

Inquiry into the Welsh Government's capital funding sources

November 2019



The National Assembly for Wales is the democratically elected body that represents the interests of Wales and its people, makes laws for Wales, agrees Welsh taxes and holds the Welsh Government to account.

An electronic copy of this document can be found on the National Assembly website: **www.assembly.wales/SeneddFinance**

Copies of this document can also be obtained in accessible formats including Braille, large print, audio or hard copy from:

Finance Committee
National Assembly for Wales
Cardiff Bay
CF99 1NA

Tel: **0300 200 6565**

Email: **SeneddFinance@assembly.wales**

Twitter: **[@SeneddFinance](https://twitter.com/SeneddFinance)**

© **National Assembly for Wales Commission Copyright 2019**

The text of this document may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading or derogatory context. The material must be acknowledged as copyright of the National Assembly for Wales Commission and the title of the document specified.

Inquiry into the Welsh Government's capital funding sources

November 2019



About the Committee

The Committee was established on 22 June 2016. Its remit can be found at:
www.assembly.wales/SeneddFinance

Committee Chair:



Llyr Gruffydd AM
Plaid Cymru

Current Committee membership:



Rhun ap Iorwerth AM
Plaid Cymru



Alun Davies AM
Welsh Labour



Mike Hedges AM
Welsh Labour



Rhianon Passmore AM
Welsh Labour



Nick Ramsay AM
Welsh Conservatives



Mark Reckless AM
Brexit Party

The following Member was also a member of the Committee during this inquiry.



Neil Hamilton AM
UKIP Wales

Contents

Chair's foreword	5
Recommendations	7
1. Introduction.....	9
2. Capital funding strategy	11
3. Funding sources	19
4. Capital borrowing.....	22
5. Local Government	26
6. Public Private Partnership models.....	28
7. Contract complexity and flexibility	38
Annex A: List of oral evidence sessions.....	48
Annex B: List of written evidence	49

Chair's foreword

In 2014 the Wales Act conferred capital borrowing powers to the Welsh Government. This Act, along with the Wales Act 2017 and the fiscal framework, have established an annual capital borrowing cap of £150 million for the Welsh Government.

We undertook an inquiry to establish how the Welsh Government is utilising the funding streams available to it following these fiscal changes, how effective the Welsh Government's funding strategy is and the benefits and risks of specific funding models, notably the Mutual Investment Model (MIM).

The Committee heard a wide range of evidence. The evidence identified that whilst the Welsh Government is utilising the powers available, stakeholders are unclear how the Welsh Government prioritises projects and plans on a long term strategic basis. We believe that if the Welsh Government were to plan on a longer term basis, and funding sources were matched to projects, it would be easier to establish the capital borrowing that will be required in the future.

The Committee heard evidence as to how Financial Transactions Capital is being utilised and we believe this could be better utilised to support housing providers, to ensure there is sufficient access to financing for capital projects. Additionally, we believe there is a case for local government capital borrowing powers to be used more effectively, to deliver a coherent capital investment strategy, which has a clear approach to funding and maintaining the existing infrastructure.

Much of the evidence we heard compared Private Finance Initiatives (PFI) and MIM. Whilst MIM is an improvement in terms of community benefits and oversight of projects, it is hard to establish a significant difference between the two models, specifically as to how MIM offers greater value for money than previous PFI models. Whilst it is reassuring that MIM is attracting interest from the private sector, we hope that MIM will enable public bodies to have greater influence over decision making and provide flexibility over changes to long-term contracts. Additionally, it is unclear how MIM minimises financing costs when compared to the UK Government's PFI and Public Finance 2 (PF2) and we hope to receive an analysis of these costs when appropriate.

In terms of the borrowing available to the Welsh Government, we have regularly heard that the Welsh Government utilises the cheapest source of borrowing first. However, we received evidence suggesting that the Welsh Government should focus more on matching funding sources to project risk across a project's lifecycle,

in order to maximise available capital and minimise financing costs and we hope that the Welsh Government will consider this going forward.

Finally, the Welsh Government told us that it was seeking prudential borrowing powers to support its capital infrastructure programme. The majority of Committee Members agreed this should be a priority and that the Welsh Government should continue to petition for these powers.

Llyr Gruffydd AM
Chair

Recommendations

Recommendation 1. The Committee recommends that the Welsh Government considers infrastructure investment plans on a longer term basis, which prioritises and allocates funding sources to projects to ensure there is a clear picture of how much borrowing will be required in future years..... Page 18

Recommendation 2. The Committee recommends that the Welsh Government considers matching funding sources to project risk across a project's lifecycle, in order to maximise available capital and minimise financing cost. Page 18

Recommendation 3. The Committee recommends that the Welsh Government further considers how Financial Transactions Capital could be utilised as a rolling loan facility for the housing sector, in order to support housing providers outside public control..... Page 21

Recommendation 4. The Committee recommends that the Welsh Government should continue to work with Local Authorities across Wales to explore innovative approaches to utilising Financial Transactions Capital and accessing private investment in capital projects..... Page 21

Recommendation 5. The Committee recommends that the Welsh Government should focus on closer collaboration with local government to deliver a more integrated approach to delivering infrastructure investment at a national and local level. Page 27

Recommendation 6. The Committee recommends that the Welsh Government ensure that projects delivered through the Mutual Investment Model are fully transparent, clearly identifying project costs and related data..... Page 37

Recommendation 7. The Committee recommends that the Welsh Government should review the level of expertise in place for contract management, and take steps to maintain this expertise to ensure effective delivery throughout the project lifecycle..... Page 44

Recommendation 8. The Committee recommends that the Welsh Government should continue to utilise the Mutual Investment Model for projects requiring continuity over the lifetime of the contract and where the private sector can deliver the greatest value for money..... Page 44

Recommendation 9. The Committee recommends the Welsh Government provide an update as to what consideration it has given to utilising alternative financing models to unlock further private investment for capital projects in Wales. Page 47

1. Introduction

1. The Wales Act 2014 (the Act) made provisions to confer capital borrowing powers to the Welsh Government. The Act established a total borrowing limit on capital of £500 million, which was increased to £1 billion through the Wales Act 2017 and incorporated into the fiscal framework for Wales. The fiscal framework sets out an annual capital borrowing cap of £150 million, which is 15 per cent of the overall borrowing cap.

2. There are four sources that the Welsh Government can use to fund capital projects:

- Conventional capital funding from the UK Government (including financial transactions capital)
- Borrowing through the National Loans Fund or a commercial bank
- Borrowing via government bonds
- Mutual Investment Model (MIM).

3. In 2018, during scrutiny of the Draft Budget 2019-20, the then Cabinet Secretary for Finance, Mark Drakeford commented,

“In terms of the strategy that we have for borrowing, well, I’ve set it out in front of the committee previously, Chair, and it’s got a basic principle in it, which is that my aim is always to use the cheapest money first.”¹

4. The Cabinet Secretary further noted that his aim would be to exhaust conventional capital before moving to European funding then the Welsh Government’s borrowing powers, innovative borrowing and finally the MIM.

5. The Finance Committee (the Committee) agreed to undertake an inquiry into the funding models available to the Welsh Government.

Inquiry terms of reference

To consider all funding models available to the Welsh Government:

- conventional funding (including financial transactions capital);

¹ Finance Committee, Record of Proceedings, 3 October 2018, paragraph 340

- government loans (including borrowing limits);
- government bonds;
- role of capital receipts;
- borrowing powers of Welsh Government bodies; and
- the Mutual Investment Model.

To consider the financial risks and costs of borrowing for different funding models or for specific models.

To look at how funding sources could be used to deliver an effective capital funding strategy.

To consider whether the Mutual Investment Model represents value for money.

To compare the Mutual Investment Model costs to other Public Private Partnerships models.

2. Capital funding strategy

Capital funding mix

6. Demand for capital investment in Wales continues to grow with capital investment, including borrowing, totalling just under £2.3 billion in 2019-20.²

7. When asked whether the Welsh Government had the necessary mix of capital funding sources to deliver an effective planning strategy, comments from witnesses were positive. Professor Holtham said:

“Yes, as far as I can see, they do. They may not have very extensive access to borrowing via the Debt Management Office and the gilt market. I think you could make a case that there should be a more generous allocation there, but, in principle, they do have that access and they have the access to private finance as well. So, I do think that there is the possibility to plan an investment programme.”

