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Supplementary Memorandum of the Auditor General for Wales to the Public Accounts Committee – Timber Sales Contracts

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I have prepared this memorandum for the Public Accounts Committee of the National Assembly for Wales to support its consideration of my report under the Natural Resources Body for Wales (Establishment) Order 2012 on the financial statements of Natural Resources Wales for the year ended 31 March 2016.

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Supplementary Memorandum

Context

- 1 NRW is a Welsh Government sponsored body created for the purpose of ensuring that the environment and natural resources of Wales are:
 - sustainably maintained;
 - sustainably enhanced; and
 - sustainably used.¹
- 2 NRW became operational from 1 April 2013, taking over responsibility for delivering the functions of the former Countryside Council for Wales, Environment Agency Wales, and the Forestry Commission Wales. NRW managed the first two years of its development as a 'transition' stage, aiming to manage continuity whilst bringing together functions from its legacy bodies. In February 2016, I published a Value for Money report on the development of NRW that focused on:
 - the creation of NRW and its operation within its initial two-year transition period, including its progress in achieving the benefits intended from its creation; and
 - the arrangements NRW was putting in place to support its transformation phase.
- 3 I found that: 'NRW [had] adopted a sound and well-structured approach to meeting the significant challenges presented by its creation; ensuring continuity in delivering its wide range of functions and with a clear focus on achieving the intended benefits and that NRW [had] learned from progress made and challenges faced and [was] proceeding with a more ambitious and comprehensive change programme, necessary to transform itself for the future and deal with legislative changes and resource pressures'.² Whilst my report on NRW's 2015/16 accounts sets out some specific concerns regarding the regularity of timber sales contracts awarded by NRW to a sawmill operator in May 2014, I remain satisfied that NRW's approach to managing the transition stage was sound and well-structured.

¹ The Environment Wales Act 2016 amended the general purpose of the Natural Resources Body for Wales to: 'The Body must pursue sustainable management of natural resources in relation to Wales, and apply the principles of sustainable management of natural resources, in the exercise of its functions, so far as consistent with their proper exercise.'

² [The Development of Natural Resources Wales](#), February 2016

- 4 One of the key operational challenges which had been facing the Forestry Commission in Wales prior to the merger was how to manage and control the spread of Phytophthora Ramorum (P Ramorum) in larch forests and woodlands. P Ramorum is a fungus-like pathogen which causes extensive damage to, and kills a wide range of trees and other plants. P Ramorum was detected in Japanese larch in Wales in 2010. Efforts were made to manage the spread of the disease through targeted felling, but the disease spread rapidly. Following its establishment NRW inherited this challenge and was faced with having to take urgent action to manage and control the disease. During the summer months of 2013, NRW identified that there was a rapid increase in the spread of P Ramorum and NRW had to find a long-term solution to combating the disease. I have been told by NRW that its intention in meeting this challenge was primarily and overwhelmingly to increase capacity for dealing with diseased larch and avoid disruption to existing trade in other types of timber.

Chronology

Tender exercise for larch long-term sales contracts

- 5 In early 2013, the Forestry Commission in Wales, faced with a significant number of Statutory Plant Health Notices³ over an extensive geographical area, decided that large-scale felling of larch was necessary if P Ramorum was to be effectively controlled. An invitation to tender (ITT) was developed, whereby interested parties would be invited to tender to purchase larch timber from the Forestry Commission in Wales. NRW inherited the tender process from Forestry Commission in Wales on 1 April 2013 as a consequence of the merger.
- 6 In April 2013, NRW issued an ITT for two long-term contracts (LTCs) 'for clearance and marketing of infected Larch stands. Each contract being 330,000m³obs [approximately 266,000 tonnes] over a five year period'⁴. The ITT noted that the award of the contract 'will be made on the combined basis of the price offered and clear demonstrable linkages to how the timber will be harvested and processed with minimal displacement to the current harvesting or processing resource in Wales'. Therefore, it is clear that NRW's decision on contract award was to take into account both the price and wider market considerations in terms of how the timber will be harvested and processed, with the objective of minimising disruption to harvesting and processing resources in Wales. The ITT made clear that there

³ Statutory Plant Health Notices require the landowner to fell, destroy and/or contain infected trees within a defined time period. In Wales, the notices were issued by the Forestry Commission until 31 March 2013 and by Natural Resources Wales thereafter as part of its regulatory functions

⁴ m³ obs = cubic metres overbark standing, i.e., volume of wood in standing trees, including bark

was the possibility of further discussions with bidders before the contract was awarded.

