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Archwilydd Cyffredinol Cymru
Auditor General for Wales

Managing the impact of Brexit on EU Structural Funds



WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU



I have prepared and published this report in accordance with the Government of Wales Acts 1998 and 2006.

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Mae'r ddogfen hon hefyd ar gael yn Gymraeg.

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Summary report

Summary

- 1 Since 2000, Wales has been eligible for £10.2 billion of EU Structural Funds, which are two of several EU funding programmes available to Wales. The current round of EU Structural Funds is part of the 2014-2020 programme although EU rules mean Wales would actually have until 2023 to commit¹, spend and claim the funding².
- 2 Wales is eligible for around £2.1 billion of EU funding under the current round. There is an additional £1.1 billion of 'match funding' from the private, voluntary and public sectors³. The Welsh European Funding Office (WEFO) is responsible for delivering the programme as the 'Managing Authority'⁴.
- 3 The European Structural Funds 2014-2020 programme is made of up of four Operational Programmes. There are two funds: the European Regional Development Fund (ERDF) and the European Social Fund (ESF). There is around £1.2 billion of ERDF for research and development, for infrastructure projects, such as improving roads, for renewable energy and energy conversation, and for supporting small business. There is around £860 million of ESF for supporting the development of skills for youth and adults, both for those in employment and for those seeking work. The funding is split between West Wales and the Valleys, which gets the majority of the funding due to lower levels of economic output, and East Wales ([Figure 1](#) and [Appendix 2](#)). The funding aims to achieve a wide range of economic, environmental and social benefits. [Appendix 2](#) sets out the intended outcomes and outputs under each of the funding priorities.

- 1 For this report, we mean that the funding is committed to a specific project following approval by WEFO and acceptance of the grant offer letter by the project sponsor.
- 2 The EU sets expenditure targets which start three years after the Operational Programmes are agreed (the framework is known as N+3). The N+3 targets are cumulative and rise each year to 100% of funding which must be spent by 2023.
- 3 Match funding can come in form of cash and time, for example, the value of volunteer contributions can be used to match EU funding contributions.
- 4 WEFO is part of the Welsh Government and is responsible for the shared management of European Structural Funds in Wales, in partnership with the European Commission. As 'Managing Authority', WEFO is responsible for the efficient management and implementation of the programme.

Figure 1: key facts about the 2014-2020 EU Structural Funds Programme

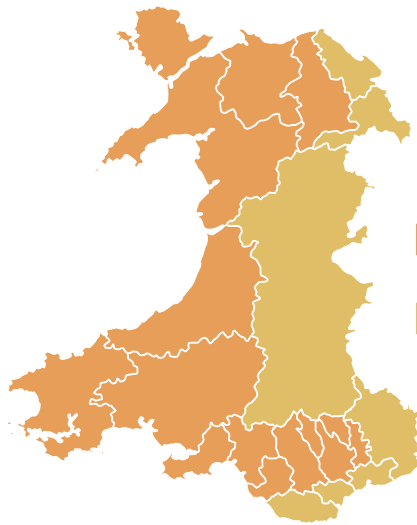
EU STRUCTURAL FUNDS



= £2.1 BILLION



= £1.1 BILLION



		EU grant (£m)	Match funding (£m)	Total (£m)
West Wales and the Valleys	ESF	687.7	236.4	924.1
	ERDF	1,030.9	533.1	1,564.0
East Wales	ESF	173.8	179.1	352.9
	ERDF	173.8	173.7	347.5

ERDF

ESF

Connectivity and Urban Development

Total Expenditure: £734.4M
EU Grant: £469.4M

Skills for Growth

Total Expenditure: £580.9M
EU Grant: £378.9M

Research & Innovation

Total Expenditure: £541.0M
EU Grant: £334.2M

Youth Employment and Attainment

Total Expenditure: £383.8M
EU Grant: £260.5M

OPEN SME competitiveness

Total Expenditure: £353.0M
EU Grant: £211.9M

Tackling poverty through Sustainable Employment

Total Expenditure: £286.9M
EU Grant: £204.9M

Renewable Energy & Energy Efficiency

Total Expenditure: £248.6M
EU Grant: £165.1M

Technical Assistance

Total Expenditure: £25.4M
EU Grant: £17.2M

Technical Assistance

Total Expenditure: £34.6M
EU Grant: £24.1M

Figures based on a conversion rate of £1:€1.17

Source: WEFO data

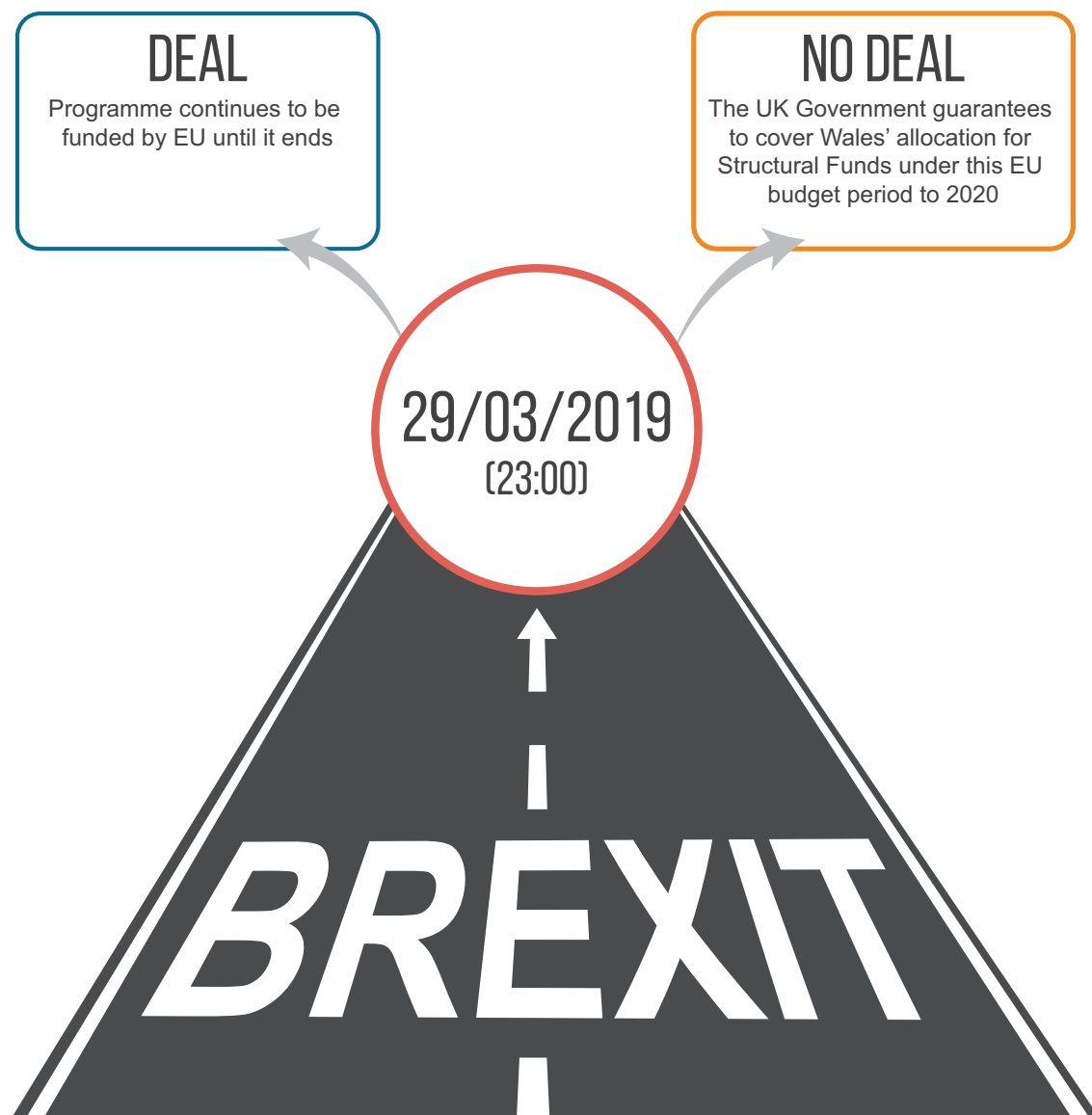
- 4 On 23 June 2016, the UK voted in a referendum to leave the European Union. In March 2017, the UK Government served notice of its intention to leave the EU. In line with the two-year timetable set out under EU law, the UK will leave the EU at 11pm on 29 March 2019.
- 5 The impact of 'Brexit' on EU Structural Funds depends on whether the UK leaves the EU with a 'deal'. EU law allows for the UK and EU to agree a 'Withdrawal Agreement' which sets out the terms of the UK's departure⁵. In March 2018, the UK and EU published a draft Withdrawal Agreement⁶. The draft Withdrawal Agreement set out a range of areas where the UK and EU agree as well as some key areas of disagreement. Among the areas of agreement are that the UK will continue to participate in the 2014-2020 EU Structural Funds programme until its end.
- 6 However, there are some key areas of disagreement, including the Republic of Ireland/UK border and the role of the European Court of Justice. There is a chance that if the areas of dispute are not resolved, the UK will leave the EU without a Withdrawal Agreement. In a no deal scenario, Wales would rely on a UK Government guarantee. Until recently, WEFO had been working to a guarantee announced in October 2016⁷, to replace EU funding for projects that have been 'signed before the UK leaves the EU'. On 24 July 2018, shortly before we finalised this report, the UK Government extended the guarantee to cover Wales' (and the rest of the UK's) allocation for Structural Funds under this EU budget period to 2020. **Figure 2** sets out at a high level the two key scenarios – 'deal' and 'no deal'.