8. The Welsh Local Government Association (WLGA) felt the range of capital sources available had supported the Welsh Government:

“I think it's certainly helped from where we sit as local government... So, if you look at the infrastructure investment plan now, you can see quite a wide variety of funding sources that aren't just the traditional capital grants.”³

9. The Minister for Finance and Trefnydd (the Minister) mentioned that the Welsh Government is utilising all its funding levers and has developed the MIM, which it would not have done if it “had access to other forms of borrowing”.⁴

Capital funding strategy

10. The First Minister, Mark Drakeford AM, outlined the Welsh Government's capital investment strategy during Plenary:

“In funding infrastructure projects, my first aim is always to use the cheapest form of capital first, beginning of course with conventional capital spending. When all public sources are exhausted, we work with

² Welsh Government – Written evidence, 3 July 2019

³ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 6

⁴ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 88

potential investors on key infrastructure projects, always ensuring that the public interest comes first.”⁵

11. Professor Holtham suggested that, if the Welsh Government had a comprehensive infrastructure plan extending out five to 10 years, then this would enable the Welsh Government to determine the extent of capital borrowing required outside the borrowing limits set by the UK Government, which is the cheapest form of borrowing. If this is significant then Professor Holtham emphasised the need to match funding sources with project risk. He noted:

“...Where the borrowing requirement exceeds the available gilt borrowing however, things are more interesting. Then there is the possibility of matching finance and projects rather than simply using up gilts first... The aim should be to minimise the total cost of the borrowing programme. It follows that private finance should be used for the least risky projects.”⁶

12. He further commented:

“Riskier projects should be financed with gilts. Risk can take several forms: construction, maintenance operation. A project can be sliced up in numerous ways. The state could acquire an asset itself and license a private operator to run or maintain it, for example, so the comparison is not straightforward. Nonetheless the principle is clear. Carve up projects appropriately and use private finance where the risks to the financier are relatively low.”⁷

13. The Welsh Government's strategy of using the cheapest form of capital first was also questioned by KPMG who suggested:

“The strategy of ‘use your money first and then let's see’ is a little bit short-sighted. I would say: look at your funding need, to the best you can forecast it; look at how much capital you think you have, and target that capital at where you think it can deliver the most at the best point in the market. For me, that's not necessarily where it can be deployed cheaper or where the private sector can deploy cheaper, it's: where are

⁵ Plenary, Record of Proceedings, 14 May 2019, paragraph 70

⁶ Written Evidence: CFS05 Gerald Holtham

⁷ Written Evidence: CFS05 Gerald Holtham

the points of market failure in the private market that the private market is going to struggle to deliver on a value-for-money basis?"⁸

14. Capital Law also concluded that “an effective funding strategy depends on multiple sources of funding (ranging from conventional funding to public/private partnership models such as MIM) appropriate to the relevant point within a project’s lifecycle”.⁹

15. However, Professor Holtham believed that the Welsh Government was not in a position to start allocating projects to capital sources:

“The point about the plan is you can look at those projects and if you say we’re going to take 30 years to do it, you don’t need to borrow at all. You’re getting £1.5 billion a year coming in in capital budget. If you take long enough you can do them all without borrowing, and if you want to do them all in five years, you’ve got a lot of borrowing to do. So I’m not sure the officials, at least the last time I was in touch with them, were clear enough about just how ambitious we were in terms of delivering the programme, and therefore I don’t think we’re in a position to start allocating projects to particular forms of finance.”¹⁰

16. In terms of longer term planning, the Minister referred to the National Infrastructure Commission publishing its first report in November [2019], which takes a five to thirty year outlook and will make recommendations relating to “longer term strategic economic and environmental infrastructure needs across Wales”.¹¹

17. The Welsh Government officials noted that where projects and programmes have a high degree of certainty the government does commit to a form of finance. For example, the Welsh Government has developed a funding package for the South Wales metro.¹²

Project prioritisation

18. When asked how projects could be prioritised to maximise capital investment, evidence focused on the lack of clarity on how projects are prioritised

⁸ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 46

⁹ Written Evidence: CFS07 Capital Law

¹⁰ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 56

¹¹ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 26

¹² Finance Committee, Record of Proceedings, 17 July 2019, paragraph 33

across the wider funding sources available to the Welsh Government.

PricewaterhouseCoopers (PwC) commented:

“...we’d benefit from some more clarity around the wider funding and how those programmes are prioritised within the constraints and the funding envelope that you’ve got.”¹³

19. Professor Holtham also highlighted the lack of clarity on project prioritisation:

“Secondly any long-term investment plan should be published in full. With a priority ordering of large projects and target dates for meeting them, the required expenditure can be compared with revenue projections and a borrowing programme derived. There is no reason why any of that should be secret. The public can discuss the priorities and timing, encouraging public debate and buy-in.”¹⁴

20. The Minister mentioned that capital investment is prioritised for projects that deliver on “Prosperity for All” and meet the Welsh Government’s responsibilities under the Well-being of Future Generations Act 2015. Further prioritisation is given to projects that could potentially reduce the public sector’s revenue spend in future years. The Minister stated:

“An example would be the additional £40 million that was provided to the education department, which then went on to local authorities in order to help them maintain their schools estates. We were very clear that those projects that are funded through that £40 million should be ones, in the first instance, that enable there to be revenue savings in the longer term, because, obviously, revenue’s more difficult to come by, and, particularly for local authorities, any revenue savings they can generate in future years are important.”¹⁵

Wales Infrastructure Investment plan (WIIP)

21. The Wales Infrastructure Investment Plans (WIIP) was published in 2012 and outlined the Welsh Government’s 10-year plan for infrastructure investment across Wales.

22. Professor Holtham suggested that for the Welsh Government to optimise its use of capital funding sources it needs to have a medium-term investment plan

¹³ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 178

¹⁴ Written Evidence: CFS05 Gerald Holtham

¹⁵ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 38

with the WIIP being “little more than a wish-list of projects put forward by spending departments”.¹⁶

23. Professor Holtham noted that even though there was no certainty beyond the three-year cycle of Barnett allocations, it is still necessary to make projections for planning investments. He suggested a scenario-based approach could be adopted where uncertainty is acute. Professor Holtham also commented that even with such projections, a “borrowing requirement can still not be calculated without target dates on all capital projects”.¹⁷

24. Professor Holtham observed the 2018 interim report on the WIIP, recognising the need to “make longer term economic and revenue projections and apparently techniques for doing so have been developed and are being refined”.¹⁸

25. The WLGA agreed with Professor Holtham, who believed there needed to be a move from a list of projects to something more strategic¹⁹, such as the **medium-term financial strategy** published by the Scottish Government.

26. The WLGA supported the approach taken by the Scottish Government in identifying the sources of funding for projects, which the WLGA viewed as a key element to planning.²⁰

27. The **Scottish Futures Trust (SFT)** emphasised the importance of taking a medium-term view and having a pipeline of projects that delivers the Scottish Government's strategies.

28. The Minister said the Welsh Government could look at determining how the riskier projects could be funded but was conscious that the Scottish Government possesses different financial levers for utilising private and local government finance.²¹

29. In terms of longer term financial planning, the Minister noted that even with a comprehensive spending review, there tends to only be a three to four year outlook for public spending. The Minister continued:

¹⁶ Written Evidence: CFS05 Gerald Holtham

¹⁷ Written Evidence: CFS05 Gerald Holtham

¹⁸ Written Evidence: CFS05 Gerald Holtham

¹⁹ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 10

²⁰ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 14

²¹ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 18-22

“... we’ve set up the national infrastructure commission, and that does take a five to 30-year look ahead to the future, and that will very much be making recommendations in terms of longer term strategic economic and environmental infrastructure needs across Wales. When we have those recommendations, we’ll be able to think of that in the context also of our next iteration of the WIIP, and also consider it against the national development framework, which will ... be published in 2020.

The National Infrastructure Commission for Wales will be publishing its first annual report in November, followed by a ‘state of the nation’ report in 2021, so in developing our next infrastructure strategy we’ll be certainly looking to respond to that work.”²²

30. When asked how the Welsh Government’s declaration of a climate emergency would impact on capital investment in Wales, the Minister noted that decarbonisation was a key area that the Welsh Government was looking at.²³ The next iteration of the WIIP is currently being developed which will take the climate emergency into account.