- 7 NRW received three tenders, one of which was submitted by the sawmill operator. In its response to the ITT, the sawmill operator set out plans for infrastructure investment at its Welsh premises. The submission noted: 'The greater the volumes of long-term contract commitments in both larch and spruce that can be acquired, will add significant weight and security to that investment decision. It is unlikely that securing just one of the parcels tendered would provide sufficient critical mass in order to secure funding for the investment and, as such, we propose two gate prices which return greater value to NRW for increased volume by awarding both contracts.' It is clear from the sawmill operator's submission that the sawmill operator was looking to be awarded both larch contracts, and for NRW to provide long-term contractual commitments in relation to both larch and spruce, in order to secure the investment at the sawmill operator's Welsh premises.
- 8 The tenders were evaluated on 19 June 2013 based on a combination of price and each bidders' overall approach to the delivery of the contract. Following the evaluation, NRW held discussions with each of the bidders, in accordance with the ITT.
- 9 In July 2013, NRW produced a report on the tender. The Report stated that since the ITT had been issued, the disease has been found to have spread significantly north and eastward and that there would be a need to fell at least 350,000m³ (c 282,000 tonnes) of larch each year for several years to come. In consequence, the conditions and objectives of the tender had 'significantly changed'.
- 10 The report of July 2013 indicated that although the overall volume of larch to be felled to 2025/26 remained the same, NRW's revised larch removal plan of June 2013 required a greater volume of larch to be felled in the years to 2019/2020 and a reduced volume thereafter (ie 'front loading' the felling). I am satisfied that the report provided justification for NRW to deviate from the course set out in the ITT.
- 11 The report referred to the key risks if NRW did not award sufficient contracts that reflected the increased larch programme. The report also notes that the proposed sawmill operator small log line and Bidder 3's pelleting plant, were both much needed new and effective capacity for marketing the increasing larch harvest. I consider these were all relevant considerations for NRW to take into account in determining how best to proceed.
- 12 The report set out NRW's assessment of each of the three responses to the tender and looks at the respective financial returns. Each bid was awarded an overall percentage score as follows:
 - Bidder 1 – 92.78%
 - Bidder 2 – [the sawmill operator] – 79.31%
 - Bidder 3 – 75.42%

- 13 The report set out the advantages and disadvantages of different options for award, for example awarding the offer volume in accordance with the scoring of the ITT to Bidder 1. The report ultimately recommends offering the original volume to Bidder 1 and/or Bidder 3 and 'offering [the sawmill operator] further standing volume to address the massive increase in the LLD programme, together with a log and bar element'. One of the stated reasons for favouring this option was that it would encourage the investment in the sawmill operator's Welsh saw line and in Bidder 3's energy pelleting plant.
- 14 The report recognised that this recommended way forward required: 'stepping outside the terms of the original tender in terms of volume and location in response to current larch replacement plan demand'. The report also recognised that there was a risk of challenge from other timber processors but that, in NRW's view, there was unlikely to be any new bidders if the tender exercise were re-run. The report set out that the risk of challenge as a consequence of deviating from the ITT, was balanced against a greater risk to NRW of not doing enough given the growing levels of infection and the marketing/harvesting requirement and the risk of losing the sawmill operator's Welsh saw line, if NRW did not take action. An internal email from NRW's Head of Forest Operations on 8 July 2013 stated: 'we could run a further exercise, however, we are sure [we] will not receive new bids other than from the existing bidders in the current exercise – failure to do this will mean further delay in putting in place contracts to deal with the disease'.

Post tender competitive dialogue process

- 15 At the end of July 2013, NRW wrote to the bidders to inform them of the outcome of the tender process. The sawmill operator was informed that it had been unsuccessful in the tender process but that NRW was willing to make the sawmill operator an offer of a standing parcel of larch in Llandovery Forest of 65,000m³obs (c 52,400 tonnes) per annum for five years. This volume was equivalent to one of the two original tendered lots. The correspondence also set out that there was an option to extend this and a possibility of further supply of larch from direct production as part of an offer which NRW wished to discuss with the sawmill operator 'in order to secure the proposals that were put forward'.
- 16 It is apparent from contemporaneous emails that the sawmill operator was unhappy with the offer and were in dialogue with NRW about it.

- 17 On 2 August 2013, the sawmill operator wrote to NRW stating: 'as explained when we spoke earlier today, I am shocked and completely dismayed that NRW have treated the sawmill operator in such an off-hand and short-sighted way Clearly NRW value a harvesting contracting business and an English sawmill with greater enthusiasm than the sawmill operator, and if that remains the situation, we will invest our time and money elsewhere outside Wales. The 'offer' from [the Head of Forest Management] is totally inadequate and unacceptable. We need a far more robust and expansive commitment if we are to re-engage with NRW. We will contact you with specific details, however, time is of the essence, while we review our future strategic plan in Wales and inform Ministers of our decisions.'
- 18 NRW and the sawmill operator met on 12 August 2013 to discuss larch and spruce contracts. In an email of 22 August 2013, the Head of Forest Operations indicated to the sawmill operator that NRW was actively considering the sawmill operator's proposal in relation to spruce and larch contracts and that, in principle, NRW had no objection to offering an extension of LTCs for a period of between five and ten years.
- 19 In August 2013, NRW's Head of Timber Marketing prepared a paper: **Developing Options for the sawmill operator Larch Investment and wider guidance on replacement of existing Spruce LTCs**, for consideration by NRW's Executive Team. Whilst the paper was prepared for consideration by NRW's Executive Team, there is insufficient contemporaneous evidence that it was provided to or considered by the Executive Team.
- 20 The paper set out a revised larch clearance plan dated July 2013 which required an even greater amount to be felled in the earlier years – 350,000m³obs (c 282,000 tonnes) per annum for the years 2014/15 to 2019/20. It noted that the larch that had been offered to the market by NRW had been absorbed by substitution, but that there was a need to increase overall processing capacity for larch.
- 21 The paper stated that two standing contracts of 65,000m³obs (c 52,400 tonnes) each per annum for five years were offered to Bidder 1 and one to Bidder 3, all in the Coed y Cymoedd Forest District area and a further standing contract for 65,000m³obs (c 52,400 tonnes) was offered to the sawmill operator in Llandoverly Forest District, ie a contract the same size as either of the two contracts advertised in the ITT, but in a different location. The paper noted that the sawmill operator was 'not content with the offer that was made to them'. The paper went on to explain that NRW was aware that the sawmill operator needed a further guaranteed supply of larch volume before committing to increase the capacity at its Welsh premises, and that it had indicated that investment at those premises would not go ahead unless they could be offered some surety on continuing supply of the spruce element of the mill. This reflected the sawmill operator's statements in its response to the ITT.