5 Article 50 of the Treaty Founding the European Union is the section of EU law dealing with how members states leave the EU.

6 UK Government and European Commission, **Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community**, March 2018.

7 In August 2016, the UK Government announced an initial UK wide guarantee to fund projects signed before the Chancellor's Autumn Statement. The October 2016 announcement followed the Autumn Statement and extended the guarantee to all projects signed before the UK leaves the EU.

Figure 2: UK/EU Withdrawal agreement – latest deal and no deal scenarios for Structural Funds in Wales



7 This report considers whether WEFO is effectively managing the risks and opportunities for Structural Funds posed by Brexit. [Appendix 1](#) sets out our audit methods. This report focuses at a high level on the key risks. We have not reviewed the overall management of the programme in depth. Nor have we reviewed the Welsh Government's broader response to the risks and opportunities of Brexit. In April 2014, the Auditor General reported in detail on the 2007-2013 EU Structural Funds Programme ([Box 1](#))⁸ and where relevant we have drawn from that report to support our findings.

8 Auditor General for Wales, European Union Structural Funds 2007-2013, April 2014.

Box 1: the Auditor General's 2014 report on Structural Funds 2007-2013

The Auditor General concluded positively on the progress with the programme and improved management arrangements. While it was too early to be certain about the overall impact of the programme, there were positive indications from ongoing evaluations.⁹ WEFO has taken action to address all of the issues covered by our recommendations.

- 8 The report is structured around the key risks to EU funding and opportunities as a result of Brexit. **Figure 3** sets out the key risks and opportunities and our conclusions in relation to how WEFO is managing them. Our work initially focussed on WEFO's progress in light of the previous UK Government guarantee. The precise impact of the UK Government's announcement of an extended guarantee is being discussed and the UK Government intends to issue new guidance shortly. Nonetheless, it is clear that the extended guarantee significantly reduces the risk that Wales will lose funding in a no deal scenario. Our report needs to be considered in that context. At the time of drafting this report, it is not yet clear how this announcement will impact on WEFO's previous plans for committing funding by March 2019.

Figure 3: key risks and opportunities related to EU Structural Funds in Wales as a result of Brexit

Risk/opportunity	Conclusion
Key risk: That Wales loses out substantially on funding.	Despite WEFO's positive efforts to commit all EU funding before Brexit, Wales faced a significant risk of losing some funding in a no deal scenario without the UK Government amending the terms of its guarantee.
Key risk: That WEFO lowers its standards in order to sign-up projects and spend EU money before Brexit.	WEFO has maintained robust checks and balances despite the intention to increase the pace of project approvals and spending ahead of Brexit.
Key opportunity: To apply lessons learnt from years of managing structural funds in Wales to any replacement scheme.	The future of regional funding post-Brexit is unclear but WEFO and the Welsh Government are trying to shape debate.

⁹ WEFO has since published a review of the 2007-2013 round, *Ex Post Evaluation of the 2007-2013 Structural Funds Programmes in Wales, December 2017* which sets out in detail the impacts of the 2007-2013 round of funding.

- 9 In relation to the risk that Wales loses out on funding in a no deal scenario, under the previous guarantee, the precise amount would have depended on the extent to which WEFO was able to commit all funding by March 2019. It would also have depended on the extent to which projects subsequently go ahead as planned and spend all of the funding allocated. For every 1% of the total available funding that WEFO does not commit or which is underspent, Wales would have lost around £21 million.
- 10 Given our generally positive overall conclusions and the high-level nature of our review, we are not making any specific formal recommendations. However, there are some key issues for WEFO and the Welsh Government to manage even with the extension of the guarantee:
 - a Keeping in view wider economic changes, including in relation to Brexit, and adapting the programme where necessary in response
 - b Increasing the rates of commitment, working with potential project sponsors to address concerns, including around the availability of match-funding
 - c Increasing the rate of spending by encouraging projects to submit their claims for EU funding more promptly
 - d Working with project sponsors to minimise project underspends that could result in funding being lost to Wales
 - e Recruiting and retaining staff at a time where there is significant uncertainty about some of the roles within WEFO and potentially increased workload as a result of an increase in the pace of project assessments
 - f Sustaining robust checks and balances
 - g Ensuring that during the transition to any replacement for structural funds, WEFO's expertise in robust project appraisal and oversight is retained either in the replacement programme or in the wider Welsh public service

Part 1

Despite WEFO's positive efforts to commit all EU funding before Brexit, Wales faced a significant risk of losing some funding in a no deal scenario without the UK Government amending the terms of its guarantee



- 1.1 This part of the report looks at how WEFO has been managing the risk that Wales loses EU funding as a result of Brexit. In particular it looks at the deal or no deal scenarios for Brexit. In the no deal scenario, we look at the risks associated with the UK Government's previous guarantee to fund projects that have been signed at the point of Brexit (29 March 2019). We then consider the consequences of the 24 July 2018 UK Government announcement extending the guarantee to cover Wales' allocation for Structural Funds under this EU budget period to 2020. In the deal scenario we consider the impact of the draft Withdrawal Agreement and any residual risks to EU funding in that scenario.

WEFO is making progress with committing funding but recognised that it was a challenging target to commit all EU funds in the shortened timescale to March 2019

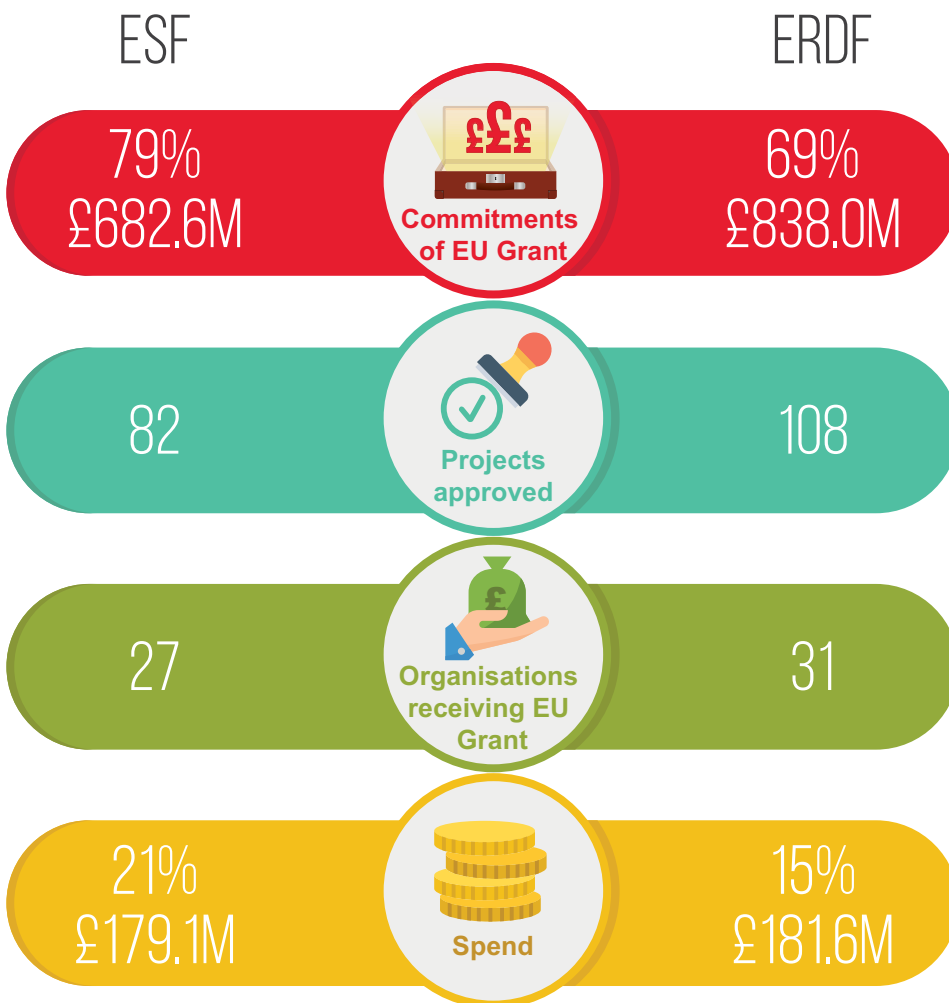
- 1.2 Under EU rules, WEFO has until the end of December 2023 to commit and spend all of the £2.1 billion in EU funding¹⁰. In practice, given the time taken to approve and deliver projects, WEFO initially aimed to commit all funding by December 2020. This would have allowed WEFO the three years between 2020 and 2023 to focus on ensuring all the committed funding was spent. However, following the UK Government's October 2016 guarantee, WEFO aimed to commit 100% of EU funding by 29 March 2019¹¹. WEFO's aim was very ambitious. To meet the aim, WEFO had three years and nine months less to commit all of the funding than it did in previous rounds. In the 2007-2013 round, WEFO had committed 86% of the funding at the equivalent point in the programme. To meet the March 2019 timescale, WEFO would have needed to commit funding significantly more quickly than in the past.
- 1.3 WEFO got off to a good start. Even before the EU issued its guidance, WEFO worked with stakeholders to develop its priorities, which ended up very similar to those of the previous round. As a result of this early work, Wales was the first part of the UK to have its programmes approved by the European Commission. However, progress in committing funding has been slightly slower than in the previous round. By mid-way through June 2018, WEFO had committed 74% of the total EU grant (£1.6 billion out of £2.1 billion). This is behind the 81% commitment level that WEFO had achieved at a broadly equivalent point in the previous round.