31. The WIIP will be integrated into the Welsh Government’s **national development framework**, which will be published in 2020. The Minister commented that the framework will provide a more strategic approach to planning by setting out “nationally important growth opportunities for infrastructure”²⁴ over a 20-year horizon and will be reviewed every five years.

Capital receipts

32. An alternative approach to financing capital projects is through the sale of existing fixed assets. Since 2014, the UK Government has **reduced the government estate** by over 1,000 properties, which has raised £2 billion in capital receipts.

33. The Welsh Government stated:

“...while the portfolio is not generally one held with a view to generating a cash return we do recognise the important part it can play in maximising the overall return to the people of Wales.”²⁵

²² Finance Committee, Record of Proceedings, 17 July 2019, paragraph 26

²³ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 13

²⁴ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 7

²⁵ Welsh Government – Written evidence, 3 July 2019

34. The Welsh Government also referred to the creation of an asset management strategy and plans:

“Following the National Assembly for Wales Finance Committee review into asset management in the public sector our corporate governance has moved forward and included the creation of a corporate asset management strategy and departmental asset management plans.”²⁶

35. The Minister discussed management of public sector assets in **Plenary in June 2019**. She mentioned that the Welsh Government had been undertaking “a piece of work that looks across the Welsh public sector, particularly in terms of the land that we own, to see if we can take a much more strategic approach”.²⁷

36. The Minister further commented that the Welsh Government is also looking at how it can work in a collaborative way with local authorities, health boards and others who have land or assets within their portfolios.

Committee view

37. The Committee notes that the Welsh Government is utilising all its funding levers, however, there is a case for the Welsh Government to be able to access other forms of borrowing.

38. The Committee would like to see the Welsh Government taking a longer term and more strategic approach to the infrastructure investment plan. If the Welsh Government was to plan on a longer term basis and allocate capital sources to projects in the pipeline, the Committee believes it would be easier to identify the amount of capital borrowing that will be required in the future, outside of the current borrowing limits.

39. Evidence presented to the Committee showed that stakeholders are not clear as to how the Welsh Government prioritises projects, in view of its funding restraints.

40. The Committee heard evidence that risk varies across a project's lifecycle with the construction phase representing the highest risk and other phases demonstrating a reduction in risk.

41. Accordingly, the Committee believes that risk should be assessed at each stage of the project lifecycle with funding sources then allocated to each project

²⁶ Welsh Government – Written evidence, 3 July 2019

²⁷ Plenary, Record of Proceedings, 26 June 2019, paragraph 109

phase, giving consideration to where the private or public sector will struggle to deliver on a value-for-money basis.

42. The Committee believes that the Welsh Government should further consider matching funding sources to project risk across a project's lifecycle, in order to maximise available capital and minimise financing costs.

43. The Committee is keen to see that the Welsh Government's declaration of a climate emergency is fully reflected in its future WIIP, and welcomes the Minister's assurance that this will be covered in the next iteration of the WIIP.

Recommendation 1. The Committee recommends that the Welsh Government considers infrastructure investment plans on a longer term basis, which prioritises and allocates funding sources to projects to ensure there is a clear picture of how much borrowing will be required in future years.

Recommendation 2. The Committee recommends that the Welsh Government considers matching funding sources to project risk across a project's lifecycle, in order to maximise available capital and minimise financing cost.

3. Funding sources

Conventional funding

44. The Welsh Government receives conventional funding as part of the Welsh block grant from the UK Government. However, the Welsh Government calculated that its capital funding allocations for the **2019-20 budget** was five per cent lower in real terms than for 2010-11 if financial transactions capital was excluded.

Financial transactions capital

45. In recent years, the nature of the Welsh Government's capital budget has changed as greater restrictions have been placed on the use of capital by the UK Government through the introduction of financial transactions capital (FTC). In 2019-20, 14.2 per cent of the **Welsh Government's capital budget** was in the form of FTC, which can only be used for loan and equity investments in the private sector and must be repaid to HM Treasury.

46. The Minister noted that the Welsh Government is required to pay back 80 per cent of the total FTC allocated by HM Treasury.²⁸ Consequently, this would enable the Welsh Government to look at providing interest free or very-low interest loans where applicable.

47. The Development Bank of Wales stated that the majority of new funds it created have been financed using FTC. To date, the total FTC allocation to the Development Bank of Wales, including Help to Buy - Wales, totals around £820 million; this represents 80 per cent of the total FTC which has been allocated to the Welsh Government.²⁹

48. The Development Bank for Wales also noted that the recycling of funding is particularly important in the context of FTC. An example is the £30 million Wales Property Fund which, through recycling, is forecast to invest up to £272 million.³⁰

49. Tirion Group **noted** the benefits of FTC for the housing sector:

“The effective deployment of Financial Transaction Revenue would appear to offer the best opportunity to support mixed-tenure housing

²⁸ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 43

²⁹ Written Evidence: CFS03 Development Bank of Wales

³⁰ Written Evidence: CFS03 Development Bank of Wales

development in the short to medium term. It also offers the best opportunity to minimise financial risk to the public sector.”³¹

50. Tirion Group also mentioned how FTC could provide a rolling loan facility for housing providers to reduce the peak debt of any single organisation at the relevant stages of the development process. Tirion Group provided an example of FTC being used as a loan facility:

- Pre-construction – 100 per cent loans for design, planning and statutory consents
- Site preparation works – 100 per cent for site remediation and preparation
- Construction phase – Up to 30 per cent loan against development costs
- Warehouse phase – Up to 30 per cent loan against warehouse finance costs

51. Tirion Group told the Committee that the key limitation for housing developments is “trying to connect the various phases of financing in a development project”.³²

52. Consequently, Tirion Group suggested that development finance and warehouse finance elements of the project have been difficult to secure, given the constraints in the banking market, with fiscal restraint restricting the availability of Social Housing Grant in the medium to long term.

“I think the real issue is how can Welsh Government or other public organisations, including local authorities, help make those connections by taking an element of risk in the construction and warehouse phases of those projects.”³³

53. The Minister confirmed that the Welsh Government is considering how it could provide Registered Social Landlords (RSLs) with a mix of grant funding and zero or low-rate interest loans to improve the viability of housing projects. The Minister noted that housing developers are currently benefitting from the Wales

³¹ Written Evidence: CFS01 Tirion Group

³² Finance Committee, Record of Proceedings, 9 May 2019, paragraph 227

³³ Finance Committee, Record of Proceedings, 9 May 2019, paragraph 228

Property Development Fund and Wales Stalled Sites Fund, which utilise FTC to deliver a mixture of residential, mixed-use and commercial projects across Wales.³⁴

54. An official from Carmarthenshire County Council suggested that FTC could be used within local authority areas, particularly with city deals:

“I think the financial transactions money, the usage of it is a challenge because it's got to be paid back in 15 years' time, but having said that, if it could be used within the local authority area, it could give us some scope. As a very easy example, we are borrowing for 15 years for the city deal money. That financial transactions money could help us and reduce the interest cost there in terms of that challenge that actually is in every authority that is involved in the city deal.”³⁵

55. He also mentioned alternative approaches for local authorities to utilise FTC:

“... the question that I've actually asked civil servants, actually, is whether there's any scope around being a bit innovative there in terms of the way that it's used, and is there scope for consideration of wholly owned subsidiary companies of the county councils or local authorities to enable that to happen.”³⁶

Committee view

56. Whilst the Minister provided details as to how FTC is being utilised to deliver various projects, evidence provided to the Committee suggested that there are issues restricting the availability of financial support in the housing sector.

Recommendation 3. The Committee recommends that the Welsh Government further considers how Financial Transactions Capital could be utilised as a rolling loan facility for the housing sector, in order to support housing providers outside public control..

Recommendation 4. The Committee recommends that the Welsh Government should continue to work with Local Authorities across Wales to explore innovative approaches to utilising Financial Transactions Capital and accessing private investment in capital projects.

³⁴ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 40

³⁵ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 40

³⁶ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 42

4. Capital borrowing

57. The fiscal framework agreement between the Welsh and UK Governments notes that the total capital borrowing limit will be £1 billion with an annual limit of £150 million.