- 22 The paper set out several options but concluded that it was essential that the proposed development at the operator's Welsh premises was secured 'as it will provide a marketing solution to the sawlog element that will be coming forward from the potential seven million cubic metres of standing larch [from both public and private woodland] that will need to be felled in Wales and the Marches over the next 10 to 12 years'. The document also showed that NRW's larch clearance plan estimated that NRW would have to clear 2.8 million cubic metres of standing larch by 2025/26 and standing infected stands at the time already amounted to nearly one million cubic metres on the Welsh Estate with further infection likely.
- 23 The paper also notes that it is unlikely that NRW would see an equally good proposal if it went out to market, (although there is no evidence set out in the paper to support that contention), and that time was of the essence in respect of the planned investment at the sawmill operator's Welsh premises.
- 24 The paper recommended offering the sawmill operator contracts for both larch and spruce. However, as noted above, there is insufficient contemporaneous evidence that the paper was presented to the Executive Team or NRW's Board for decision. I therefore understand that the decision to proceed on this basis was therefore taken by NRW officers exercising delegated powers. The paper indicated that the recommended option could be viewed as contentious: 'we recognise that there is a danger of seeming to favour the sawmill operator if only volume that was destined to their facility was granted a long-term contract extension, having the effect of reducing opportunity for others in future sales'.
- 25 A paper presented to the Board dated 15 October 2013 titled: 'Phytophthora ramorum Update' noted that 'the overall level of non-compliance with Statutory Plant Health Notices increased sharply at the end of August, as this was the deadline for compliance, and that 2000Ha of new infections were identified on the Welsh Government Woodland Estate in that year'. The update referred to the competitive bidding process and the contracts offered and noted that the final amount offered may be higher depending on the outcome of negotiations relating to investment decisions by processors. However, there is insufficient evidence that the details of the negotiations were brought to the attention of the Executive Team or the Board at the time.
- 26 In November 2013, the Head of Forest Operations sought further information from the sawmill operator in order for NRW to make a final decision. The sawmill operator responded on 11 November 2013.
- 27 On 14 November 2013, the Head of Forest Operations emailed the sawmill operator to confirm that, in principle, NRW was satisfied with the pricing mechanism and was entering into the ten year contract. NRW has not been able to provide internal emails or documentation in this period regarding its decision making, and so I have been unable to confirm the internal reasons for the decision. In his email of 14 November 2013, the Head of Forest Operations stated that there would be detail to agree with the sawmill operator and this would progress over the coming weeks.

28 NRW has recently provided me with some further contemporaneous evidence of the contract negotiations that took place between November 2013 and May 2014, although I note that there remain some gaps in the documentation.

Contract Award

29 In May 2014, NRW's former Executive Director National Services signed eight timber sales contracts between NRW and the sawmill operator and an overarching Memorandum of Agreement. The contractual start date is specified as 1 April 2014. The contracts remain in force.

30 The eight linked timber sales contracts are set out in [Table 1](#).

Table 1: timber sales contracts awarded by NRW to the sawmill operator in May 2014

Contract	Type of contract	Contract period (years)	Species type	Contract Volume (tonnes)	Annual Volume (tonnes)
A	Sale of pre-felled timber	10	Spruce	100,000	10,000
B	Sale of pre-felled timber	10	Spruce	350,000	35,000
C	Sale of pre-felled timber	10	Larch	70,000	7,000
D	Sale of pre-felled timber	10	Larch	150,000	15,000
E	Sale of standing trees	10	Larch	525,000	52,500
F	Sale of standing trees	10	Spruce	162,000	16,200
G	Sale of standing trees	10	Spruce	242,000	24,200
H	Sale of standing trees	5	Larch	262,500	52,500
				1,861,500	212,400

New saw line investment

31 In August 2015, NRW's former Head of Forest Operations wrote to the sawmill operator regarding NRW's concern that the sawmill operator would not meet its contractual duty to construct and commence operating a new saw line at its Welsh premises by 31 March 2016. The sawmill operator responded setting out reasons why the project had been delayed and requesting an extension to the contractual deadline. In March 2016, NRW and the sawmill operator entered into a contract variation whereby the deadline for the operator to construct and commence operation of the new saw line was extended until 31 March 2017.

