

Ken Skates AM
Cabinet Secretary for Economy and Infrastructure

20 July 2017

Dear Cabinet Secretary

Welsh Government's budget for 2017-18: In-year scrutiny of the 2017-18 economy and infrastructure budget

On 13 July 2017 the Economy, Infrastructure and Skills Committee questioned you as part of its in-year scrutiny of the Welsh Government's draft budget for 2017-18.

I am writing to draw a number of headline issues to your attention, which we expect to return to during our scrutiny of the draft budget in the autumn 2017.

Prioritisation and value for money

Following scrutiny of the first Supplementary Budget 2016-17 in July 2016, the Finance Committee recommended that, in future the Welsh Government should publish "greater evidence setting out the rationale behind budget allocations such as the business rate relief scheme for Port Talbot Waterfront Enterprise Zone, including details of the anticipated economic impact" to enable value for money to be measured. The Welsh Government accepted this recommendation stating: "we will publish a narrative which includes an assessment of the best available evidence which has informed our spending plans at a strategic level".

During draft budget scrutiny last autumn, you told us that you were considering "the evidence base for making decisions on budgets". We discussed this further during in year financial scrutiny.

The Committee agrees that in order for us and the wider public to assess whether the priorities chosen are reasonable, and whether the anticipated outputs represent value for the public money, it is vital that greater effort is put into sharing the thinking and evidence which underpins the government's spending decisions.

The Committee believes that more needs to be done to meet the Welsh Government's commitment to provide detail of the evidence and rationale underpinning budget allocations,



illustrating how you have strengthened your department's evidence base for budget decision making.

Although you assured the Committee that full consideration is given *within the Welsh Government* to ensure that procedures are robust and Value for Money, the Committee believes that the evidence base for making decisions on budgets needs to be made public and explicit, particularly during draft budget /financial scrutiny.

Business support and finance

The Welsh Government's current economic strategy '*Economic Renewal: A New Direction*' was published in July 2010. The document weighed-up the pros and cons of providing grants to businesses. The Welsh Government decided that it needed to "move to an investment culture" and announced in the strategy that in future "all finance that [the Department for Economy and Transport] provides directly [would] be repayable".

Your written evidence gave a breakdown of loan and grant funding paid from the Welsh Government's 'Sectors and Business' budgets since 2011-12. The evidence showed us that over the six full financial years since the strategy was published, 2011-12 to 2016-17, only 24 per cent of capital grant and loan funding paid was repayable. The remaining balance (76 per cent) was non-repayable.

The Committee was pleased to note your intentions to create an environment which supports the development of skills and that the programme is currently meeting or exceeding the Welsh Government's expectations. However, the Committee agreed that it needed more assurances on the progress being made in grant and loan funding.

The Committee would like more information on the progress made in moving to an "investment culture" since the publication of '*Economic Renewal: A New Direction*', including the rates of funding and timescales for repayable and non-repayable capital grants and loans. The Committee will explore this further during budget scrutiny in the autumn 2017.

Road and rail infrastructure schemes: The impact of rising inflation

Following scrutiny of the draft budget in November 2016, we wrote to the Finance Committee highlighting evidence from the Deputy Permanent Secretary which stated that the draft budget assumed inflation of 2-3% with forecasts suggesting that it could be up to 4% by the end of 2017. We raised concerns about the impact that this could have on major projects such as the M4 relief road and the South Wales Metro.

The Committee asked you to provide an update on how any changes to future inflation assumptions are being factored into delivery of Welsh Government funded road and rail infrastructure projects in 2017-18 and beyond.



In response, you stated that inflation, as measured by the Consumer Prices Index (CPI), is currently 2.9%, which has been the highest since June 2013, and above the Bank of England's 2% target. We are mindful that construction inflation often runs above CPI.

During in-year budget scrutiny, you told the Committee that inflation would be factored in to financial planning of major transport projects with budgets being re-calibrated and approved at key stages of each project. The Committee also heard that construction contracts will include an allowance to manage changes in inflation, and that Government's approach, including Early Contractor Involvement and use of capped budgets on schemes such as the Metro, help manage this issue.

The Committee was concerned that, with continued financial uncertainty around the impact of Brexit and the potential for further exchange rate fluctuations and increases in inflation, it would be difficult for the Welsh Government to guarantee that future increases in inflation and further economic instability would not have an impact on large scale, long-term road and rail infrastructure projects. Given the scale of these projects, and therefore the potential scale of cost overruns affecting value for money and affordability, we believe that careful monitoring of the impact of inflation in the coming years is essential.

Development Bank for Wales

The Welsh Government's budget for 2017-18 included £45.75 million over four years for the Development Bank for Wales to improve access to finance for Small and Medium-Sized Enterprises (SMEs). The Welsh Government is currently managing the transfer of functions between Finance Wales and the Development Bank for Wales.

Your paper stated that the Development Bank 'will address the funding gap for micro, small and medium-sized business' which 'in Wales is estimated at around £350 million to £500 million per annum'.

During our in-year scrutiny of your budget, we asked you to clarify the extent of the funding gap that the Development Bank will be seeking to address and requested further information on whether the bank would be subject to banking sector resilience requirements, such as maintaining minimum capital and leverage ratios. You stated that such requirements would not apply to the bank, however the Committee will continue to seek reassurance that the bank has sustainable plans to deal with economic shocks where loans may become difficult to retrieve.

The Committee has taken a regular interest in the evolution of Finance Wales, and intends to return to this subject once the business plan for the Development Bank is published. We will explore this further during budget scrutiny in Autumn 2017.



Funding for the South Wales Metro and commitment to the Valleys lines infrastructure

In 2014 the then UK Government committed to contribute £125m towards the cost of Valleys Lines rail electrification. During the Committee's recent rail franchise inquiry we heard evidence from the Department for Transport (DfT) which suggested this funding for the Valleys line electrification depended on the nature of the Welsh Government proposal for the lines.

When providing evidence to the Committee for its inquiry into rail franchise and Metro, you outlined three areas where agreement was required from the DfT and Network Rail to achieve his ambitions for the franchise and Metro.

In scrutinising the in-year budget, regarding the £125m, your written evidence stated "we have full freedom to optimise the final scope of the scheme following Green Book guidance so as to achieve best value for money". Additionally, we hear that while progress is being made, the same three issues remain to be agreed with the UK Government and Network Rail, specifically that delivery of this project is dependent upon:

- the UK Government transferring the [franchise procurement] powers on time and as agreed;
- the UK Government and Network Rail agreeing our plans for the Valleys Lines; and
- the Department for Transport agreeing suitable financial arrangements for the Valley Lines infrastructure.

You informed the Committee that the target date for launching the tender competition is 18 August 2017. The Committee is concerned that, should the Welsh Government not achieve clarity on these outstanding issues by the time the specification is shared with bidders, it could reduce value for money in the procurement exercise either through uncertainty leading bidders to include a risk premium in their bids, or by further delaying a tender exercise originally planned for July.

The Committee would like to receive regular updates from you on the progress being made on reaching agreement on the outstanding issues for agreement, and the development of the rail franchise and Valleys line infrastructure.

Our discussion raised a number of other specific issues, which we will raise and monitor with the relevant Ministers in our regular scrutiny throughout the year.

Yours sincerely



Russell George AM
Chair
Economy, Infrastructure and Skills Committee

cc. Simon Thomas AM, Chair of the Finance Committee