58. The command paper Financial Empowerment and Accountability, published in 2014, stated “Welsh Ministers can borrow from the National Loans Fund (NLF) or from commercial banks to fund capital spending”, the command paper also said that the total capital borrowing limit would be reviewed at each Spending Review.

National Loans Fund & commercial bank loans

59. The NLF is the principal borrowing and lending account for the UK Government. The Welsh Government can borrow from the fund via the Secretary of State for Wales and can also secure commercial loans directly from a bank or other lender.

60. NLF interest rates are determined each morning by the Debt Management Office (DMO), which is an Executive Agency of HM Treasury. NLF repayments are based on an annuity repayment profile with loans offered at low interest rates, compared to those offered by commercial banks, and are provided with either a fixed or variable interest rate.

61. Professor Holtham viewed the NLF as the cheapest form of borrowing:

“... relative to other forms of borrowing, there are no disadvantages that I can see [for the NLF]. It's going to be the cheapest form of capital and you know what the costs are. So, like any borrowing, you've got to pay it back, so it is borrowing, they're not giving you anything, but it is by far the cheapest source.”³⁷

Government bonds

62. On 30 November 2018, the Welsh Government gained new powers to issue bonds, which can be used as an alternative source for capital borrowing. However, any issuing of bonds will count towards the Welsh Government's borrowing cap.

³⁷ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 40

63. Conventional bonds are issued by governments to raise money and can be structured in a number of ways. In principle, the government promises to pay the buyer small cash payments, called coupons which are set at a fixed interest rate by the government, usually twice a year until the bond matures, when the buyer also gets back the money loaned to the government.

64. The UK Government also issues **index-linked bonds**, which reflect borrowing rates available at the time of first issue. Governments issue bonds with a range of different maturities - three months, a year, 10 years, 30 years and so on.

65. The then Cabinet Secretary for Finance, Mark Drakeford, when **giving evidence** to the Committee in November 2018 stated:

“...the purpose of acquiring the power is not to use it immediately; it’s to keep the UK Government honest, in that, if it were to increase the interest rate charged on the loans that we get through the national loans fund, we would have somewhere else to go.”³⁸

66. This was supported by Professor Holtham **who stressed**:

“When I was talking to people in the City, they said ‘If the Welsh Government issued bonds, it would pay 45 basis points over gilt.’ So, why do you want to do that? It’s just a way, as I say, to keep the Debt Management Office honest, but it will be more expensive. So, there’s no financial reason for doing it.”³⁹

Increasing capital borrowing limits

67. Professor Holtham felt **there is an argument** for the Welsh Government’s capital borrowing limits to be increased:

“The Scottish are up to 5 per cent. If we said 5 per cent of the Welsh budget—now, this is going to test my mental arithmetic—you’re looking then at £750 million, or something, a year. So if you look at it that way—what is the maximum carrying capacity of your budget—I don’t suggest you go as far as 5 per cent, necessarily, but you’d think, ‘Okay, 2 per cent’, and then you can work out the capital sum you’re allowed to borrow, and it’s higher than we’ve currently got.”⁴⁰

³⁸ Finance Committee, Record of Proceedings, 21 November 2018, paragraph 73

³⁹ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 82

⁴⁰ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 71

68. He also noted the favourable conditions for borrowing, which strengthens the argument:

“So I think there is a perfectly fair argument that says: money’s constrained at the moment, we don’t assume it’s going to be constrained forever, interest rates are very low, it’s a reasonable time to be borrowing, and we’re nowhere near being allowed to borrow as much as even a prudent carrying cost rule would imply. So, yes, we should be able to borrow more.”⁴¹

69. When asked what borrowing limits the Welsh Government would consider appropriate, the Minister stated “we would see an appropriate limit within the context of prudential borrowing”. She further commented:

“... it should be for us to set that limit, but we would do so in discussion with the National Assembly. So, we’d have to have debates on that and so forth, and it would be in the context of our ambitions at the time, what the interest rates are and a whole range of economic and financial conditions.”⁴²

70. The Minister updated the Assembly on her efforts to increase the borrowing limits:

“... what I did do was write to the Treasury last year seeking an increase in our borrowing limit, which, as I said, is currently £150 million a year, sequentially up to £1 billion, to help deliver our investment priorities. And when we talk about borrowing, when we talk about our capital fund, we talk about it in the round. So, we don’t borrow against a specific project or a specific scheme. We borrow to increase our available capital in order to deliver our portfolio of priorities and projects for that year and years beyond.”⁴³

Committee view

71. The Committee notes the evidence on which funding sources are utilised and supports the principle that the cheapest form of borrowing should be used first where appropriate.

⁴¹ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 71

⁴² Finance Committee, Record of Proceedings, 17 July 2019, paragraph 80

⁴³ Plenary, Record of Proceedings, 26 June 2019, paragraph 120

72. The Committee recognises the case made by the Welsh Government for an increase in borrowing to allow a rational approach to capital borrowing and would support the Welsh Government's borrowing limits being increased to help deliver investment priorities. The majority of Members agreed that the Welsh Government should continue to seek prudential borrowing powers.

5. Local Government

73. The WLGA stated that local government is able to borrow in two ways:

- Internally from balances
- Externally through the public works loan board (PLWB), known as prudential borrowing.⁴⁴

74. The prudential system for local authority capital finance was introduced in 2004 and enables local authorities to decide for themselves how much they can afford to borrow based on a prudent assessment of their capital needs. The duty to determine the level of affordable borrowing places reliance on self-regulation under professional codes of practice.

75. The WLGA noted that local authorities' borrowing powers have not been fully realised:

“One point we repeatedly make is that local government enjoys considerable freedoms to borrow and more could be made of this to fund local infrastructure.”⁴⁵

76. Local authorities are required to develop and approve long term capital strategies with a significant element of grant funding being in the form of Welsh Government grants. The WLGA highlighted issues with the current process for allocating capital funding:

“The view of many of the officers involved in capital planning is that the current approach to annual allocations are not conducive to longer term planning and securing value for money.”⁴⁶

77. The WLGA also noted that a more strategic approach is required to support the maintenance of capital infrastructure:

“Whilst grants for expenditure such as roads and school buildings are welcome, the deteriorating condition of assets requires sustained levels of investment (rather than periodic one-off amounts late in the year). This also applies to rent policy in terms of Housing Revenues Account borrowing. A more strategic approach has been requested by local

⁴⁴ WLGA [written evidence](#)

⁴⁵ WLGA [written evidence](#)

⁴⁶ WLGA [written evidence](#)

government officers who sit on the joint Welsh Government-Local Government's Capital Finance and Investment Group."⁴⁷

78. The Minister mentioned that the Welsh Government works with local authorities to help them explore their own borrowing powers. However, the Minister highlighted that local authorities had already undertaken significant borrowing of around £320 million in Wales and was looking for alternative approaches to delivering capital projects:

“... we wouldn't want to look for funding models that would push that any further than necessary, which is why we're exploring things such as the mutual investment models and so on for projects that we can be delivering.”⁴⁸

Committee view

79. The Committee heard that more could be made of local government's capital borrowing powers to deliver a coherent capital investment strategy at national and local levels.

80. The Committee is concerned by the evidence that suggests that capital infrastructure is deteriorating and believes there should be a more strategic approach to maintaining this infrastructure, including additional investment where necessary.

Recommendation 5. The Committee recommends that the Welsh Government should focus on closer collaboration with local government to deliver a more integrated approach to delivering infrastructure investment at a national and local level.

⁴⁷ WLGA [written evidence](#)

⁴⁸ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 83

6. Public Private Partnership models

81. A key reason for developing Public Private Partnership (PPP) models is the ability to keep any capital liabilities off the public sector balance sheet in the National Accounts. This results in lower recorded levels of public debt and spending in the short term and would allow public bodies to invest in capital projects without the need to deliver significant capital investment up-front. However, projects delivered through PPP models would commit public bodies to future revenue allocations to pay regular instalments to the private investor to effectively lease the building or piece of infrastructure over several decades of a project's lifecycle.

UK PFI/PF2

82. The UK Government first introduced its private finance initiative (PFI) in 1992. The initiative enabled the UK Government to commission a private sector company to deliver a public infrastructure project. Given the concerns relating to PFI, which included the model being “too costly, inflexible and opaque”, the Chancellor of the Exchequer (the Chancellor) decided to reform the model and implement PF2.