Compliance with framework of authority

Internal delegation arrangements

- 32 The functions of NRW are set out in the Natural Resources Body for Wales (Establishment) Order 2012 (the 2012 Order). These functions include undertaking any devolved function of the Forestry Commissioners. NRW is therefore empowered to manage the publicly-owned forest estate and to make decisions necessary to effectively carry out that function. The 2012 Order sets out that NRW may delegate the exercise of its functions to a committee, sub-committee, member or employee of NRW. This includes entering into contracts with external suppliers and purchasers.
- 33 The Board approved a 'Financial Scheme of Delegation' that ensured that all financial activities of NRW were delegated to an agreed level of authority or specific post holder. It allowed the Board and Executive Team to delegate decision-making responsibility for financial matters. The Financial Scheme of Delegation in place in 2014 delegated authority to the Head of Enterprise to sign harvesting timber contracts with a value above £1 million.
- 34 The contracts with the sawmill operator were signed off by NRW's Executive Director for National Services, who was a member of NRW's Executive Team with executive responsibilities for forestry operations (and the line manager of the Head of Enterprise). I am of the view that the Executive Director for National Services had the necessary delegated authority to enter into timber sales of any value.
- 35 NRW's Financial Scheme of Delegation stated that: 'all staff must alert their line manager if they are involved in any financial decisions which they believe the Chief Executive and/or the Board would want to be consulted with, particularly if it involves novel, unusual or financially contentious action'. I consider that the decision to contract with the sawmill operator was contentious and repercussive for the reasons set out in [paragraph 44](#).
- 36 Although NRW considers that the Financial Scheme of Delegation did not require the matter to be referred to NRW's Board or Executive Team, it has provided evidence that the CEO and Board were, at least, aware of the negotiations with the sawmill operator. NRW has provided me with a letter dated 16 October 2016 from NRW's former Executive Director for National Services in which he states that he kept NRW's Chief Executive apprised of the ongoing negotiations with the sawmill operator. In addition, NRW has provided a Board paper dated 15 October 2013 that referred to the competitive bidding process and that there were further negotiations relating to investment decisions by processors (but, as noted above, the paper did not provide further detail). A non-executive Board member attended a meeting with the sawmill operator in August 2013 and NRW has provided board minutes showing that this was discussed at a Board meeting on 3 September 2013.

37 The Chief Executive of NRW has confirmed to me that both he and the Board were aware of the negotiations with the sawmill operator and that the requirements of the Financial Scheme of Delegation were complied with. Nevertheless, I am concerned that the Board and/or Executive Team do not appear to have scrutinised and discussed the proposal given its financial size and contentious and repercussive nature.

Requirement to refer novel, repercussive or contentious activities and proposals to the Welsh Government for scrutiny and/or approval

- 38 Whilst NRW complied with its internal delegation arrangements, the principal document that provides authority for NRW transactions is the NRW Framework Document. The Framework Document sets out that payment of grant-in-aid to NRW is conditional upon the satisfactory performance by NRW of all its obligations as set out in the Framework Document, which includes compliance with Welsh Government publication, 'Managing Welsh Public Money'. The requirement to comply with Managing Welsh Public Money relates to section 70 (2) of the Government of Wales Act 2006 (2) which states that: 'the Welsh Ministers may attach conditions to the giving of financial assistance by them; and the conditions which may be attached include, in particular, conditions requiring the repayment of the whole or any part of a grant, or the making of any other payments, in any circumstances'.
- 39 Under the title 'Expenditure', paragraph 3.9.1 of the NRW Framework Document says that: 'NRW shall comply with the delegations set out in Annex 5'. Annex 5 sets out that approval of the sponsor team is required for any novel, contentious or repercussive proposals.
- 40 Paragraph 3.9.8 of the Framework Document provides that NRW's income-generating activity must be undertaken in accordance with the terms of Managing Welsh Public Money and the Framework Document. In addition, paragraph 1.2.9 of the Framework Document states that the Chief Executive of NRW, as Accounting Officer, is personally responsible for ensuring compliance with the requirements of Managing Welsh Public Money.

- 41 I have considered the version of the Welsh Government's Managing Welsh Public Money which was in force at the relevant time. This document states in paragraph 3.8.3: 'The framework document agreed between a public body and its sponsor always envisages the sponsor department exercising meaningful oversight of the public body's strategy and performance, pay arrangements and/or major financial transactions, eg by monthly returns, standard delegations, exception reporting or other techniques. Public bodies should refer to their sponsor departments any activities which appear novel, contentious or repercussive; in turn the sponsor department may need to seek WAG's Corporate Governance Unit consent.' Managing Welsh Public Money does not confine the requirement to refer novel, contentious or repercussive activities to expenditure.
- 42 I am therefore satisfied, that Managing Welsh Public Money required NRW to refer any activities to its Welsh Government sponsor departments which appeared novel, contentious or repercussive.
- 43 Neither the Framework Document nor Managing Welsh Public Money define 'novel, contentious or repercussive' proposals, though the latter gives some examples. Determining whether a proposal or activity is novel, contentious or repercussive, is therefore a matter of fact and judgement.
- 44 The Oxford English Dictionary defines 'contentious' as 'causing or likely to cause an argument; controversial' and defines the noun 'repercussion' as 'an unintended consequence of an event or action, especially an unwelcome one' (the adjective 'repercussive' is not in the dictionary). NRW's Chief Executive has told me that he does not consider the decision to contract with the sawmill operator in May 2014 to be contentious or repercussive. I disagree and consider that it was contentious and repercussive for the following reasons:
- The contracts awarded to the sawmill operator were very substantial in size, NRW has estimated that the volume of timber sold under these contracts represented approximately 20 to 25% of the total timber made available to the market by NRW over a ten year period and the award of such a large contract to one purchaser had wider market repercussions. NRW's Executive Team Paper of August 2013 acknowledges that in consequence of the proposed contract with the sawmill operator 'there will be very little spruce to offer standing sales merchants over the next five years'.
 - The contracts for larch and spruce were awarded following a competitive tender for larch contracts (in which the sawmill operator was not the winning bidder, however, NRW decided to offer contracts for larch to all three bidders) and therefore no other potential purchasers were given the opportunity to purchase the volume of larch and spruce timber which was ultimately awarded to the sawmill operator. NRW's view is that there was no market for diseased larch based on (a) the lack of interest in 21 individual parcels of trees that NRW sought to sell between November 2012 and September 2013 referred to in [paragraph 71](#); and (b) that only three bids were received in response to the 2013 tender referred to in [paragraphs 5 to](#)

