

**A REPORT BY THE CONTROLLER OF AUDIT TO THE ACCOUNTS COMMISSION
UNDER SECTION 102(1) OF THE LOCAL GOVERNMENT (SCOTLAND) ACT 1973**

THE HIGHLAND COUNCIL: CAITHNESS HEAT AND POWER

Summary

1. The external auditor's report on the 2008/09 audit refers to The Highland Council's involvement in the Caithness Heat and Power (CHaP) project. The company set up by the council to deliver this innovative heating system for houses in Wick failed to deliver and experienced a range of problems.
2. The council requested its internal auditors to investigate, covering the period from project inception in 2002 through to the formation of the company in 2004 and its takeover by the council in 2008. Their report was presented to the council in January 2010 and identified fundamental failings in the way in which the project was initiated and authorised, and in risk management. There were also significant weaknesses in governance. Overall, the council failed to comply with 'following the public pound' principles which apply in cases such as this where councils decide to fund arms-length external organisations (ALEOs) to provide services.
3. The council contributed around £6.9 million and its 2008/09 accounts included provision for a further £6.9 million to cover financial guarantees and possible repayment of grants. Overall costs and potential liabilities to date are therefore about £13.8 million; the final amount is uncertain and will depend on the outcome of current tendering aimed at securing a new provider for the heating system. However, in the worst case, involving reinstatement of more traditional methods of home heating, total costs may be in the region of £16 million.
4. The council reorganised its committee and management structures in 2007 and most of the officers involved in the project, including the former Chief Executive and several Service Directors, have left the council's employment.
5. The council agreed an action plan in March 2010 which sets out steps to prevent similar situations arising. Actions include training and awareness sessions for elected members and council managers to highlight weaknesses in the governance of the project and lessons learned.
6. The purpose of my report is to bring to the attention of the Accounts Commission and the public the serious and wide ranging deficiencies in the council's dealings with

Caithness Heat and Power and to highlight matters for councils to consider in future when approving and governing projects of this nature.

Introduction and background

7. In 2002, the council initiated a project aimed at providing heat and hot water to 500 homes in Wick from an innovative wood-fired system. In later phases, it was envisaged that the system would provide heat and hot water to a wider community and would also generate income from the sale of electricity to the national grid. Assurances were provided to the council that each phase of the project would be self-contained and fully funded.
8. Between 2002 and 2004, officers based locally made a series of reports on the project to the Caithness Area Committee. During that time, an officer and two local elected members visited Finland and the Shetland Islands to help establish the scope of the project. The Area Committee approved the project in principle in March 2004.
9. This decision was ratified by the council in October 2004, at which point it agreed to establish Caithness Heat and Power Limited as a community-owned enterprise to deliver the project. However, due to significant financial and technical difficulties, the council decided in August 2008 to take ownership of the company. The council's aim at that point was to: improve governance and financial stewardship; maintain heat and hot water to the 247 houses connected to the system by way of a temporary oil-fired boiler; and seek a longer term solution. A high-level summary of key events from project inception through to takeover by the council is set out in Appendix 1.
10. As at January 2010, the council's expenditure, commitments and provisions can be summarised as follows:

	<u>£ million</u>
Expenditure/commitments:	
• Committed in November 2005	1.6
• Working capital advances: currently £3.6 million, but could rise to £5 million due to ongoing commitments	5.0
• Council development and procurement costs	0.3
Provisions (per 2008/09 audited accounts):	
• Provision for potential costs from premature redemption of lease	4.0
• Provision for potential claw back of Energy Saving Trust grant	2.9

Overall actual and potential costs	— <u>13.8</u>
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11. Potential future costs are uncertain until decisions on next steps are taken, and will depend on whether the council can secure a new provider for the heating system. Following a tendering exercise the council is currently negotiating with two companies that have expressed an interest in taking over the project. If these negotiations are not successful the council estimates that in the worst case, involving reinstatement of conventional heating systems in the properties, the total costs over the lifetime of the project could be of the order of £16 million.
12. The council's internal auditors reviewed the governance of the project from its inception through to the time at which the council took control of the company. The external auditors have reviewed internal audit's work and have informed me that in their opinion the scope of the internal audit investigation, the audit approach and the conclusions are appropriate. They have also informed me that in their opinion the council's action plan reflects the key improvements required. I relied on these audit findings to highlight key issues in this report and provided a copy of the report to the council's Chief Executive for comment.

There were fundamental failings in project initiation and authorisation, and in project risk management

13. The internal auditors' investigation identified a range of issues arising from project initiation and approval. In particular, they found:
 - Given its size and nature, it was inappropriate for the Area Committee to consider the project and to approve it in principle. Eight reports were considered between August 2002 and August 2004. Despite the potential costs and the risks associated with the use of new technology, these reports were made without recourse to a Headquarters Committee (specifically the Resources Committee within whose remit matters of this nature fell, in terms of the council's Scheme of Delegation).
 - In relation to the locally based officer who initiated the project, internal audit questioned whether the officer had the appropriate qualifications and skills to take forward a project of this nature.
 - Although the elected member and officer visits to Finland and the Shetland Islands to inspect district heating systems were intended to inform decision

making, it is not evident that the visits were of relevance. Furthermore, internal audit questioned whether the elected members and officer in attendance possessed the appropriate skills and qualifications.