83. The National Audit Office (NAO) reported the objective of the PF2 model was “to create a model which was less expensive, provided access to a wider range of financing sources, such as pension funds, allowed for greater flexibility, cheaper and accelerated procurement and greater financial transparency”.

84. In his 2018 Autumn Budget speech the then Chancellor, Philip Hammond, made clear that, whilst existing contracts would be honoured, the UK Government would abolish the use of PFI and PF2 due to compelling evidence that PFI does not deliver value to the taxpayer and that it does not genuinely transfer risk to the private sector.

85. The NAO, in its PFI and PF2 report, noted potential benefits of the models:

- **Certainty over construction costs** as the private sector would bear the risk of construction cost overruns.
- **Improved operational efficiency** as the private sector would have an incentive to consider how it could reduce long-term running costs at the outset.

- **Higher quality and well-maintained assets** as the private sector would be required to maintain the assets during the contract period.

86. In Wales, PFIs have been used less extensively than in the rest of the UK. In June 2018, there were 23 current PFI projects in Wales with a capital value of £701 million that were sponsored by the Welsh Government, and five projects sponsored by UK Government departments. The £885 million capital value of the 28 Welsh PFI projects represented 1.5 per cent of the capital value of all UK PFI projects, the lowest in the UK.

87. The then Chancellor, Philip Hammond, announced during the Spring Statement 2019 he was publishing a consultation to review infrastructure financing in the UK to: consider the finance infrastructure market; analyse future challenges; and look at the future role of government in ensuring viable projects can raise the necessary private investment.

Scottish Non-Profit Distributing Model

88. The Non-Profit Distributing (NPD) model was developed in Scotland to replace the UK Government's PFI model. The rationale for using privately financed investment was for the Scottish Government to explore all possible means to support higher levels of infrastructure investment than would be possible through the capital budget alone.

89. SFT noted that NPD has "been found by the Office for National Statistics (ONS) and Eurostat to be publicly classified, so it doesn't deliver additionality"⁴⁹ as projects would be included on Scottish Government's balance sheet. SFT commented:

"... we wouldn't use NPD again, because it was there to deliver additionality, and if it doesn't, then it's not meeting its fundamental purpose."⁵⁰

90. Consequently, in June 2019, Scottish Government announced it would accept SFT's recommendation to adopt the MIM.

Mutual Investment Model

91. The Mutual Investment Model (MIM) has been developed by the Welsh Government to provide more than £1 billion to finance public infrastructure in

⁴⁹ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 215

⁵⁰ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 215

Wales. MIM schemes will see private partners build and maintain public assets. In return, the Welsh Government will pay a fee to the private partner, which will cover the cost of construction, maintenance and financing the project. At the end of the contract the asset will be transferred into public ownership.

92. MIM is based on the Scottish Government's NPD model. The Welsh Government worked with the ONS and the European Investment Bank (EIB) to develop the MIM and ensure no debt liability is recorded on the government's balance sheet. This source of borrowing would therefore not apply to the Welsh Government's capital borrowing limits and would represent an independent borrowing stream for the Welsh Government.

93. The Minister updated the Assembly on the developments of MIM in Plenary in February 2019, noting:

"From the outset, our intention has always been to ensure that the mutual investment model promotes the public interest in the widest possible definition of that term. To that end, the model will deliver positive, additional outcomes in relation to well-being, value for money and transparency, and in doing so will avoid many of the criticisms levied at historic forms of public-private partnership."⁵¹

The case for MIM

94. There was agreement that given the Welsh Government's borrowing limits utilising private financing through MIM would be the only way of delivering additional capital investment in Wales. The WLGA noted:

"There have been concerns about MIM. Is it different from PFI? We think it is. It's an evolution of that. Now, the downsides are, of course, that the cost of borrowing is higher, but if you accept that there is capital rationing and you need that additional funding, then it's potentially a price worth paying."⁵²

95. Capital Law felt developing projects through PPP models such as MIM is the only way to deliver the Welsh Government's "ambitious project pipeline":

"...public-private partnerships are the only feasible option for delivering large-scale infrastructure projects. We know that public finances are

⁵¹ Plenary, Record of Proceedings, 5 February 2019, paragraph 195

⁵² Finance Committee, Record of Proceedings, 5 June 2019, paragraph 124

tight at the moment, so it's the only real solution, and we can deliver at scale by involving the private sector.”⁵³

96. The then Cabinet Secretary for Finance, Mark Drakeford, mentioned in his written statement that MIM would “promote the public interest – unlike the old discredited PFI model – including wellbeing and value for money”. He further noted:

“Private partners will be required to adopt the Code of Practice Ethical Employment in Supply Chains and establish high levels of environmental sustainability. MIM projects will promote value for money through the provision of public equity; the adoption of standardised, replicable contracts; and the exclusion of services which can be funded more efficiently from capital budgets. Transparency will be promoted through the appointment of public interest directors to MIM project boards.”⁵⁴

97. The omission of services from the MIM model which can be funded more efficiently from capital budgets was supported by evidence provided during the inquiry. However, there was concern that infrastructure maintenance is included in the model and could be exploited by contractors seeking a significant premium to account for risks over the project lifecycle.

98. The Welsh Government was invited to present MIM at the UN headquarters in Geneva in May 2018 and the MIM has subsequently been published in the UN compendium of aspiring People First Public Private Partnerships.

99. MIM schemes that are in the pipeline include:

- Redevelopment of Velindre Cancer Centre, Cardiff
- Work to complete the dualling of the A465 from Dowlais Top to Hirwaun
- Additional investment in Band B of the 21st Century Schools Programme.

100. The majority of evidence from witnesses agreed that MIM is an improvement on the previous PFI models utilised in the UK. KPMG felt MIM has evolved from the PFI model:

⁵³ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 7

⁵⁴ Welsh Government Written Statement: Promoting the Public Interest Using the Mutual Investment Model, 20 June 2018

“It borrows a lot of material and principles from PFI—hopefully, the good principles—and seeks to address some of the key things that have been challenging: what terms have driven exorbitant cost of finance, what’s been difficult to manage, what creates the inflexibility of contracts—that’s a personal bugbear of mine in working in this industry—and how do we address that, how do we get you better transparency of contracts by giving you a seat at the table, a voice on the board, all those things. They are sensible, practical steps to evolve the model. Does it still have at its roots, in its genetics, PFI? Yes, it does.”⁵⁵

101. Local Partnerships stressed that lessons learnt from PFI models had been applied to MIM:

“...Lessons have been learned, and I am confident that the Welsh Government have learnt those lessons and have applied that to the development of the MIM programme. I think it’s always good to apply lessons learned, and that’s part of our role, given our remit, to make sure that the public sector learns from the experiences of the past and therefore makes future projects and programmes better than the ones that preceded that. And I would say that the Welsh Government is doing that.”⁵⁶

102. However, a comparative analysis made between key features of MIM and PFI/PF2 showed the only significant difference is the required community benefits integrated into MIM.

103. The integration of community benefits into MIM was highlighted as a key difference by the Minister:

“Community benefits might include jobs created, particularly for people who are not in employment, education or training at the moment, or people who have been long-term unemployed; training and apprenticeship opportunities, including graduate work placements, pupil placements; school engagement can take place; community initiatives; and supply chain initiatives to make sure that we’re making the best opportunities available to our SMEs here in Wales.”⁵⁷

⁵⁵ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 71

⁵⁶ Finance Committee, Record of Proceedings, 9 May 2019, paragraph 292

⁵⁷ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 96

104. The Minister also mentioned the requirement to deliver “environmental priorities [through MIM] in a way in which traditional PFI contracts have not demanded”. For example, the key design principles for the Velindre Cancer Centre include the use of natural resources with energy efficiency demonstrated in all possible areas.⁵⁸

105. The Welsh Government also considered the exclusion of soft services such as cleaning and catering as another difference which it felt led to inflexible contracts and were areas of key concern in the traditional PFI. However, later PFI deals and the PF2 model also enabled the public sector to exclude such services.⁵⁹

Financing costs

106. Given MIM is in the early stages of implementation, financing costs for projects delivered through the model are currently unavailable but both Capital Law and KPMG felt that MIM is not necessarily in search of the lowest price but rather best value.