14. In my view, the size of those parcels and tender offer are not comparable to the offer of eight Long Term Contracts (LTCs) for both diseased larch and spruce, particularly as the sawmill operator itself made clear that four LTCs for larch would be insufficient for it to invest in the new saw line. The contract volume awarded to the sawmill operator was designed to enable it to make major investment in its sawmill. This investment enabled the sawmill operator to significantly increase its processing capacity. NRW considers that it was highly unlikely that any other operators would have been interested in such significant volumes of diseased larch and in the timescales in which NRW had to act and that it was aware of the risk of challenge on this point but that their 'professional view was that there was no alternative'. However, there is little within the contemporaneous documentation to evidence that NRW officials gave careful consideration to whether the higher volumes might draw interest from a wider range of timber companies (ie, companies that did not bid in the 2013 competition) nor whether those volumes might have sufficed to encourage other competitors to invest in additional capacity. In my view, the commitment of NRW to sell the sawmill operator a high volume of timber over a ten year period would appear to be an opportunity which other operators may have been interested in.

- The decision to award the contracts was not informed by relevant market testing.
- Internal papers prepared by NRW acknowledged the risks associated with awarding these contracts given that the sawmill operator had been unsuccessful in the tender exercise conducted in 2013. The papers also acknowledged that the decision to award the contracts to the sawmill operator in this way might be subject to challenge.

45 I therefore consider that the proposal should have been referred to NRW's sponsor division within the Welsh Government in accordance with the requirements of the Framework Document and Managing Welsh Public Money.

46 NRW has told me that at the time it did not regard the award of the contracts as contentious or repercussive. NRW has also told me that the Board and Welsh Government were aware of the process and NRW has provided me with a copy of an email sent to NRW's Sponsor division within the Welsh Government on 4 August 2013 (nine months before the contracts were entered into). The email was sent to the Welsh Government following receipt of the correspondence from the sawmill operator referred to in [paragraph 17](#). The email to the Welsh Government set out NRW's concern that the sawmill operator might seek to lobby Ministers following its unsuccessful tender and its unwillingness to accept an offer it viewed as 'totally inadequate and unacceptable'.

- 47 The email does not specify the details of the offer made to the sawmill operator and states that: 'we will continue to speak with [the sawmill operator] and develop lines to take in pursuit of a good outcome for all parties'. I do not consider the email represents a referral to the Welsh Government. I am of the view that the purpose was to alert the Welsh Government of potential lobbying and not to make the Welsh Government aware of a matter that was contentious and repercussive. Furthermore, as at 4 August 2013, the volume of timber offered to the sawmill operator was only 14% of the total eventually sold to the sawmill operator under the contracts entered into in May 2014, and the offer was solely for larch.
- 48 The Welsh Government has told me that whilst its forestry officials were aware that negotiations were taking place between NRW and the sawmill operator, they were not involved in the detail. Furthermore, the Welsh Government's forestry officials briefed the relevant Minister prior to a ministerial visit to the sawmill operator's premises that: 'Welsh Government has an interest in ensuring a competitive timber market, both for the good of the sector and for its own revenues via NRW's timber sales. Opportunities for [the sawmill operator] to expand should be balanced by fair open and transparent marketing of timber from the [Welsh Government] woodland estate.'
- 49 I therefore consider that NRW did not meet the requirements of the Framework Document and Managing Welsh Public Money to refer a contentious and repercussive proposal to the Welsh Government. I consider that the transactions related to these contracts which are included within NRW's financial statements for 2015/2016 were outside the framework of authority governing them and are therefore irregular. In consequence, I have qualified my regularity opinion on NRW's 2015/2016 financial statements.

Compliance with public law principles in decision-making

Impact of legality concerns on the regularity opinion

- 50 Where there is significant uncertainty that transactions are lawful, I am unable to provide a clear opinion. This is because positive assurance cannot reasonably be given where there is significant uncertainty.
- 51 As part of my deliberations leading to giving my regularity opinion on NRW's financial statements for 2015/16, I accordingly considered concerns relating to the legality of transactions associated with contracts NRW entered into with the sawmill operator in May 2014. These concerns were whether NRW's decision to award the contracts to the sawmill operator was lawful in terms of public law and State aid rules.