¹⁰ WEFO also has some flexibility to make amendments after 2020, for example, to respond to changes in the exchange rate or move funding between projects to manage underspends.

¹¹ Unlike previous rounds, the EU did not set commitment targets and WEFO did not set its own internal commitment targets at the outset.

1.4 **Figure 4** shows that WEFO faced a particular challenge to commit ERDF funding, although commitment of ERDF was slower than ESF under the previous round as well. WEFO has highlighted a number of factors that have made it difficult to commit funding to date (**Box 2**).

Figure 4: position of the 2014-2020 EU Structural Funds programme at 18 June 2018



Source: WEFO data

Box 2: factors affecting WEFO's ability to commit funding to date

Uncertainty about Brexit

WEFO reports that some sponsors have not been coming forwards with projects as they are unsure as to whether the funding would be available if their project were to run beyond the point the UK leaves the EU.

Commencement of programme

Although WEFO was ahead of many Managing Authorities in getting the programme approved, factors largely outside of WEFO's control meant that the approval was around four months later than the previous 2007-2013 programme. Those issues included late agreement of the EU regulations and budgets and delays associated with needing to have a UK-wide strategic documents in place.

Exchange rate volatility

The maximum level of funding available to Wales is set in Euros at the beginning of the programme period. The drop in the value of the pound earlier in the programme means that the expected value of the EU funding in pounds is now £132 million higher than first thought. As a result, WEFO currently has more grant available to commit than it initially expected.

Increase in value of funding for East Wales

Changes in the way the programme is applied at a UK level meant that there is three times more funding for East Wales than in the previous programme. WEFO has already committed more grant to East Wales than under the entire 2007-13 round but is behind the commitment levels at the same point because it has more funding to commit.

Changes in the economic environment

WEFO reports that the low unemployment rate means there is less demand for projects to increase employment. It also reports that previous investment in projects to boost skills means there are fewer people with no or very low skills. WEFO is working with potential project sponsors to encourage more projects aimed at developing the skills of people who are already in work but it is taking time for these to be developed.

Box 2: factors affecting WEFO's ability to commit funding to date

Increased focus on results

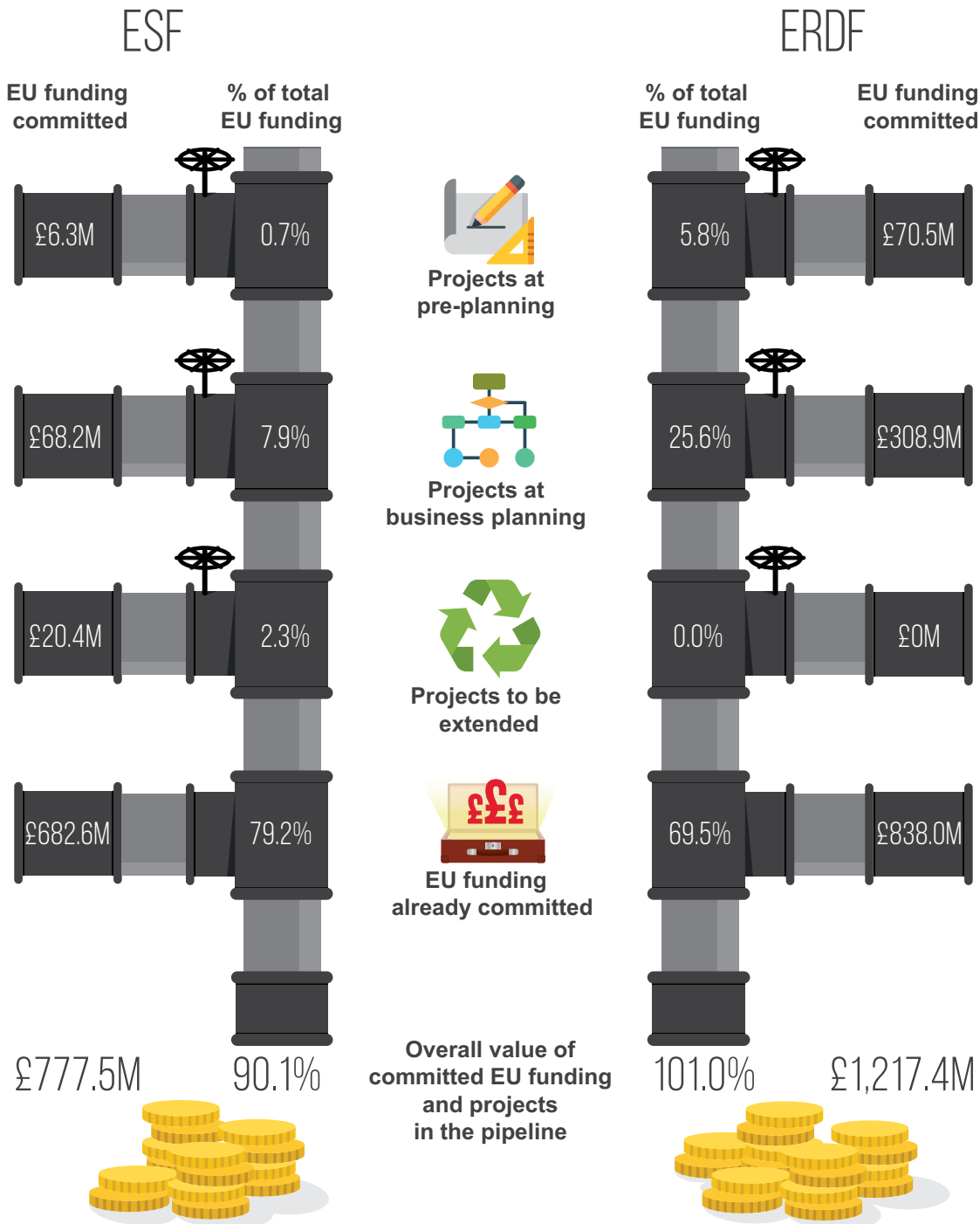
WEFO reports that the programmes have strengthened requirements for projects to demonstrate clearly how they will achieve specific results in line with the programme objectives and economic opportunities (paragraph 2.2). While, ultimately, this approach is intended to achieve longer-term benefits, project sponsors are taking time to adapt and come forwards with sufficiently clear proposals.

- 1.5 WEFO was still intending to commit all of the funding by March 2019. It has projects at various stages of the formal approval process, which would take it to 100% commitment of ERDF and 90% of ESF if they are all approved. Figure 5 shows that as of the middle of June, WEFO has projects worth £77 million at the more tentative pre-decision phase, while £377 million are at the more advanced business planning phase¹². Some of the projects in the pipeline involve renewing existing projects, such as work-based learning schemes¹³.

¹² Paragraphs 2.3 to 2.4 and Figure 8 set out the approval stages in more detail.

¹³ Following a recommendation from the European Court of Auditors, WEFO decided to let contracts for some projects for three to four years rather than the full seven years of the programme.