107. Capital Law highlighted that consideration should be given to the ancillary benefits available with the Heads of the Valleys A465 road project leading to £300 million being spent with Welsh companies, the creation of 140 apprentice roles and community benefits.⁶⁰

108. KPMG was cautious about associating the cheapest form of finance with best value:

“I would make a distinction between the cheapest form of finance and best value. I’m with you on, ‘We need best value’, but it’s not all about the cost of finance. The cost of finance coming with risk is different to someone else taking the risk and, therefore, charging a slight premium for it, and is that good value to do that?”⁶¹

109. KPMG argued that cheaper forms of borrowing would load risk onto the public sector:

“We have to worry about just taking a cookie-cutter approach and rolling it out, but where the private sector is pricing risk effectively, there’s no market failure in the financing market and the financing

⁵⁸ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 97

⁵⁹ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 50

⁶⁰ Written Evidence: CFS07 Capital Law

⁶¹ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 16

market is acting in good competition and working efficiently, there's no reason that Government should be borrowing cheaply, loading risk up on taxpayers, because that's all that borrowing cheaply is really saying, and trying to undercut pricing."⁶²

Risk transfer

110. HM Treasury considered that the risk transfer to the private sector through the PFI model would result in benefits which could outweigh the higher financing costs. However, in his 2018 Autumn Budget speech, the then Chancellor stated that evidence had shown the PFI models did not genuinely transfer risk to the private sector.

111. PwC felt PPP models effectively transferred risk during the construction phase, which is the riskiest stage of an infrastructure project:

"I think there are elements of real risk transfer in PPP. I think that risk around construction cost overrun does sit squarely with the operator. And I have worked with PPP operators, investors, that have incurred real cost overruns, and they have had a real—you know, there's been a real impact on the financial performance of those vehicles as a result."⁶³

112. The Welsh Government agreed with PwC's view on risk transfer by stating:

"... what we're saying with the mutual investment model scheme is that, through the model itself we'll be transferring cost risk, we'll be transferring the financing, the construction risk. So, if problems do arise during that phase of a project, through construction, those risks sit squarely with the project company... So, the main way in which you manage those cost risks arising are actually by transferring them to your project company."⁶⁴

113. The NAO report emphasised "the risk of construction cost overruns could also be transferred using a shorter private finance contract that only covers the construction period", which removes the need to use long-term private finance contracts.

114. When asked how risk could be effectively transferred to the private sector given the private investor could simply close down a project if there were cost

⁶² Finance Committee, Record of Proceedings, 15 May 2019, paragraph 16

⁶³ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 198

⁶⁴ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 107

overruns, the Chartered Institute of Public Finance and Accounting (CIPFA) emphasised the need for **effective contract management** by the public sector at the start to ensure risk is transferred appropriately:

“... it’s about the public sector’s ability to manage those contracts, and that’s how you’re going to minimise those risks. You’re never going to get away from a risk-free environment, but if we were better at managing those contracts, we’d go some way to achieving that, and we’re not.”⁶⁵

115. Local Partnerships **noted project agreements** should deal with such events:

“...it’s also around what’s in the project agreement for when things go wrong, around termination and default. The project agreements will have that in detail, such that there is the contractual arrangement there and the compensation that’ll be payable for certain default events will be known before you enter into the contract.”⁶⁶

116. Conversely, Professor Holtham **concluded** “in practice shifting risk is not so easy since the state is always responsible in the end for providing the services that the infrastructure is there to sustain – which makes the higher interest charges a bit irritating”.⁶⁷

117. The Welsh Government agreed that the public sector could not completely transfer risk:

“If you’re building a road or a hospital, at the end of the day, the Government needs to provide healthcare services, it needs to provide schools, it needs to provide a road. But the mutual investment model does not transfer continuity of service risk, because we can’t. What it does is transfer construction, financing, maintenance and life-cycle risk, and those things you actually can transfer.”⁶⁸

Equity stake and pricing

118. Evidence suggested that the MIM model would enable the public sector to take up to 20 per cent of the total equity in a project thereby allowing the public sector a share in any returns. It was also noted that taking equity in a project

⁶⁵ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 193

⁶⁶ Finance Committee, Record of Proceedings, 9 May 2019, paragraph 281

⁶⁷ Written Evidence: CFS05 Gerald Holtham

⁶⁸ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 132

would allow the public sector to have a seat on the board, which would provide better transparency and permit the public sector to influence rather than make decisions according to CIPFA.⁶⁹

119. The Welsh Government highlighted the importance of having a director on the project board:

“From the outset, we wanted to address some of the criticisms that had been raised by the National Audit Office, not just about equity—we’ve spoken about public equity already—but transparency was one of the key criticisms that we wanted to address. So, from the outset, it was important to Ministers that we had a public sector-nominated director on the board of these companies.”⁷⁰

120. When asked how much influence the Welsh Government would have in the decision-making process, a Welsh Government official noted that in the shareholder agreement there is a list of “reserve matters” over which any material shareholder could have a meaningful say by effectively exercising a veto.⁷¹

121. There are also disadvantages to the public sector taking an equity share in a project. CIPFA reported if a project experienced cost overruns then this could negatively impact the public sector:

“...the way you’d be holding that vehicle is essentially as an equity investment on the balance sheet. Now, any impact of that cost overrun that comes through in the year would equate to a movement in the value of that equity investment, up or down. If it made a profit, you’d get a 20 per cent share of it. If it made a colossal loss, you’d take a 20 per cent share of that in year, rather than spread over 25 years.”⁷²

122. Professor Holtham also stressed the public sector would need to be confident that the project would not suffer cost overruns because taking an equity share would expose the sector to any losses.⁷³

123. The National Audit Office’s (NAO) report on PFI and PF2 noted that the UK Committee of Public Accounts had criticised the level of investor returns achieved

⁶⁹ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 223&228

⁷⁰ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 109

⁷¹ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 111

⁷² Finance Committee, Record of Proceedings, 5 June 2019, paragraph 203

⁷³ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 139

on some PFI projects and the NAO itself previously concluded that inefficient pricing of equity had contributed to high returns.

124. In response, the Welsh Government felt competitive bidding would ensure the fair pricing of equity:

“The equity would be tested in competition. That’s the main way that you ensure you get a good price for the equity, as indeed with the other prices. So, as a matter of policy, we want to take three consortia through the procurement exercise and have competitive tension through those three consortia, as equity will be part of the consortia.”⁷⁴

Committee view

125. The Committee notes the evidence on PFI and MIM, and agrees that MIM represents an improvement on aspects such as community benefits and oversight of project contracts. However, it is difficult to ascertain how MIM substantially differs from PFI. Additionally there was limited evidence presented as to how MIM offers greater value for money than previous PFI models.

126. The Committee acknowledges the benefits of the Welsh Government being represented on the project board as a shareholder, which will allow greater access to project information and influence in decision-making. The Committee is concerned, however, about how the existing governance arrangements would effectively mitigate potential conflicts of interest resulting from the Welsh Government being both a shareholder and client.

127. The Committee is also concerned about the risk of a private investor terminating a project if it became financially unviable leaving the public sector to seek contingencies. The Welsh Government should ensure that contracts are significantly robust so this cannot occur.

128. The Committee believes it is unclear how MIM minimises financing costs when compared to the UK Government's PFI and PF2 and is keen to receive an update on these costs when further analysis of these costs have been undertaken by either the Welsh Government or the Wales Audit Office.

Recommendation 6. The Committee recommends that the Welsh Government ensure that projects delivered through the Mutual Investment Model are fully transparent, clearly identifying project costs and related data.

⁷⁴ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 101

7. Contract complexity and flexibility

129. The NAO report on PFI and PF2 found that operational inflexibility was a drawback of PFI. The report stressed that the PFI structure meant that changes in contracts could be expensive with lenders and investors charging administrative and managements fees.