- 52 I note that my consideration of the transactions arises in the context of my audit functions and does not bear on the validity or enforceability of the decisions taken by NRW (and I note NRW's point that none of the industry representatives sought to bring a challenge to the award of the contracts). The decision to award the contracts remain valid in the absence of any challenge and quashing by a Court. My regularity opinion, however, takes the form of positive assurance, which means that I state whether transactions are in accordance with the authorities that govern them.
- 53 My considerations of these matters are set out below.
- 54 For a decision of a public body to be lawful it must be made in accordance with applicable legislation and with public law principles (for example, the decision must not be irrational). A decision should be taken in accordance with the public body's policies, unless there is a good reason to depart from them.

Powers

- 55 I have considered whether NRW had the legal powers to enter into contracts for the sale of timber with the sawmill operator in May 2014. At the relevant time, the Forestry Act 1967 (the 'Act') applied to NRW. Under the Act, NRW has a general duty of promoting the interests of forestry, the development of afforestation and the production and supply of timber and other forest products. NRW has the power to sell or dispose of any timber belonging to it and to generally promote the supply, sale, utilisation and conversion of timber.
- 56 In addition, the 2012 Order provided at the relevant time that the purpose of NRW was to ensure that the environment and natural resources of Wales were: (a) sustainably maintained, (b) sustainably enhanced and (c) sustainably used. Under the 2012 Order, the NRW has the power to charge 'for work that it carries out and for goods, services and facilities that it provides'. It also has incidental powers under the 2012 Order to 'do anything that appears to it to be conducive or incidental to the discharge of its functions', and in particular (amongst other things) to enter into agreements, and acquire or dispose of property.
- 57 NRW was also subject to statutory notices under the Plant Health (Forestry) Order 2005 in relation to the diseased larch trees in specified areas which required the felling, destruction and/or containment of infected trees within a specified timescale. NRW was therefore under a legal duty in relation to the diseased larch trees and sought to comply with that duty by exercising its power to enter into contracts for the sale of standing and pre-felled timber.
- 58 I am therefore satisfied that NRW had the powers required to enter into timber sales contracts in May 2014.

Policies

- 59 As noted above, public bodies must: (a) take into account and (b) follow relevant policies, unless they have a good reason to depart from them, or at the very least have stated clear reasons for the departures. A failure to do so can render a decision, and in turn an item of account, contrary to law. Public law also requires that any reasons given are substantiated.
- 60 I have seen some evidence that NRW took its policies into account and considered whether there were good reasons to depart from them. For example, the tender evaluation report produced in July and the Executive Team paper dated August 2013 contained consideration of different options, including going back to the market.
- 61 However, there is an evidential gap (in terms of NRW's internal decision making) between the Executive Team Paper dated August 2013 and the contracts entered into by NRW in May 2014. If the policies were not taken into account but the decision nevertheless clearly followed the policy, this would be unlikely to render the contracts and associated transactions unlawful. I have therefore considered whether there are incidences of NRW's policies being departed from with no good reasons set out for doing so.
- 62 NRW's timber sales policy, at the relevant time was contained in the FCW Timber Marketing Strategy 2011 – 2016. This document covered both standing and roadside sales. It also provided that NRW's marketing objectives in selling timber were that it would:
- 'Secure best value from the sale of timber by offering it for sale in a fair, open and transparent way;
 - offer timber to the market in ways that allow the greatest practicable number of customers to compete for it and in ways that recognise the business needs of NRW's customers and enable them to add the greatest possible value to it;
 - offer timber in ways that supports investment in the whole supply chain, from harvesting through to processing and which focuses on areas where that supply chain is weaker; and
 - offer timber in ways that encourage its use to best effect to help Wales to reduce its carbon footprint.'
- 63 In this case the spruce and larch timber was not offered for sale to the market, potentially contrary to (a) and (b) above. However, the document also includes a section: 'Dealing with unforeseen events' and, in particular, a statement that: 'In exceptional circumstances only we may decide to negotiate the sale of timber to customers who are able to respond quickly to events'.

- 64 NRW argues, and has provided contemporaneous evidence in support, that the circumstances it faced in 2013, ie the rapid increase in the spread of P Ramorum during the summer months represented 'exceptional circumstances' that warranted departing from its stated timber marketing objectives. This was considered necessary as NRW needed to act quickly to find a long-term solution to combating the disease.
- 65 I am accordingly satisfied that NRW has demonstrated that there was a good reason to depart from its usual policy and that there were exceptional circumstances such that it might decide to negotiate the sale of timber to those customers who could respond quickly.

Process

- 66 In paragraphs 5 to 31 I have set out my understanding of the decision-making process followed by NRW leading to contracts being awarded to the sawmill operator in May 2014.
- 67 Considering the decision-making process as a whole, it is evident that NRW took steps at various stages to assess the advantages and disadvantages of the options available to it. However, crucially, NRW has been able to provide me with very little documentation in respect of its decision to enter into the larch and spruce contracts and the Memorandum of Agreement. In particular, there is little documentation relating to the decision to enter into the contracts (which appears to have been taken in November 2013). NRW has recently provided me with documentation relating to the negotiations that took place between August 2013 and May 2014. NRW position is that the negotiations to 14 November were in line with the decision making arising from the Executive Team paper and that the contracts which were concluded were largely on Forestry Commission/NRW standard terms and in line with the strategy in the Executive Team paper. In my view, on the basis of the records provided by NRW, there is insufficient documentation in relation to the decision to enter into the contracts and it is not possible to be certain what factors were considered by the decision maker when entering into the contracts and consequently whether the decisions taken were lawful.
- 68 The failure of NRW to maintain sufficient contemporaneous documentation setting out its decisions during this period and the reasons for those decisions has meant that I have been unable to satisfy myself on some key issues. NRW has told me that having only just concluded an open market exercise for diseased larch, it took the view that the time pressures, driven by the rapid spread of the disease, were such that repeating the exercise would significantly delay its response by several additional months and such an exercise was deemed by its experienced timber marketing team as highly unlikely to attract any new interested parties.