Figure 5: WEFO's committed funds and project pipeline at the middle of June 2018



Source: WEFO data

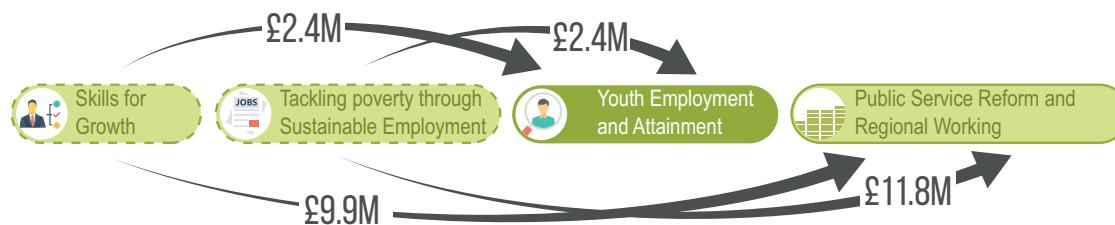
1.6 To bridge the gap in the ESF programme, WEFO is in early talks with sponsors of existing projects to expand them and to develop new projects. These talks have not yet reached the formal pre-planning stage. If all these tentative discussions were to result in the projects going ahead and being approved, WEFO could commit up to £80 million and the remaining gap would be fully filled.

1.7 WEFO wants to amend the programme to help it to increase commitment levels. WEFO proposes to move approximately £64.1 million between existing priorities and to create a new priority around public service reform and regional working (Figure 6 and Appendix 3). WEFO believes that these changes will help it to attract more projects and commit more funding. Changes to the programme are routine and WEFO has made changes in previous funding rounds. WEFO sent its proposals to the European Commission in June 2018. It is hoping for approval by December 2018. WEFO is working with potential project sponsors to develop new projects that will be ready for approval if the European Commission approves the changes. The potential projects for ERDF are included in the 'pre-planning' figure in Figure 5. The potential projects for the ESF programme are at a much earlier stage and not yet fully factored in to WEFO's calculations.

Figure 6: summary of WEFO's proposed amendments to the Structural Fund Operational Programmes

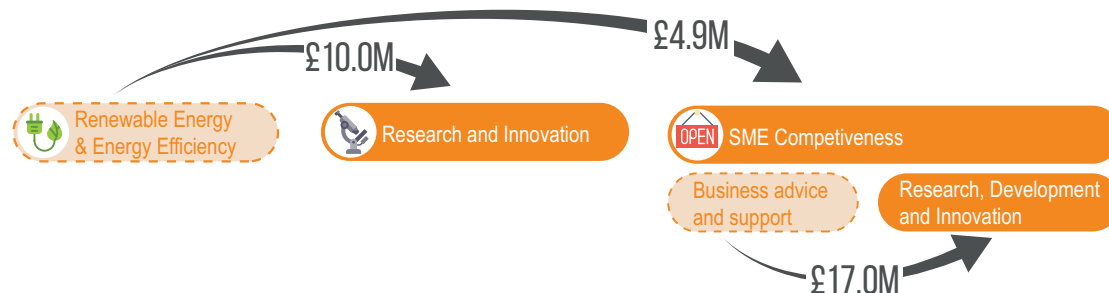
EUROPEAN SOCIAL FUND

WEFO is proposing taking £14.3 million out of the priority to tackle poverty through Sustainable Employment and another £12.3 million out of the priority skills for growth and putting £21.7 million of it into a newly created priority called Public Service Reform and Regional Working. The remaining £4.9 million is being put into the priority focused on youth employment and attainment.



EUROPEAN REGIONAL DEVELOPMENT FUND

WEFO is proposing moving £14.9 million from the priority focused on renewable energy and energy efficiency and reallocating £10.0 million of it to the priority focused on research and innovation and a further £4.9 million to the priority focused on SME competitiveness. WEFO is proposing a further £17.0 million is relocated between 'Thematic Objectives' within the SME Competitiveness priority.



Figures based on a conversion rate of £1:€1.17 which may change

Source: WEFO

- 1.8 Although WEFO has committed just 74% of EU funds as at June 2018, it has committed funding worth 92% of the total value of the programme, taking account of match-funding. This situation has occurred because the projects WEFO has approved have a higher proportion of match-funding than is required by EU rules¹⁴. WEFO commits funding to projects on the basis of need. That means EU funding is set as the minimum required to fill the gap between the total cost of the project and the match-funding that a project-sponsor can provide. WEFO has chosen not to commit EU funds to projects at the maximum level for various reasons. These reasons include ensuring EU funds can be spread across a larger number of projects. Also, having a higher rate of match-funding allows some flexibility to manage risks around changes to exchange rates and eligibility of expenditure.
- 1.9 It is too early to judge the likely impact of the funding and whether the original expectations or targets will be achieved overall. WEFO measures and reports progress against a wide range of detailed measures. **Figure 7** sets out the key performance measures that WEFO reports having achieved by the end of March 2018.

¹⁴ For each of the four Operational Programmes, there is an agreed 'intervention rate'. This sets out what proportion of the Operational Programme will be funding from EU funds and what proportion must come from domestic match-funding. WEFO can set individual intervention rates for each project but these must balance out to ensure that each Operational Programme remains within the agreed rates.

Figure 7: WEFO's key indicators for the Structural Funds programme as at 14 July 2018

	Progress	Target
Enterprises supported	4,903	45,512
Enterprises created	830	7,400
Employment increase in supported enterprises	6,065	26,980
Amount of research funding secured	£48 million	£230 million
Increase in level of exports	£48 million	£233 million
Additional capacity of renewable energy production*	0	28
Number of households with improved energy consumption classification*	0	9,700
Public transport services created or improved*	0	2,900,000 vehicle km
People assisted	143,435	434,100
Young people assisted	39,637	150,000
People supported into employment	9,651	40,642
People gaining qualifications	42,875	194,633

Note: * As part of the proposed changes to the programme (paragraph 1.7) WEFO intends to remove these three indicators. WEFO has not made progress towards the targets because it has not approved any projects that would directly contribute towards these measures.

Source: WEFO data

There was a significant risk of Wales losing out on some funding in a no deal scenario until the UK Government very recently extended its guarantee

Under the previous terms of the UK Government guarantee, there was a significant risk of Wales losing funding if there is no Withdrawal Agreement in March 2019

- 1.10 If the UK leaves the EU without a deal in March 2019, EU funding to Wales will immediately stop. The UK Government's guarantee had said that it would replace funding for 'all structural and investment projects' that have been 'signed before the UK leaves the EU'. As previously drafted, the guarantee only covered funding for projects approved by 29 March 2019.
- 1.11 WEFO has projects in progress to help move towards the 100% commitment target by March 2019. However, there is a risk that some projects will not make it through the application process and some may be delayed beyond March 2019. Some of the projects are complex and depend on other organisations for match funding that is not yet secure. There are some large projects in the pipeline, notably transport and renewable energy projects. If a small number of those dropped out or slipped behind the March timescale, there would be a significant gap. And several of the projects are at a very early stage of discussion and development.
- 1.12 WEFO has been alert to the risks of projects dropping out and has some projects from over-subscribed schemes that it is asking project sponsors to keep under consideration. These contingency projects could potentially replace projects that drop out. The value of these contingency projects is around £47 million. However, as time moves on, it would get increasingly difficult for WEFO to be able to get the contingency projects through the approval processes ahead of Brexit.
- 1.13 As a result of the likelihood of some projects not making it through to full approval and the growing difficulties of replacing them as the Brexit date approaches, we think there was a significant risk that WEFO would not commit 100% of funding before March 2019. For every 1% of funding that WEFO did not commit, Wales would have stood to lose around £21 million.

1.14 There could also have been losses to Wales due to a lack of flexibility to move funds around between projects after Brexit. In a programme of this size, some projects will inevitably spend less than they planned. WEFO has previously been able to redirect underspends to other projects. However, it was not clear that the UK Government guarantee, which was specifically related to approved projects, would allow flexibility to move funding between projects. We estimate that in the previous round underspends were around 6% of the total value of the funding.

The UK Government has recently extended the guarantee with the new terms significantly reducing the risk of Wales losing funding in a no deal scenario

1.15 On 24 July 2018, the UK Government announced that it was extending its guarantee of EU funding to cover Wales' (and the rest of the UK's) allocation for Structural Funds under this EU budget period to 2020. As drafted, this extension of the guarantee significantly reduces the risks associated with both not committing funding and underspends in a no deal scenario. However, the precise impact will become clearer as the UK Government sets out further details on how the guarantee will work in practice.