130. In terms of complexity, KPMG felt MIM contracts were still complex but it was suggested that if a project is trying to raise significant amounts of private capital then contracts will always be complex.⁷⁵

131. When asked whether it felt MIM had learnt from the PFI model regarding contract inflexibility, PwC commented:

“PPP should only really be used where you have certainty over the specification and the demand for the asset over the long term. I know the MIM model has looked to address some of that and I know work has been done around the change regime and so on to try and address some of that, but I think we do need to be honest with ourselves that these remain reasonably rigid contracts.”⁷⁶

132. PwC also noted issues with inflexible contracts which lock the public sector into long-term projects where demand has fallen away:

“Where I’ve seen authorities come unstuck with these is where the demand for the asset has fallen off over time and they are then locked into a long-term revenue obligation where, perhaps, the utilisation of the asset isn’t there.”⁷⁷

133. The NAO report highlighted an example of this where Liverpool City Council continues paying around £4 million each year for Parklands High School which is empty.

134. The Minister focused on the exclusion of soft services, such as cleaning and catering which she thought were “things that led to inflexible contracts and those were areas of key concern and criticism in the traditional PFI model”.⁷⁸

⁷⁵ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 19

⁷⁶ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 173

⁷⁷ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 173

⁷⁸ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 98

Revenue implications

135. PwC focused on the revenue implications given public bodies would be entering into a long-term revenue obligation which would require robust financial planning:

“... the related point is that you are locked into a long-term expenditure profile. So, you need to look at that revenue commitment alongside your wider capital programme and look at it in the round and make sure that you're applying sensible, prudent financial planning and looking at all of that holistically.”⁷⁹

136. This view was supported by the WLGA who noted that a main drawback to local authorities is the revenue implications of using MIM as this would commit future revenue resources to current capital spend:

“Local Government is committing future revenue resources into current day capital spend and without any assurance on the longer term funding arrangements. It does raise a potential scenario where local authorities may be struggling to find the money to run them as paying the capital charges (or equivalent for MIM) will take precedence.”⁸⁰

137. The Minister agreed with the need to consider the future impact on revenue of the Welsh Government's capital programmes when thinking about the level and type of investment to be made in Wales.⁸¹

Refinancing

138. Within a PPP model, private investors are able to refinance the project during its lifecycle which could give rise to significant savings. Professor Holtham noted:

“... the idea of this MIM—the two elements—is to try and limit excess profits that can be made because people make excessive provision for initial risk, and then, when they refinance it at a lower interest rate, they make a large gain—(a) the state will share that gain through the 20 per cent, and (b) if it has managed to bring in some long-run investors

⁷⁹ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 173

⁸⁰ WLGA written evidence

⁸¹ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 18

initially, that also reduces the scope for that kind of gain. So, that's the thinking, I think."⁸²

139. The NAO mentioned in its report that although PFI contracts had mechanisms which allow savings to be shared from refinancing there was sometimes little incentive for investors to cooperate.

140. CIPFA commented on contractual issues relating to refinancing:

"You know, they have found situations where the procuring body didn't realise the contract had been refinanced and those savings weren't working their way through to the public body because of the original contract."⁸³

Attracting private investment

141. Witnesses felt a key factor in attracting private investment was the need for the Welsh Government to have an established pipeline. SFT noted this was important for Scotland to attract such investment:

"The publication of that pipeline, we find, is really important, because the market needs to know where the opportunities are coming from."⁸⁴

142. PwC also believed that a viable pipeline would be critical for attracting investors:

"From an investor point of view—investors in infrastructure and assets like pipeline—there is a cost in responding to projects like this. So, where investors can see a pipeline, that does increase appetite because they can see that there is a number of projects that they can potentially invest into."⁸⁵

143. However, KPMG stated "MIM style project structures seek to pass significant risk to main contractors, few of whom in the UK [construction industry] have the financial standing to bear that risk".⁸⁶

⁸² Finance Committee, Record of Proceedings, 1 May 2019, paragraph 139

⁸³ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 163

⁸⁴ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 149

⁸⁵ Finance Committee, Record of Proceedings, 5 June 2019, paragraph 163

⁸⁶ Written Evidence: CFS06 KPMG

144. This view was supported by other evidence taken which questioned whether there would be contractors out there to bid for risky projects and if not then what would this mean for competitive bidding.

145. The Minister reported there had been marked interest from the private sector for MIM projects:

“There’s been a really high level of market interest in our MIM schemes. Every market event that we’ve done in Wales has been very well attended. We’ve got an event tomorrow for the schools project, and we have more than 100 delegates expected at that bidders’ day. And, obviously, the interest has turned into real bids. As Steven said earlier on, we’re in dialogue currently with three consortia for the delivery of the A465 scheme. So, there’s a great deal of interest in this.”⁸⁷

Public sector capabilities

146. A theme running through the evidence sessions was given the complex nature of PPP contracts there was a fundamental need for the public sector to have in-house capabilities and expertise in place at the outset of MIM projects. Dr Milcheva of University College London stressed:

“I think what is very important is probably to try to have an in-house expertise regarding the project management and the financial management, because we can see from private equity funds, for example, that having a very good understanding of the projects, the infrastructure projects, is very important, and it’s not a straightforward thing.”⁸⁸

147. This view was supported by SFT who noted:

“I think there’s a big point about capacity and capability. These are complicated contracts... So, having the capacity and capability to understand that, to handle it, both in the individual authorities that are doing the procurement, and as a central body developing the contracts and assuring that they’re being progressed right through the procurement process and that they’re managed right, is really, really important.”⁸⁹

⁸⁷ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 120

⁸⁸ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 13

⁸⁹ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 197

148. The SFT **further commented** that the organisation was established to “retain some of that capacity and capability for use across the public sector”.⁹⁰

149. Given PPP projects are also delivered over the long term, evidence received by the Committee underlined the importance of effective contract management by the public sector throughout a project's lifecycle. KPMG **highlighted issues** faced by the public sector relating to on-going contract management:

“Contracts get passed down. The people that deliver a deal—these are at times 25 to 30-year deals—people will deliver a deal, they'll work hard for 18 months to get a deal done, and they'll move on in their careers, move on to something else. The detail of those negotiations and why something was done and what was there can get lost... It'll get passed, passed, passed down the chain to new employees and the knowledge gets lost and the expertise gets lost.”⁹¹

150. KPMG stressed ongoing contract management required significant investment and the need for government to think about how it would support the parties that are going to be running these contracts to manage them properly.

151. Local Partnerships which has supported the Welsh Government on the development and implementation of MIM in Wales felt the Welsh Government was **putting in place the necessary capabilities** to support delivery of MIM projects:

“The Welsh Government have been pretty demanding in making sure they get the right type of resource to help these projects—people with the right experience to deliver these projects. Certainly, from our perspective, they've been quite demanding, and it's—. I am confident they've got the right people—not just at the procurement phase; we need to be thinking about the ongoing management of these contracts. It does not end when a project agreement is signed. And in terms of governance, again, the structures are there, in place. It is early days and therefore those involved in those governance structures are, no doubt, learning as they go along. But, yes, the signs are positive, is what I would say.”⁹²

152. The Minister reported that the Welsh Government had brought commercial experts in to ensure it had the necessary skills to procure MIM scheme and also

⁹⁰ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 197

⁹¹ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 41

⁹² Finance Committee, Record of Proceedings, 9 May 2019, paragraph 301

acknowledged the need for effective management of contracts over the longer term of the project. Consequently, the Welsh Government is considering different options for managing contracts:

“A prudent approach would be to have contract managers in place before you reach financial close on a contract, so that they know the contract and so that we have a little more time to work through the options. There are different ways of doing it. You heard in the UK Chancellor’s statement last year that they were creating a centre of excellence. That’s one option we could choose to follow. The Scottish Futures Trust has its own commercial experts for contract management. That’s another approach we could follow. So there are a number of options that we need to work through over the late summer and autumn.”⁹³

MIM projects

153. There was agreement that the Welsh Government had chosen appropriate projects to deliver through MIM. Evidence provided focused on the need to select projects that are deemed stable over time such as roads, schools and hospitals. Capital Law noted:

“It’s those that are scalable, so it’s the big value projects, and it’s those that have that can be clearly defined, I think. Highways are a very good example. It’s clear what you require out of a highway project. It’s clear, to an extent, where risks sit with highway projects.”⁹⁴

154. Projects with complex requirements, high-technology assets and innovative projects are not considered appropriate to deliver through MIM. SFT also commented that “smaller projects are not necessarily the best, because of the relatively high transaction costs of doing a finance deal”.⁹⁵

Committee view

155. The Committee is concerned about the lack of influence the public sector had over inflexible PFI contracts. It is difficult to determine whether MIM enables public bodies to have a greater influence over contracts and decision making. The Committee would hope that the Welsh Government works to ensure that MIM

⁹³ Finance Committee, Record of Proceedings, 17 July 2019, paragraph 168

⁹⁴ Finance Committee, Record of Proceedings, 15 May 2019, paragraph 117

⁹⁵ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 223

contracts will have a degree of flexibility, allowing the public sector a greater degree of influence.

