiative (PFI) and Public Private Partnership (PPP) models that have been widely deployed in England.
- 3 In July 2018, we published our [Guide to Welsh Public Finances](#). That guide set out the main sources of funding for public services in Wales and described the processes for making budget decisions across the main devolved public bodies in Wales. It also looked at some of the key factors that public bodies consider in setting their financial plans.
- 4 The guide referenced the July 2012 report by the Finance Committee in the fourth Assembly on [Borrowing Powers and Innovative Approaches to Capital Funding](#)¹. While the landscape has moved on, that report and much of the evidence that Committee received does remain relevant in the context of this latest inquiry. Indeed, our understanding is that the Mutual Investment Model has itself arisen from work that the Welsh Government undertook to consider models for revenue financing infrastructure investment in response to one of that Committee's recommendations, including the Non-Profit Distributing model which was launched by the Scottish Government in 2007. Our October 2011 [Picture of Public Services](#) report had noted that non-profit distributing was one of a number of

¹ The Finance Committee in the third Assembly had also reported in September 2008 on its [Inquiry into Public Private Partnerships](#).

potential sources of funding for investing in infrastructure in the context of cuts to capital funding.

- 5 The 2012 Finance Committee report also recognised that underpinning the consideration and application of any capital funding models is a need to ensure that there is robust asset management across the public sector, supported by the development of relevant skills and capabilities.

The Mutual Investment Model and the 21st Century Schools and Education Programme

- 6 In May 2017, we published our report on the [21st Century Schools and Education Programme](#). We noted the planned use of the Mutual Investment Model to design, build, finance and manage new-build schools². At the time of our report, the Welsh Government had not confirmed its funding plans and the appetite of local authorities to adopt the Model remained unclear. However, many councils told us that they were struggling to find the funding to continue to invest in schools. Councils had already significantly increased their borrowing and sold off assets to fund their contribution to Band A of the programme.
- 7 Our report noted that new governance arrangements, particularly around the public-private Mutual Investment Model, would be required for Band B. We noted that the Welsh Government would need to provide central support for the procurement process for any private finance for the programme and be able to ensure that the programme aligns with other programmes funded through the Mutual Investment Model as well as the Welsh Government's wider private finance initiatives.
- 8 Our report acknowledged that several important areas of difference between the Mutual Investment Model and the Private Finance Initiative, which the Welsh Government intends will promote the public interest, increase transparency, and enhance value for money. We understand that the Committee has already received a technical briefing on the Model, but we had outlined these differences at the time of our report as follows:
 - the Welsh Government is able to invest in the company that is created to design, build, finance and maintain the asset. This ensures that the public sector has a share in profits of the project company;
 - the Welsh Government is able to appoint a director to the Board of the company formed to deliver the project giving greater say and visibility on decision-making; and
 - the service payment will be made by a monthly revenue charge over a 25-year period and will not start until the facilities are built and ready for use.
- 9 We made clear in our report that introducing a form of public-private finance will necessarily carry new risks for the programme which the Welsh Government will need to

² We also noted that the Welsh Government had initially intended to adopt the Non-Profit Distributing Model used by the Scottish Government but that that model had faced challenges following an Office of National Statistics ruling that some of the projects funded through the model could not be counted as off-balance sheet.

manage carefully as it moves into Band B. We considered that the Model was unlikely to be suitable for all projects in the programme, including refurbishments or bespoke projects, those likely to result in long and complex consultations, where there are complex land ownership issues or if there is a doubt about the long-term demand for places. It was also not clear to us if voluntary aided schools could participate in a revenue funded programme. And, as experience in Wales and elsewhere shows, all public-private finance programmes carry the challenge of balancing good value for money for the public sector with providing enough incentives to make the model attractive for private investment. We also noted that the Model would require some changes to the approach to procurement which may not be popular, or even feasible, for some councils.