1.16 WEFO, along with other parts of the UK, had tried to clarify the UK Government's interpretation of the previous guarantee. **Box 3** sets out the areas where WEFO had asked for further detail. Some of these issues remain relevant even with the extended guarantee. The UK Government had produced draft guidance on the previous guarantee which was under discussion with the devolved governments and other stakeholders. The UK Government intends to produce updated guidance on the extended guarantee in the near future, which we understand will address some of the issues that WEFO has raised. Ultimately, the scope of the guarantee is a decision for the UK Government.

Box 3: key areas where WEFO had sought clarity over the UK Government's previous guarantee

Project variation flexibility

Will the UK Government permit variations to agreed projects committed at 29 March 2019 and still regard varied commitments to be covered by the guarantee?

Impact on other funding

Can the UK Government confirm the guarantee will not impact on any other funding earmarked for Wales?

Overall value of guarantee

How and when will the UK Government determine whether there is a Sterling value of the ceiling on its guarantee?

Regulations

What existing EU regulations does the UK Government expect to retain and what audit and inspection process will be required post Brexit?

Cut-off point

Will the UK Government meet any amounts that are in the system at the point of Brexit?

Technical assistance

Will the UK Government continue to fund WEFO staffing and other training, advice and support costs under the guarantee?

- 1.17 Although this report focuses on the risks to Wales, there is a wider risk to the UK funding position in a no deal scenario. In a no deal scenario, the gap in funding for signed projects would be covered by the UK Government. The size of that gap depends in part on the amount of EU funding that Wales (and other parts of the UK) are able to claim from the EU before Brexit. In order to draw down funding from the EU, projects need to first spend the money, then submit a claim to WEFO. WEFO then submits claims to the European Union to draw down the funding.

- 1.18 WEFO has encouraged project sponsors to submit claims promptly in order to draw down EU funding. WEFO's plans for draw-down are primarily driven by the EU's annual spending targets. To the end of 2017, WEFO has significantly exceeded the spending targets. WEFO has already exceeded the targets for 2018 in three out of the four operational programmes¹⁵.
- 1.19 Although it is meeting its targets, WEFO recognises that project sponsors are not submitting claims as promptly as they could. WEFO attributes this to several factors:
- Some project sponsors taking extra time to check their claims and verify all of their expenditure and eligibility paperwork before submitting claims.
 - Despite prompting from WEFO, some parts of Welsh Government prefer to use their own domestic funding upfront and then claim EU funding in the latter stages.
 - One part of Welsh Government having a large claim pending for work-based-learning activity, which is delayed while it resolves problems with the computer systems that verify the eligibility of the expenditure.

¹⁵ The West Wales and the Valleys programme has not yet met the 2018 targets but it has until December 2018 to do so. WEFO expects that some of the financial targets for The West Wales and the Valleys programme has not yet met the 2018 targets but it has until December 2018 to do so. WEFO expects that some of the financial targets for this operational programme will be reset if the EU approves proposed changes to the programme.

If there is a Withdrawal Agreement, EU structural funding will continue largely unchanged so there is a limited risk of Wales losing out substantially

- 1.20 If the draft Withdrawal Agreement is agreed between the UK and EU, the UK Government guarantee will not be needed. Under the terms of the draft Withdrawal Agreement, Wales will continue to be able to participate in the 2014-2020 programme until its end. WEFO will have until December 2023 to commit all funding and to submit claims for funding. Although WEFO is behind where it was in the previous round, it is confident that it will commit all of the funding by the end of the programmes in 2023.
- 1.21 Even with a Withdrawal Agreement in place, Wales could lose out on some funding if projects underspend. WEFO manages the risk of underspends by overcommitting. In the previous round, WEFO committed 106% of the value of the programme but actually spent 99.98% of the funding. In the past WEFO has had a fall-back position that if underspends and over-commitments do not balance out and there is a shortfall of funding, projects can be rolled over into the next round of EU funding. However, due to Brexit, Wales will not be participating in the next round of funding, so this fall-back position is not an option. WEFO may need to be more cautious about over-commitment, thereby increasing the risk that it is unable to balance out and redistribute underspends. For each 1% of the value of the EU funding underspent, Wales would lose around £21 million.

Part 2

WEFO has maintained robust checks and balances despite the intention to increase the pace of project approvals and spending ahead of Brexit



- 2.1 This part of the report looks at the risk that WEFO lowers its standards in order to approve projects and spend EU money more quickly before Brexit. It considers at a high-level the arrangements in place to:
- a ensure that only good and eligible projects are selected to get EU funding;
 - b ensure that projects only use money in line with EU rules; and
 - c monitor progress with the overall programme.

WEFO has strengthened its approach to approving projects and only commits to those which meet strict criteria and match its strategic priorities

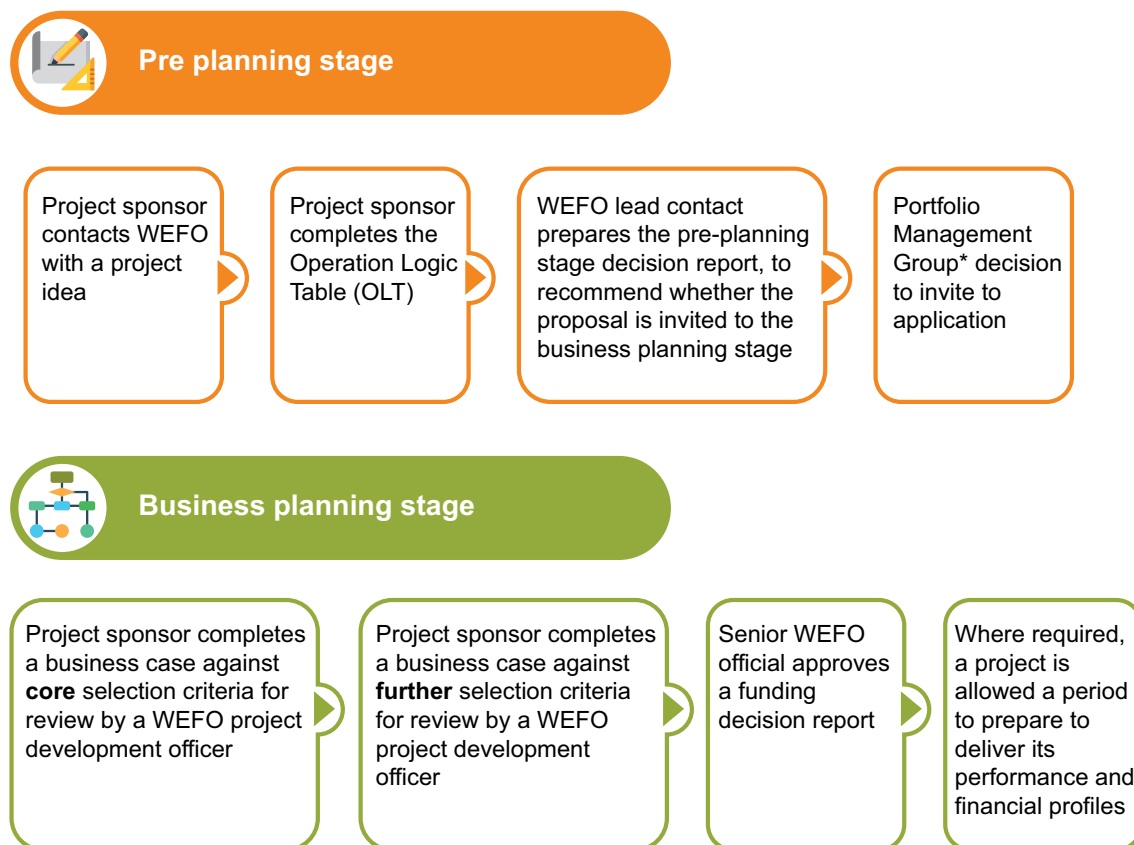
- 2.2 WEFO introduced a new approach to help to choose and prioritise projects in the 2014-2020 programme. Our April 2014 report on the 2007-2013 programme found that WEFO already had a robust system in place for selecting projects. Since then it has strengthened its approach further. As with previous rounds, the Operational Programmes are driven by their priorities and the underpinning objectives. Following a 2013 review by Dr Grahame Guilford, WEFO introduced a cross-cutting Economic Prioritisation Framework¹⁶. The framework sets out seven thematic opportunities for the Welsh economy and three regional opportunities¹⁷. The framework aims to put project proposals in the context of wider efforts to improve the economy of Wales.
- 2.3 WEFO has a two-part approach to deciding whether to approve project proposals (**Figure 8**). WEFO initially discusses an idea with project sponsors before asking them to complete an 'Operation Logic Table'. The Table must set out exactly how proposed projects would deliver one or more programme objectives and how that would be measured. In completing the Table, project sponsors must set out how their project would align with the economic opportunities in the Economic Prioritisation Framework.