156. The Committee is encouraged that MIM projects are attracting significant interest from the private sector. However, the Committee recognises the revenue implications of using MIM for local authorities in the future. The Committee believes that the Welsh Government must work closely with local authorities to ensure that future revenue implications are managed appropriately.

Recommendation 7. The Committee recommends that the Welsh Government should review the level of expertise in place for contract management, and take steps to maintain this expertise to ensure effective delivery throughout the project lifecycle.

Recommendation 8. The Committee recommends that the Welsh Government should continue to utilise the Mutual Investment Model for projects requiring continuity over the lifetime of the contract and where the private sector can deliver the greatest value for money.

Alternative finance models

157. SFT mentioned a range of finance models being utilised in Scotland to unlock private investment:

Hub programme

Hub is a public-private partnership delivery vehicle developed by Scottish Futures Trust. The Hub model operates across five geographical areas with an independent private limited company or “HubCo” in each. The total value of the Hub programme is around £3 billion and was set up to deliver a programme of investments across community infrastructure such as schools, health centres and other community facilities.

158. SFT notes that the Hub model has delivered value for money across smaller projects by using a programme approach to bring consistency, reduce transaction costs and develop longer term partnering arrangements between the public and private sectors.⁹⁶

⁹⁶ Written Evidence: CFS06 KPMG

Growth Accelerator

The key objective of the Growth Accelerator approach is to deliver a funding mechanism for the public sector infrastructure which stimulates private sector investment and the wider economy.

The model recognises and captures both the economic, financial and social impacts of these investments; and establishes a payment-by-results mechanism based upon modelled impacts.

There are currently two Growth Accelerators in operation. The Edinburgh St James development will unlock £1 billion of new retail, leisure, hotel and residential development in the city centre. The Dundee Waterfront will see £60 million of Scottish Government investment support the wider £1 billion Waterfront Development.

159. SFT explained:

“What we’ve tried to do there is to work with councils and with the Scottish Government where the Government has wanted some outcomes to be delivered from a package of investment and a local authority has borrowed to finance infrastructure that has allowed those outcomes to be delivered.”⁹⁷

National Housing Trust

The National Housing Trust programme delivers affordable homes through limited liability partnerships (LLPs) established between SFT, Local Authorities and private developers.

160. In relation to the National Housing Trust programme, which uses local authority borrowing powers with a government guarantee and private equity to build affordable housing, SFT noted that 2,000 homes have been delivered through this scheme.⁹⁸

Tax Incremental Financing (TIF)

Tax Incremental Financing (TIF) is described in the Scottish budget 2019-20 as an innovative form of finance where councils retain future tax revenue to fund

⁹⁷ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 247

⁹⁸ Written Evidence: CFS06 KPMG

current infrastructure investment and unlock significant private sector development.

A TIF project must demonstrate that the enabling infrastructure will generate additional public sector revenues to repay the financing requirements of the enabling infrastructure.

There are currently four TIF projects being undertaken which sees almost £187 million of council investment, with a further two being developed and taken forward to full business case for approval.

161. TIF⁹⁹ seeks to capture locally generated, incremental public sector revenues (e.g. business rates) that wouldn't have arisen were it not for investment in the delivery of "enabling" public sector infrastructure. SFT explained that TIF is not utilised for many projects:

"What we've demonstrated there is that they're pretty tricky, actually, because it requires quite a lot of things to come together at a point in time, and it allows local authorities to take risk and things; it doesn't give them extra money. It allows them to retain rates. So, there's quite a limited set of circumstances, I would say, where that will work. But it is one of the tools in the box."¹⁰⁰

162. When asked whether there were alternative models the Welsh Government could potentially look at, **KPMG mentioned** the Regulated Asset Base (RAB) model, which would allow the Welsh Government to maintain control and influence through regulation rather than funding.

Regulated Asset Base model

The model assesses the value of the assets used in the performance of a regulated function and has been used to unlock private capital in the electricity transmission, water and transport industries.

163. KPMG also suggested making financing sourcing decisions on the basis of balance sheet treatment should not be the overriding factor with a move to value for money and addressing market failure. This would allow better partnership

⁹⁹ Money retained by a local authority under TIF is money not available to be shared amongst the other local authorities as part of the shared non domestic rates portion of Aggregate External Finance (AEF)

¹⁰⁰ Finance Committee, Record of Proceedings, 1 May 2019, paragraph 247

between the public and private sector through alternative financing models such as:

- Targeted risk taking – the government could underwrite specific risks such as high impact low probability events through a form of financing guarantee.
- Joint funding - this could be through public sector capital contributions alongside private finance.
- Mixed funding - the deals are complex and bespoke, and need to be worked through on the basis of what is the best form of government intervention to make the project happen.¹⁰¹

Committee view

164. The Committee welcomes the alternative financing models identified during the inquiry and believes there is merit in exploring additional methods of financing, in a bid to be more innovative with the funding available and to enable organisations to access further private investment for capital projects in Wales.

Recommendation 9. The Committee recommends the Welsh Government provide an update as to what consideration it has given to utilising alternative financing models to unlock further private investment for capital projects in Wales.

¹⁰¹ Written Evidence: CFS06 KPMG

Annex A: List of oral evidence sessions.

The following witnesses provided oral evidence to the committee on the dates noted below. [Transcripts of all oral evidence sessions](#) can be viewed on the Committee's website.

Date	Name and Organisation
1 May 2019	<p>Gerald Holtham, Hodge Professor of Regional Economics</p> <p>Dr Stanimira Milcheva, Associate Professor in Real Estate and Infrastructure Finance, University College London</p> <p>Peter Reekie, Chief Executive, Scottish Futures Trust</p>
9 May 2019	<p>David Ward, Chief Executive, Tirion Group</p> <p>Howel Jones, Corporate Director, Programmes and Project, Local Partnerships</p> <p>Rosie Pearson, Corporate Director Business Development, and Programme Director PPP and PFI, Local Partnerships</p>
15 May 2019	<p>Gwyn Llewelyn, Director, Infrastructure Advisory, KPMG LLP</p> <p>Stuart Pearson, Senior Associate - Construction, Energy and Projects, Capital Law</p>
5 June 2019	<p>Jon Rae, Director of Resources, Welsh Local Government Association</p> <p>Chris Moore, Director of Corporate Services, Carmarthenshire County Council</p> <p>Tim Jones, Director, Financial Advisory, Deloitte LLP</p> <p>Alan Bermingham, Policy Manager, Governments, Chartered Institute for Public Finance and Accountancy</p>
19 June 2019	Private
17 July 2019	<p>Rebecca Evans AM, Minister for Finance and Trefnydd</p> <p>Andrew Jeffreys, Director Treasury, Welsh Government</p> <p>Steven Davies, Deputy Director Innovative Finance, Welsh Government</p>

Annex B: List of written evidence

The following people and organisations provided written evidence to the Committee. [All Consultation responses and additional written information](#) can be viewed on the Committee's website.

Organisation	Reference
Tirion Group	CFS 01
Auditor General for Wales	CFS 02
Development Bank of Wales	CFS 03
Scottish Futures Trust	CFS 04
Gerald Holtham	CFS 05
KPMG	CFS 06
Capital Law	CFS 07

Additional Information

Title	Date
Letter from the Chief Secretary to the Treasury - Inquiry into the Welsh Government's capital funding sources	2 April 2019
Letter from the Rt Hon Alun Cairns MP, Secretary of State for Wales - Inquiry into the Welsh Government's capital funding sources	10 April 2019
Letter from the Chair of the Public Accounts Committee	14 May 2019
Letter to the Chief Secretary to the Treasury	3 May 2019
Letter from the Rt Hon Alun Cairns MP, Secretary of State for Wales	3 May 2019
Written evidence - Welsh Local Government Association	5 June 2019
Letter from the Chief Secretary to the Treasury	6 June 2019
Evidence paper from the Minister for Finance and Trefnydd	3 July 2019