- 10 We have supported the Public Accounts Committee (PAC) in its consideration of matters arising from our report in, and since, mid-2018. In [written evidence](#) following an oral evidence session on 25 June 2018, the Welsh Government provided further commentary on issues raised by the Committee in respect of the Mutual Investment Model, including the safeguards that would be in place to ensure high quality building standards for school buildings in light of issues that had arisen in Scotland.
- 11 The PAC then wrote to the Welsh Government, noting that it had concerns about whether the Mutual Investment Model represented the best value in the round. The PAC highlighted that oral evidence from both Colegau Cymru and the WLGA suggested that the Model was not ideal and that they would prefer other options. However, some later written evidence from the WLGA did acknowledge the Model's potential benefits. The PAC also sought re-assurance on various other issues, including some specific to the Model:
 - That alternative options – capital and supported borrowing – had been fully exhausted.
 - That the Welsh Government, as a whole, had identified that the school building programme is the most appropriate programme for using the Model.
 - That there is an appropriate 'pause and review' moment to reflect in the round as to whether the Model is a good value-for-money method for building schools and colleges.
- 12 In addition, the WLGA had suggested that Mutual Investment Model contracts would look to transfer risks associated with the energy efficiency of the design of buildings to the private sector. The PAC therefore asked the Welsh Government to clarify how it expects that risk transfer to work.
- 13 The Welsh Government responded to those concerns in [written evidence](#) in August 2018 and provided a further [written update](#) in late February 2019. The February 2019 update outlined changes to the intervention rates for projects supported by the Model and otherwise. Those changes have closed the gap between the intervention rates for different

projects, which may have a bearing on the appetite of local authorities and further education institutions for the Model³.

- 14 The Committee may wish to explore matters arising from the Welsh Government's written evidence to the PAC as part of its inquiry. We are planning to undertake some follow-up work on the 21st century schools and education programme once Band B is further progressed, but this may not be until 2021-22. We would expect to consider the extent to which, and how, the Mutual Investment Model has been applied in practice as part of that work.

The Mutual Investment Model - road projects and the Velindre Cancer Centre

- 15 We have noted the October 2018 report by the Economy, Infrastructure and Skills Committee on [The State of Roads in Wales](#) and its commentary and recommendations on the Mutual Investment Model. We are aware of the Welsh Government's plans to use the Model for sections 5 and 6 of the A465 scheme (Dowlais Top to Hirwaun). We have been looking into the A465 project recently because of the cost and time overruns on section 2 of the scheme (Gilwern to Brynmawr). We do not have any current plans for value-for-money work on the remaining sections of the scheme.
- 16 In respect of the Velindre Cancer Centre project (where construction work is yet to commence on site), we are currently liaising with finance officers at Velindre NHS Trust to understand how the Mutual Investment Model for the new hospital is intended to work and we will need to confirm the accounting arrangements in due course. However, we do not have any current plans for value-for-money work on the project.

Other recent audit evidence that may be relevant when considering capital funding sources

- 17 Our work on waste management in Wales has highlighted the example of the private finance initiative arrangements entered into by Wrexham County Borough Council. Our October 2018 report on [Procuring Residual and Food Waste Treatment Capacity](#) noted that the Council had not participated in the Welsh Government's Waste Infrastructure Procurement Programme. While we did not examine the detail of the Council's arrangements, our report noted that the Private Finance Initiative arrangements included provision of a Mechanical Biological Treatment facility for residual waste with a capacity of 55,000 tonnes per year. The facility started to operate and to take the Council's waste in July 2015, and the contract will expire in March 2038. We noted that the gate fees for

³ An increase from 50% to 65% for all capital funded mainstream school and college projects; an increase from 50% to 75% for capital funded special schools and pupil referral units; an increase from 75% to 81% for Mutual Investment Model projects.

Wrexham's residual waste treatment facility are more than double the median cost of the residual waste projects under the Waste Infrastructure Procurement Programme⁴.