¹⁶ Welsh Government, **The Economic Prioritisation Framework – Version**, June 2015.

¹⁷ The seven themes are: energy; food and farming; climate change and resource efficiency; exploitation of ICT assets and the digital marketplace; advanced manufacturing; life sciences and health; tourism, recreation and leisure. The regional opportunities set out the major investments that projects should align with in three regions of Wales. For example, WEFO has highlighted the opportunities in South West Wales related to the Swansea Bay City Deal and alternative energy generation, including the potential tidal lagoon in Swansea.

2.4 This early work and challenge helps to sift out projects that are unlikely to meet the objectives and criteria, although WEFO’s systems do not enable us to readily identify how many proposals were sifted out this way. In other cases, the early challenge helps project sponsors improve their proposals before WEFO reviews them in depth. If they get through this stage, project sponsors will need to develop a full business case. Alongside a range of criteria, WEFO requires project sponsors to set out how their project supports sustainable development¹⁸. WEFO then carries out a range of detailed appraisals and checks before final approval.

Figure 8: process for selecting and approving projects



Note: * The Portfolio Management Group is responsible for ensuring there is a sufficiently diverse range of operations to maximise delivery of the Structural Funds Programmes and for determining which proposed projects should, and should not be invited into the Business Planning Stage.

Source: WEFO data

18 The four operational programmes and the Economic Prioritisation Framework predate the Well-being of Future Generations (Wales) Act 2015 which sets out a range of duties for named public bodies, including pursuing sustainable development. Nonetheless, WEFO expects project sponsors to set out and monitor their contribution to sustainable development and the national wellbeing objectives.

- 2.5 The Auditor General's 2014 report on EU Structural Funds made several recommendations aimed at clarifying the guidance to sponsors, to explain the requirements and different stages. WEFO has made progress with these recommendations and has updated its guidance. It now provides detailed guidance to potential project sponsors so that they can understand the checks and balances at each stage of the process. We have not tested with project sponsors whether the updated guidance has been helpful in making the processes clearer.
- 2.6 Overall, we consider that WEFO's project selection and approval process is thorough. It can be a lengthy and challenging process. But it helps to ensure that only good quality projects receive funding. If WEFO were to approve poor quality projects, it would expose itself to the risks of severe financial penalties by the EU. We can take assurance from the independent European Funding Audit Team (EFAT)¹⁹ work showing that WEFO's processes for selecting and approving projects were operating effectively.
- 2.7 Two 'intermediate bodies' – the Welsh Government's Department for Economy Skills and Natural Resources and Wales Council for Voluntary Action – deliver part of the 2014-2020 programme on WEFO's behalf. These intermediate bodies run grant schemes that support the voluntary and private sectors. To date the grant schemes have a value of £141 million. EFAT's most recent review found that the intermediate bodies' approaches to selecting and approving projects were operating effectively.

¹⁹ Appendix 1 explains EFAT's role and work.

WEFO has robust checks to ensure that projects can only claim funding if they can show they have complied with all eligibility and delivery requirements

- 2.8 WEFO has strengthened the checks it carries out to ensure that projects only spend EU money in line with strict criteria. During the previous 2007-2013 programme, European Commission auditors found some technical problems in the way WEFO approached its checks on project spending. The auditors also found some problems with guidance WEFO provided to project sponsors. As a result, the EU temporarily suspended payments to Wales during 2014. WEFO responded quickly to strengthen its checks and the EU resumed payments. EFAT's 2018 annual control report sets out that WEFO's control systems are operating effectively.
- 2.9 WEFO's controls over funding mean that it has a very low 'error' rate. In its 2018 annual control report, EFAT found that just 0.05%²⁰ of audited expenditure had an error. This overall error rate is significantly below the 2% 'materiality level' which would trigger challenge and intervention from the European Commission. It is also an improvement on the 0.39% error rate at the end of the previous round.
- 2.10 WEFO has been pro-active in ensuring that recent difficulties with staff shortages do not impact on its approach to checking spending claims. WEFO plans on the basis of having 190 full-time equivalent staff. Between March 2017 and March 2018, WEFO had a staff shortage varying between 11% and 16%. WEFO told us that during this period staff worked overtime to ensure that all of the required checks on projects were completed. In addition, uncertainty around Brexit means some staff do not know whether they will still be needed after March 2019 and have been looking elsewhere for jobs. WEFO is alert to these risks and is taking action. WEFO's options had been limited by Welsh Government restrictions on recruitment and promotion. However, in early 2018, the Welsh Government approved WEFO's business case, allowing it to recruit and appoint staff within its existing budget.

²⁰ The 0.05% is a projected error based on a statistical sample of project expenditure and calculated in line with European Commission guidance.

There are clear arrangements in place for monitoring and reporting progress with the overall programme

- 2.11 WEFO has good information to track the progress of the programme. Our April 2014 report on the 2007-2013 Structural Funds Programme found that the introduction of the Project and Programme Information Management System (PPIMS)²¹ made it much easier for WEFO to manage its programme finances. PPIMS also records the information on the outputs and outcomes of projects. EFAT's 2018 annual control report confirmed that the financial data in PPIMS was accurate and complete²² in regard to the figures audited to support the accounts submitted to the European Commission.
- 2.12 The data from PPIMS is used to monitor and report through WEFO's various layers of programme oversight ([Appendix 4](#)). We have not tested the arrangements in detail. However, we did observe two meetings of the overarching Programme Monitoring Committee. We found that the information presented on Structural Funds was comprehensive, although the volume and complexity of the material can make it difficult to identify the most important areas for scrutiny. WEFO is currently amending the format of the papers to give a clearer summary of the key issues. Committee members provided a good level of challenge on finances, delivery and wider issues. The WEFO staff that attended were knowledgeable and able to provide detailed answers to queries.

²¹ PPIMS is a bespoke system used by WEFO to record and store in computerised form data on each operation necessary for monitoring, evaluation, financial management, verification and audit.

²² EFAT has not carried out tests on the non-financial data.

Part 3

It is not yet clear what will replace structural funds post-Brexit but WEFO and the Welsh Government are trying to shape debate



3.1 This part of the report looks at emerging plans for replacing EU Structural Funds post-Brexit. This section does not comment on the merits of the plans. At the time of drafting this report, the Finance Committee of the National Assembly for Wales is holding an inquiry into the replacement of EU funds. We have set out the position of the UK Government and the Welsh Government on the future of regional funding at the time of drafting. Ultimately, the question of which tier of government is responsible for any replacement scheme is a political and constitutional matter to be resolved between the UK Government and the devolved governments.

The UK Government intends to introduce a Shared Prosperity Fund but has not set out key details about the value of the fund or how it will operate

3.2 To replace the EU funding stream, the UK Government intends to develop a UK Shared Prosperity Fund. At the time of drafting this report, there are very few details as to what the Shared Prosperity Fund will look like. In a letter to the Chair of the UK Parliament's Work and Pensions Committee, the Department for Work and Pensions stated that: 'We are also keen to ensure that the [Shared Prosperity] Fund design minimises bureaucracy and is as administratively simple and straightforward as possible for recipients to engage with.' The UK Government intends to commence consultation on its proposals for the Shared Prosperity Fund in autumn 2018. Some of the key uncertainties for Wales are:

- a whether the Fund will be a single scheme run by the UK Government or whether the devolved governments will determine for themselves how the scheme will run in their respective parts of the UK; and
- b the value of the Fund, whether it will match or exceed the current EU funding levels and what rules and requirements there may be, for example, in relation to match funding.

The Welsh Government has set out its vision for the future of regional investment and wants full control and funding to be devolved

3.3 In December 2017, the Welsh Government produced a policy paper on **Regional Investment in Wales after Brexit**. The paper set out the Welsh Government's objection to the Shared Prosperity Fund as a UK-wide programme. It made a case for funding to be devolved and to match the levels provided by the EU as a minimum. The paper also called for the development of regional policy to be devolved to the Welsh Government.

- 3.4 In setting out its thinking on the future of regional investment, the Welsh Government has sought to learn lessons from WEFO's experience in managing Structural Funds. The Welsh Government's policy paper is clear that the Welsh Government does 'not want to replace EU funds like for like. It identifies a number of opportunities to improve the replacement scheme as well as building on lessons learnt. In particular, it identifies opportunities to improve joint-working between agencies and geographical areas, with a stronger focus on regional working, by reshaping funding criteria.
- 3.5 The Welsh Government and WEFO have engaged with a range of organisations at events in north and south Wales and ran an open online survey to gather views on a set of proposed principles (Box 4) for future regional investment. WEFO has commissioned independent evaluators to analyse the views. WEFO published a report setting out the analysis at the end of June 2018 which concluded that the overall approach set out by the Welsh Government was broadly welcomed.