- 69 I am however not persuaded that the urgent need for NRW to contract to address the rapid spread of P Ramorum was the reason, or the only reason NRW entered into the contracts with the sawmill operator. I am concerned that one of NRW's considerations may have been to secure the investment at the sawmill operator's premises. That is unlikely to be a legitimate consideration in and of itself. NRW has provided some evidence to support the award of contracts on the basis of urgency and has stated that its purpose was to increase capacity for processing diseased larch and that there were no other options in the market, but in its internal documents it also refers to the objective of wanting to support the sawmill operator's investment.
- 70 NRW maintains, and I accept, that it may have been the case that NRW's underlying consideration was to increase capacity as a way of dealing with the increasing amount of infected larch to be processed in the years to come. Whilst this was a potentially valid motive, I have received representations from industry representatives that in 2013 there was significant unused capacity in other Welsh sawmills which would have taken, subject to price, as much timber as could be supplied. If that is correct, it is clearly a relevant consideration which NRW should have been aware of and taken into account. If it was aware of it, it would call into question NRW's motive in entering into these contracts with the sawmill operator. NRW strongly disputes the assertion that there was unused sawmill capacity.
- 71 NRW holds the view that there was no market for infected larch because during November 2012 to September 2013 Forestry Commission/NRW attempted to sell 21 individual parcels of infected larch and, of these, seven received no bids, eight received only a single bid and there were no parcels which received more than three bids. NRW has informed me that the average price was a negative price of -£20.71 per tonne. NRW also considers that the three bids received in response to the 2013 tender show that there was neither demand for, nor capacity for, switching to diseased larch. As stated above, in my view, the size of those parcels and tender offer are not comparable to the contracts which NRW entered into with the sawmill operator. The contract volume awarded to the sawmill operator was designed to enable it to make major investment in its sawmill. This investment enabled the sawmill operator to significantly increase its processing capacity. The commitment of NRW to sell the sawmill operator a high volume of timber over a ten year period would appear to be an opportunity which other operators may have been interested in.
- 72 I am also concerned that NRW may have been influenced by the sawmill operator's statement that unless NRW changed its position it would seek to invest its time and money outside of Wales ([paragraph 17](#) refers). I note that NRW informed the Welsh Government by email on 4 August 2016 that the sawmill operator was using such statements to apply pressure. I also note that NRW said that it was used to this type of behaviour and would not be influenced by it. I remain, however, concerned the sawmill operator's pressure may have influenced NRW because NRW's documentation as a whole does not set out a clear record of the decision-making process.

- 73 I am of the view that serious questions remain as to why, given that the sawmill operator was unsuccessful in the competitive tender, it was ultimately awarded such a high volume of timber on the basis that NRW felt that increased capacity was needed. This is within the context that NRW did not go out to market to see whether other operators could increase capacity in a way which would secure better value for money.
- 74 Whilst I have concerns regarding the decision-making process, the evidence is not sufficient for me to reach a conclusion that the decision to enter into the contracts was in breach of public law principles. My uncertainty does not mean that the contracts should now be regarded as unlawful as set out in [paragraph 52](#), however, means that I am unable to give an unqualified regularity opinion on the financial statements.
- 75 The Chief Executive of Natural Resources Wales has told me that he considers that qualification of the regularity opinion is disproportionate to the shortcomings identified and that he disagrees with my conclusions and relies on legal advice which NRW sought during the course of my audit investigation and shared with me. However, I have sought my own legal advice from Counsel (including in relation to NRW's advice) and I agree with the advice I have received, which is to the effect that there is insufficient evidence to conclude that the decision-making process was in compliance with public law principles and State aid rules. The significant uncertainty which exists means that I consider that the correct and proportionate action for me to take as the auditor of NRW is to qualify my regularity opinion.

Compliance with State aid rules

- 76 The decision of NRW to enter into timber sales contracts with the sawmill operator without opening the opportunity to the wider market led me to consider whether NRW has provided the sawmill operator with unlawful State aid.
- 77 State aid is any aid granted by an EU Member State or through State resources in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, in so far as it affects trade between Member States (Article 107 of the Treaty on the Functioning of the European Union). The provision of State aid is unlawful unless authorised in advance, whether by an existing 'block exemption' or by individual authorisation granted by the European Commission in response to a notification from the relevant State.