- 18 More generally, the Committee may be interested in the contractual arrangements put in place through the Waste Infrastructure Procurement Programme. We noted that six of the ten projects under the Programme were for service contracts for waste treatment capacity where private sector providers have built facilities at their own cost and risk (albeit that the long-term service contract commitments from local authorities may have given them the confidence to do so). The remaining four projects (three food waste and one residual waste) included the construction of a facility, paid for in part by the local authority partners over the course of the contract as part of the gate fees. In those four cases, the facility will revert to local authority ownership at the end of the contract. The Welsh Government provided capital contributions totalling £3.5 million for the three food waste projects. We made a recommendation in our report about the provision of ongoing contract management support for local authorities.
- 19 Our July 2016 report on [Coastal Flood and Erosion Risk Management in Wales](#) noted that the Welsh Government had identified additional funding for coastal protection – by developing the 2018-2021 Coastal Risk Management Programme – but had not developed a long-term funding strategy beyond 2020-21 or helped councils to secure options for external funding, including for example levies and partnership funding with, for example, private sector organisations that stood to benefit from schemes. We noted that some stakeholders had raised concerns that the Welsh Government had not explored all of the options available to fund coastal flood risk management. Among other things, we recommended that the Welsh Government should develop a strategy to identify long-term funding for coastal protection including funding from across government departments and external bodies, and particularly to deliver multiple benefits. We suggested that the Welsh Government should learn from the partnership funding model in England to understand how councils there had been able to attract external funding for projects.

Other general reflections

- 20 As the Finance Committee in the fourth Assembly touched upon in its report, it is important that decisions about funding models are underpinned by robust asset management arrangements. We have noted examples of improvements in public bodies' capital planning in some of our recent work, for example in our July 2017 report on the [Implementation of the NHS Finances \(Wales\) Act 2014](#). Nevertheless, public bodies, including NHS Wales, still need to do more to plan for the long-term and we have also highlighted in previous work the limitations arising from the Welsh Government's own financial planning horizons. The work of the new National Infrastructure Commission for

⁴ Our November 2018 report on Municipal Recycling also noted that the Private Finance Initiative contract was a factor in the relatively high costs reported by the Council for kerbside collection of dry recyclables and its overall household waste services.

Wales, launched by the Welsh Government in November 2018, will also now be a crucial part of the process of identifying and planning for Wales' future infrastructure needs.

- 21 Our report on the 21st century schools and education programme provides an example of the potential benefits of a long-term approach to capital funding. We found that the certainty of funding over multiple years enabled councils to move away from a short-term 'patch and mend' approach to a more strategic approach to renewing and upgrading their school estates.
- 22 While there are specific considerations in Wales, not least because of the Well-being of Future Generations (Wales) Act, some of the general principles of effective capital strategies and programming are already set out in guidance from other professional bodies. For example, the Chartered Institute of Public Finance and Accountancy has produced guidance material on [capital strategies and programming](#).
- 23 The Finance Committee in the fourth Assembly also touched on the question of whether public bodies have the right capacity/capability to consider and exploit the opportunities provided by an increasingly diverse range of funding models, including City/Growth Deal funding. As shown in a related context through our work on [Public Procurement in Wales](#), concerns about capacity/capability across the public sector are, if anything, even more of an issue now as austerity has continued to bite.
- 24 Whatever capital funding models are deployed, the lessons of experience here and elsewhere show that when it comes to securing value-for-money, the devil is in the detail of how relevant contracts for projects are established and managed. These issues are picked up in some of the evidence that the Economy, Infrastructure and Skills Committee received during its inquiry on the state of roads and by the conclusions and recommendations in its report. The balance of risk transfer is particularly important, as well as ensuring that contractual provisions are sufficiently watertight to stand up to challenge when those risks materialise.
- 25 Whilst written in the context of their experience of auditing Private Finance Initiative projects, many of the principles that the National Audit Office (NAO) set out in its 2006 framework documents⁵ would also appear relevant in more general terms when considering choices about funding models and the practicalities of project delivery. In 2015 the NAO issued a briefing paper: ['The choice of finance for capital investment'](#), which provides a helpful overview of the topic. More recently, the NAO has also published a [briefing](#) on the rationale, costs and benefits of PFI; its use and impact; the ability to make savings from operational contracts; and the introduction of PF2.
- 26 Finally, the Committee may be interested to know that we will be taking forward local audit work across all local authorities on the topic of financial sustainability. Our work will examine medium- and longer-term financial strategy, budget management, cost pressures,

⁵ In May 2006, the National Audit Office published [Volume 1](#) and [Volume 2](#) of its 'Framework for evaluating the implementation of Private Finance Initiative projects'.

efficiency and savings plans, and levels and use of reserves. We anticipate reporting the findings from that work in some way at a national level once the local audit work is completed.

Wales Audit Office

April 2019

ENDS