Box 4: the Welsh Government's principles for future regional investment

- Strengthening partnership working.
- Long-term multi-annual programming approach to provide investor confidence.
- A mix of complementary national, regional and local investment.
- Greater role for regional partnerships and associated alignment of resources.
- Greater integration of different policy areas focussing on people and places.
- Integration of funding sources and funding models.
- Strengthened focus on outcomes, ensuring they include inequality, wellbeing, inclusion and environmental sustainability.
- Strengthened monitoring and evaluation but introducing simplification and proportionality.
- Simplifying rules and criteria whilst ensuring level playing field for all.
- Greater risk encouraged to attract private sector investment and innovation.
- Promotion of cross-border collaboration.

3.6 The future for WEFO is inevitably uncertain until there is clarity on what will replace the Structural Funds in Wales. If responsibility for any replacement scheme is devolved to Wales, we think that there is merit in retaining the positive benefits of rigour in project appraisal and monitoring, and the skills and experience garnered over many years by WEFO staff. In the event that the replacement programme is not devolved, there is merit in ensuring that WEFO's expertise is used to strengthen projects and programmes elsewhere in the Welsh public sector.

Appendices



Appendix 1 – Audit methods

Document review and data analysis

We reviewed a wide range of documentation including:

- WEFO guidance documents
- Independently commissioned reviews of the Programmes
- European Commission audits
- Financial and performance data provided by WEFO
- Ministerial briefings
- Minutes from various meetings including the Programme Monitoring Committee

A self-assessment completed by WEFO

WEFO completed a self-assessment against a set of questions we posed, related to its management of the programme, in light of the risks and opportunities of Brexit. The questions covered lessons learned from previous reviews, the overall strategic direction, and management of the programme including progress with committing funding and drawing down funding from the EU. It also included questions around plans for the future of regional development after Brexit.

European Funding Audit Team (EFAT) reports

WEFO are required by the European Commission to appoint an independent audit body to oversee the efficient running of the management and monitoring of the control system for the programme. The European Funding Audit Team (EFAT) is part of the Welsh Government's corporate governance and assurance division and acts as the Audit Authority for EU Structural Funds programmes in Wales. We reviewed a number of EFAT reports, in particular annual control reports and reports on WEFO's systems for appraising project applications, monitoring the progress of projects, paying grant claims and project verification and inspection.

Interviews

We have discussed the administration of the programmes with WEFO and Welsh Government senior officials and held a series of interviews to discuss emerging findings and clarify key aspects of the programmes and queries arising from WEFOs self-assessment.

Observations

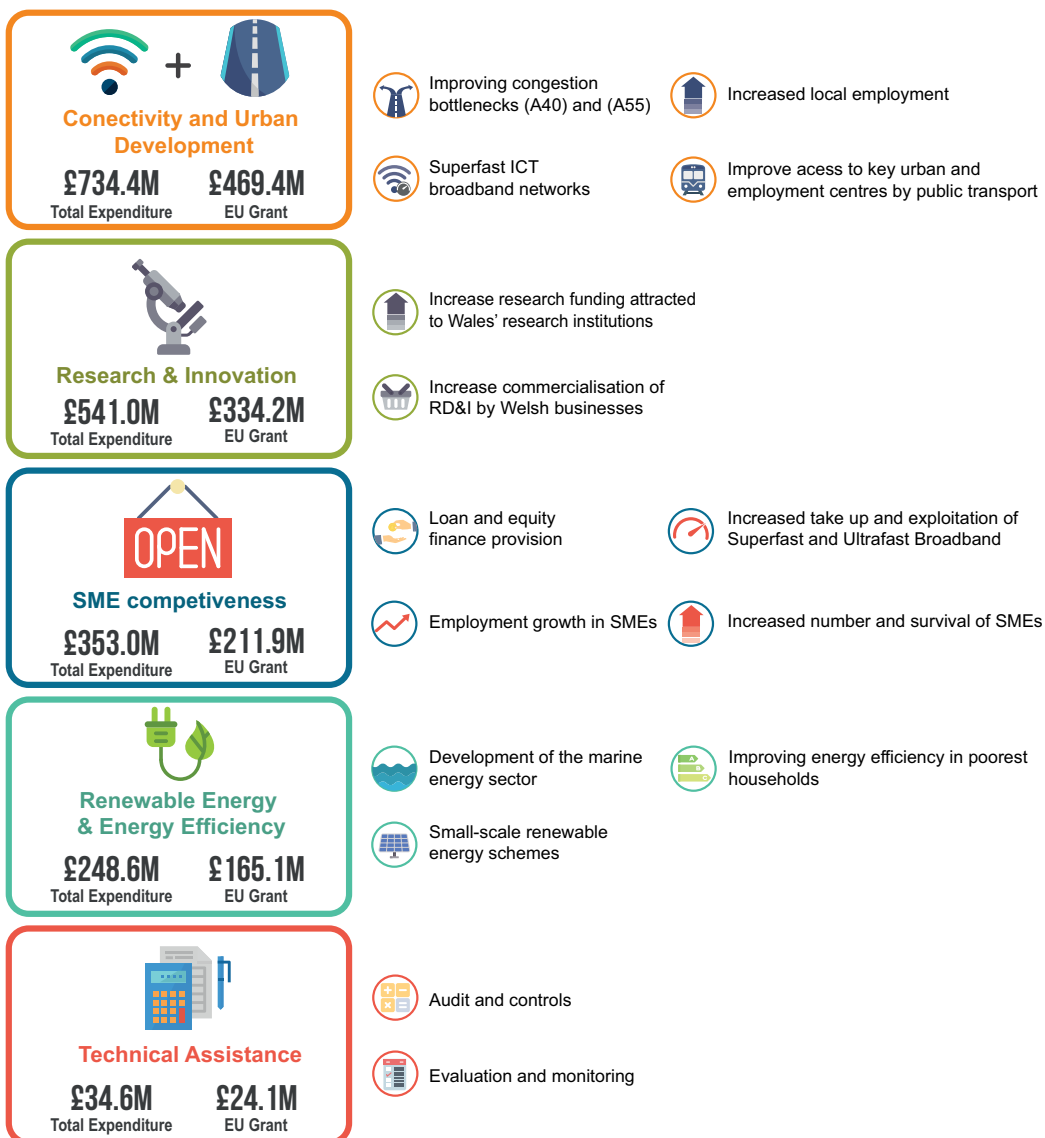
We attended and carried out observations at the December 2017 and May 2018 Programme Monitoring Committee meetings and the South Wales stakeholder engagement event held by WEFO in February 2018 to consult on views for what regional investment in Wales after Brexit should look like.

Appendix 2 – EU Structural Funds priorities and intended outcomes and outputs

Figure A1 sets out WEFO’s five priorities for the European Regional Development Fund and Figure A2 sets out the four priorities for the European Social Fund. For each priority, WEFO has set out the ‘changes’ that the investment is intended to deliver. In some cases, the changes are based on outcomes such as increased local employment, in others they are outputs or actions, such as loan and equity finance provision.

Figure A1: European Regional Development Fund priorities and intended outcomes and outputs