- 78 I have sought legal advice on whether or not the award of the contracts to the sawmill operator constituted a grant of State aid to the sawmill operator. I am advised that this turns on whether or not those contracts constituted the provision of an 'economic advantage' to the sawmill operator. If they did, and the value of that advantage was potentially material to inter-State trade (a benchmark for materiality in this context is the European Commission's State aid *de minimis* threshold of €200,000), then the other conditions for State aid will also be satisfied because such an economic advantage:
- a. would plainly be granted from State resources, since the assets of NRW (including trees that it has the right to sell) are State resources, and decisions of NRW are imputable to the United Kingdom as an EU Member State;
 - b. would plainly be 'selective', since the advantage would have been given specifically to the sawmill operator and not to other sawmill operators; and
 - c. would also be liable to distort competition and affect inter-State trade, since (i) the advantage would strengthen the overall economic position of the corporate group of which the sawmill operator is part, and (ii) the markets (such as for timber and timber products) in which that corporate group competes are markets in which there is clearly a significant amount of cross-border trade within the EU.
- 79 The kinds of measures which can constitute an 'economic advantage' provided by the State, include direct financial measures (eg capital investments or interest free loans), indirect financial measures (eg waiver of debts or exemptions from taxes) and the provision of assets, services or dedicated infrastructure free of charge or at an undervalue. The award of a contract will constitute an advantage where its terms are unduly generous (as compared with 'market terms') to the undertaking, whether because those terms provide for the supply of goods or services to the undertaking at an undervalue, or because they provide for the undertaking to receive remuneration for the goods or services that it supplies which exceeds the market price.
- 80 The burden of proof in relation to showing that a measure constitutes an economic advantage is on the person (usually the European Commission) alleging that it does so. The European Commission has, in its decisions and published guidelines, adopted the position that it is incumbent on a State body that is awarding a contract, or selling land or other valuable assets, to either (a) carry out a competitive process or, (b) where it is not practicable to hold a competition, at least use 'market testing' or some other mechanism for verifying that the terms to which it ultimately agrees are in accordance with market terms and therefore do not confer any economic advantage. Where the State body has not done so, the position as a matter of law is still that the burden of proof of advantage is on the person alleging the advantage. Nevertheless, the European Commission will typically take the position that it is entitled to draw from the circumstances an inference (or 'rebuttable presumption') that the terms of the contract were generous

to the undertaking as compared with the terms that would have been produced by a competitive process.

- 81 No economic advantage arises where the State is doing something (such as selling a piece of land that it owns) which can also be done by non-State entities, and does so on terms that a non-State entity in a comparable situation might well have been willing to accept *for commercial reasons*. This principle is known as the 'market economy operator principle'. To apply that principle, it is necessary to compare the behaviour of NRW with what a market operator would have done in comparable circumstances. This may give rise to evidential difficulties because evidence of what a market operator would have done may not be available and because there may be room for argument as to whether certain objectives or interests should, or should not, be amongst those imputed to the hypothetical market operator. I am not persuaded that NRW acted as a market operator would have done as one of NRW's reasons for seeking to increase capacity for processing diseased larch was to ensure increased capacity, both for the public sector and the private sector estates, which is not a consideration which a market operator would have taken into account.
- 82 NRW's position is that the sawmill operator did not have significant numbers of overseas customers and therefore that the contracts did not have the requisite effect on inter-State trade. However, I am advised that a selective advantage to a particular operator is effectively assumed to affect inter-State trade where the undertaking receiving that advantage is active in markets characterised by significant volumes of inter-State trade. That is so regardless of whether the undertaking itself supplies customers in, or has a presence in, any other EU State. There is very substantial inter-State trade in markets for timber and timber products and the sawmill operator is involved in cross-border trade.
- 83 It is apparent from the contemporaneous documents that the terms of the contracts were not determined either by the outcome of a competition for meeting NRW's relevant requirements, or by other relevant market testing focussed upon those requirements. Although NRW's officials were informed by their experience of the bids received in 2013, the difference between the volumes covered by that competition, as compared with the volumes being awarded to the sawmill operator alone, was very substantial. There is little within the contemporaneous documentation to provide evidence that NRW officials gave careful consideration to whether the higher volumes might draw interest from a wider range of timber companies (ie companies that did not bid in the 2013 competition, potentially including companies without an existing presence in Wales). Nor do they appear to have considered whether those volumes might have sufficed to encourage the sawmill operator's competitors with sawmills in Wales to invest in additional capacity so as to be able to handle those volumes. I am not aware of any convincing evidence which would allow a conclusion that these possibilities could be dismissed out of hand as being wholly unrealistic.

- 84 If the terms of the contracts reflected market prices then there would be no State aid arising from the contracts, and I accept that the contracts may be on market terms. However, NRW's decision to award the contracts to the sawmill operator was not informed by relevant market testing, and was also not supported by persuasive reasoning to support a conclusion that seeking alternative providers would inevitably have proved fruitless. In my view, NRW failed to follow appropriate processes for ensuring that the outputs for which it contracted with the sawmill operator were obtained on market terms. This failure gives rise to doubt as to the compliance of the contracts with the State aid rules. In view of this uncertainty, I am again unable to give an unqualified regularity opinion on the financial statements.
- 85 As noted at [paragraph 75](#) above, the Chief Executive of Natural Resources Wales has told me that he considers that qualification of the regularity opinion is disproportionate to the shortcomings identified and that he disagrees with my conclusions and relies on legal advice which NRW sought during the course of my audit investigation and shared with me. However, I have sought my own legal advice (including in relation to NRW's advice), with which I agree and which is to the effect that there is insufficient evidence to conclude that the decision-making process was in compliance with public law principles and State aid rules. The significant uncertainty which exists means that I consider that the correct and proportionate action for me to take as the auditor of NRW is to qualify my regularity opinion.

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