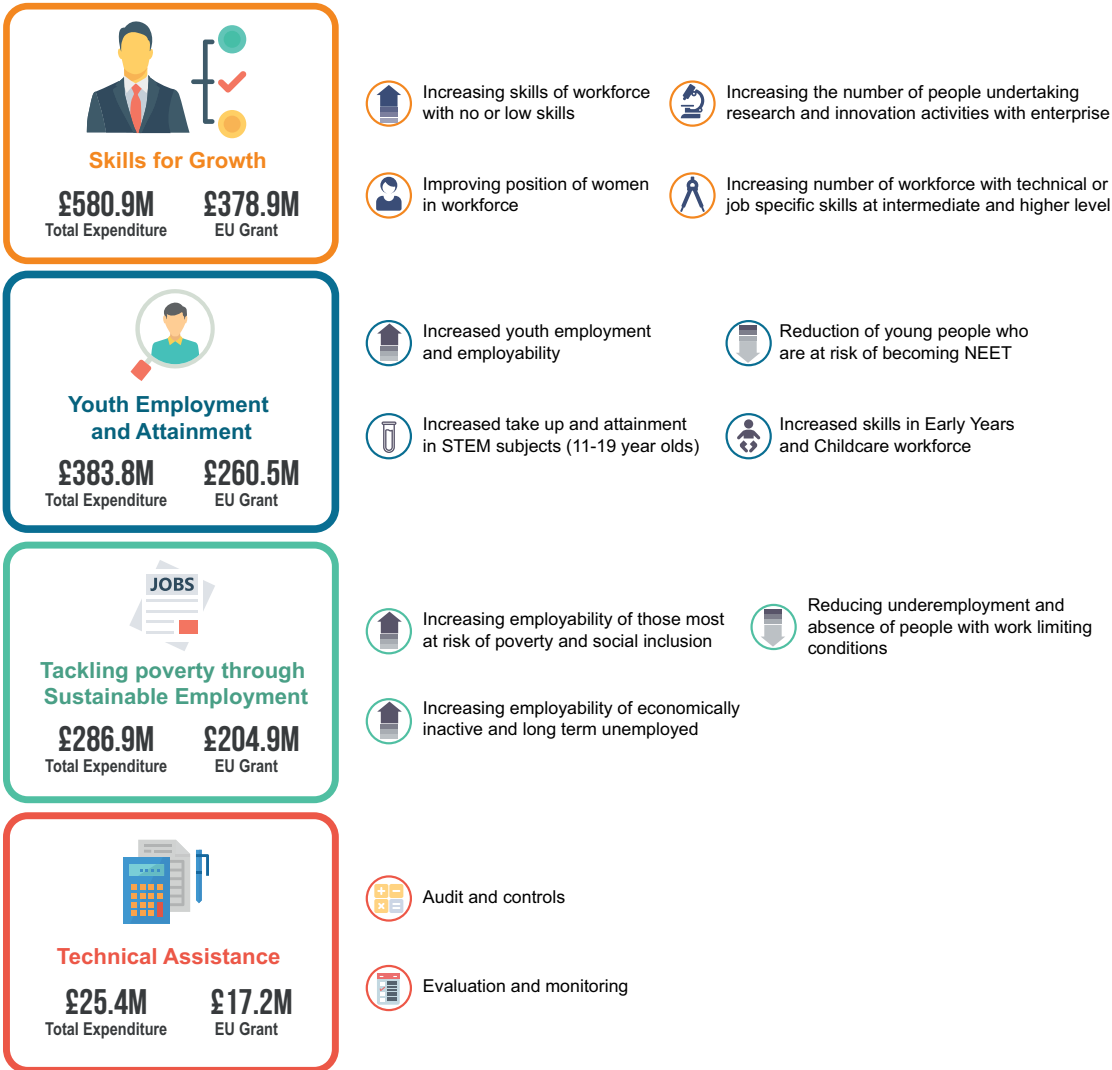
EUROPEAN REGIONAL DEVELOPMENT FUND



Source: WEFO data

Figure A2: European Social Fund priorities and intended outcomes and outputs

EUROPEAN SOCIAL FUND



Source: WEFO data

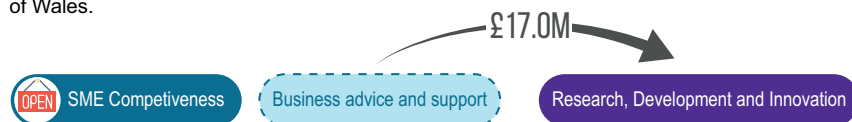
Appendix 3 – WEFO’s proposed changes to the programme

Figure A3 sets out in more detail the proposed changes to the operational programmes described in paragraph 1.7 and Figure 6. These changes are being proposed in light of progress to date and in order to create a new priority around regional working. The changes are still to be formally approved by the European Commission.

Figure A3: proposed changes to the operational programmes

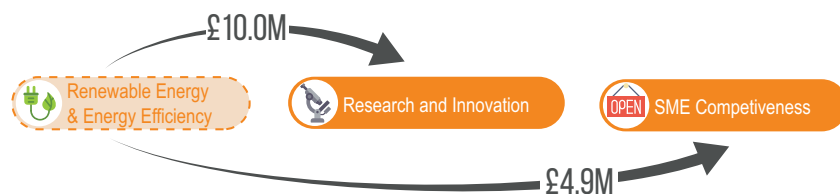
WEST WALES AND VALLEYS EUROPEAN REGIONAL DEVELOPMENT FUND

WEFO is proposing reallocating £17.0 million within the priority focused on the competitiveness of SMEs. It is proposing moving this funding from business advice and support and using it to boost the equity finance for research, development and innovation under the financial instrument managed by the Development Bank of Wales.



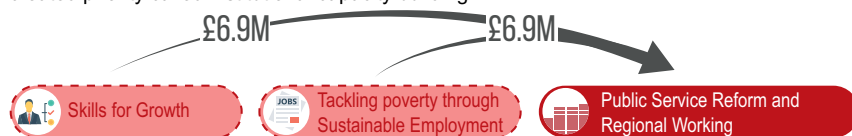
EAST WALES EUROPEAN REGIONAL DEVELOPMENT FUND

WEFO is proposing moving £14.9 million from the priority focused on renewable energy and energy efficiency and reallocating £10.0 million of it to the priority focused on research and innovation and a further £4.9 million to the priority focused on SME competitiveness.



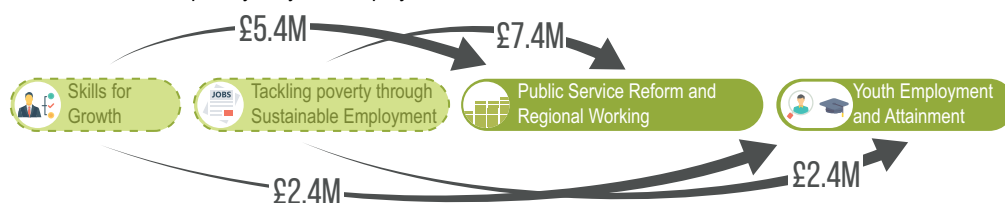
WEST WALES AND VALLEYS EUROPEAN SOCIAL FUND

WEFO is proposing taking £6.9 million out of the priority to tackle poverty through Sustainable Employment and another £6.9 million out of the priority skills for growth and putting the total of £13.9 million into a newly created priority called institutional capacity building.



EAST WALES EUROPEAN SOCIAL FUND

WEFO is proposing taking £10.0 million out of the priority to tackle poverty through Sustainable Employment and a further £7.9 million out of the priority skills and growth and putting £12.9 million of it into a new priority called institutional capacity building and regional working. WEFO is also proposing putting the remaining £4.9 million into the priority for youth employment and attainment.



Figures based on a conversion rate of £1:€1.17 which may change

Source: WEFO data

Appendix 4 – Programme oversight and monitoring

Figure A4 sets out more detail on the oversight and monitoring arrangements, referred to in paragraph 2.12.

Figure A4: WEFO oversight and monitoring structure



PPIMs	WEFO’s IT system that contains all approval, financial and performance information relating to projects.
Programme Management Division (PMD)	WEFO has put in place a team of officers who work within this division. Their role is to work with beneficiaries from an early stage in the development of operation ideas to advise on how successfully it might contribute to the programme level outputs
Technical and Financial Appraisal Team (TFAT)	WEFO’s TFAT provides support to PMD staff responsible for appraising and selecting operations. TFAT has a number of qualified accountants to ensure beneficiaries have the financial capacity to run their operations

Project reviews	<p>PMD – continuously review the performance and progress of each operation. This includes – following the submission of each claim to WEFO – the performance to-date against agreed profiled expenditure, output and results indicators. In addition to indicators/ profiles, PMD consider the overall effectiveness and impact of the operation’s activities to ensure that the desired outcomes are likely to be achieved. PMD identify and monitor risks and issues throughout the lifetime of an operation and meet with the beneficiary following the submission of each claim, along with relevant WEFO teams, to discuss progress, performance and issues.</p> <p>TFAT – review the financial information of potential and current beneficiaries to ensure that they have the financial capacity to run their operations.</p> <p>Management verification checks – operate a framework of checks and controls on claims received from beneficiaries and through site visits, to ensure that the expenditure included in the drawdown requests from WEFO are compliant with the rules.</p>
Intermediate Bodies (IBs) quality assurance reviews	<p>WEFO review claims submitted by IB’s before including expenditure in draw down from the EC.</p>
Intermediate Body review group	<p>WEFO have established an IB review group to discuss the projects delivery, and identify any risks and actions needed. The group also reviews the Quality Assurance reviews and systems audits of WEFO’s IB’s.</p>
Programme Risk Management Group (PMG)	<p>PMG monitors risks and processes across the programme through numerous risk registers.</p>
Delivery and compliance group	<p>The Group considers and reviews delivery and compliance issues affecting programme. The Group is made up of both internal and external stakeholders and usually meets on a quarterly basis.</p>
Programme performance board	<p>Responsible for planning, monitoring and directing the delivery of programmes.</p>
Programme monitoring committee	<p>Under EU regulations, Member States are required to appoint monitoring committees to check that operational programmes are being correctly implemented. It is chaired by WEFO and has regional, economic and social partners.</p>

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