- In terms of the council's Scheme of Delegation it was inappropriate for the project to have been initiated and progressed by the Planning & Development Service when the remit lay with Property & Architectural Services, which had the technical expertise and authority to investigate and recommend projects of this nature. There is evidence that the most senior officer in Property & Architectural Services expressed concerns about the project to senior officer colleagues outwith his department in advance of the council's approval, but it appears no effective action was taken.
 - The momentum and expectation of delivery at area level led to the application for external grant funding from the Energy Saving Trust. This was submitted by locally based officers without recourse to council headquarters and contained inaccuracies. The announcement in September 2004 of grant funding of £1.54 million and the perceived benefits for the Caithness area was made prior to the council's approval of the project in October 2004.
 - The council approved the project without establishing whether it had been subject to a formal project and risk appraisal or if a sound business case existed.
 - The council approved the establishment of CHaP Limited without receiving proper assurances regarding the project and without key documentation being in place. In particular, there was no formal project appraisal, business plan or risk management plan, nor was there any detail of the proposed remit, structure, resourcing and governance of the company.
14. In relation to risk management, the internal auditors concluded that inadequate consideration was given to the various risks (technical, financial, business and legal) associated with the project, both at the outset and during the project's life. When risks were identified these were largely dismissed and were not formally recorded and managed. In addition, the measures to mitigate any risks were insufficiently considered, were inappropriate or were disregarded. Internal audit concluded that there was a drive to push ahead by certain officers irrespective of the risks identified.

There were also significant weaknesses in governance

15. The internal auditors identified significant weaknesses in the governance of the project. In particular, they found:

- It was not evident to internal audit that the council's elected member on the CHaP Board had the appropriate skills or had received appropriate training to fulfil the role effectively.
- The council acknowledged the need to strengthen the governance arrangements, before the project commenced and throughout its life, but no meaningful progress was made. Governance was exercised on an ad-hoc basis and with no clarity as to how and by whom any resultant actions would be addressed.
- Despite initial assurances from a locally based officer to the Area Committee that the company would employ professional managers, this did not happen to the extent envisaged and the council provided a considerable resource and effectively took on the role of professional managers.
- Governance of the project was weakened by a lack of communication between Area and Headquarters staff. In particular, and at critical times before the project was agreed by the council and over the duration of the project, Headquarters was not made aware of important issues and developments.
- Despite the risks inherent in an innovative project, following the project's approval in October 2004 reporting to the council was infrequent and only took place when the company was urgently seeking funds. Reports also provided assurance that the project was on track when this was not the case. When key decisions were made by the company, in particular to move beyond the initial phase to include electricity generation and to merge the distinct phases of the project, despite their significance these were not brought to the attention of the council.
- Prior to the council approving the project, council officers worked with the proposed company's prospective external legal and technical advisors, effectively engaging them prior to the company's incorporation. As a consequence, the council's Contract Standing Orders were breached.
- Although a form of due diligence was undertaken by the company before it awarded the gasification tender (which extended the project to include electricity generation) in April 2006, the risks highlighted were not adequately

considered by the officers involved in the project locally, or the council-nominated Member on the CHaP Board. Furthermore, these risks were not made known to the council when it would have been appropriate to do so given their significance. Ultimately the project failed because the company procured 'experimental' and high risk gasification technology which could not be commissioned successfully. In awarding the contract, the CHaP Board decided to procure a system which had no clear history of success elsewhere.

- Although the evaluation of the gasification tenders by the company was overseen by its external technical advisor, of considerable concern is that the advertised evaluation criteria, including the need to demonstrate proven capability, were disregarded. Instead, price and potential output became the key drivers. The company's failure to adhere to its advertised criteria represents a breach of the procurement legislation which could have exposed it to legal challenge.

16. Internal audit was of the opinion that the Joint Ventures Board of senior officers was an appropriate forum for governing the project. Although the board considered the project in its early stages, until June 2005, the project was not on the agenda for subsequent meetings. Internal audit has not been able to establish why that was the case.

17. In relation to the statutory officers, who have specific powers and responsibilities as set out in the local government legislation, internal audit suggested that the council's officers should have exercised greater influence, to varying degrees, on the governance of the project through the application of their statutory roles.

The council did not comply with 'following the public pound' principles

18. Councils fund arms-length external organisations (ALEOs) as alternative ways of providing vital services and securing social benefits. To ensure that public money is used properly and achieves value for money, it must be possible to 'follow the public pound' across organisational boundaries and to establish and maintain good governance and clear accountabilities for finance and performance. The Accounts Commission/COSLA Code¹ sets out the principles of best practice when councils establish significant funding arrangements with ALEOs, covering crucial areas such as financial and performance monitoring, representation on the boards of ALEOs and establishing limits on the degree of involvement.

¹ *The Code of Guidance on Funding External Bodies and Following the Public Pound, Accounts Commission/Convention of Scottish Local Authorities 1996*

19. Internal audit's findings on CHaP point to a range of areas where the council did not comply with the Code's requirements. As a consequence, officers were not clearly aware of their responsibilities and relevant monitoring procedures. Where specific responsibilities were assigned, including maintaining a watching brief to represent the council's interests, there is little evidence to suggest these roles were delivered effectively.
20. The internal audit report highlighted the potential for conflict of interest arising from a lack of appropriate separation between the responsibilities of council officers and the advisors to the company. For example, a locally based council officer became involved in the financial affairs of the company and was appointed Company Treasurer.

Action taken by the council

21. The current Chief Executive and Depute Chief Executive & Director of Finance reported to the council on five occasions between May 2008 and February 2009, informing it about technical, financial and governance problems in the company and the findings of an operational team of officers set up to support the project. In February 2009, they provided an update on the action taken since the council took over the company in August 2008 to improve governance and financial stewardship, maintain heat and hot water to tenants and to seek a long term solution. The report also stated that internal audit would undertake an audit of the project.
22. The council considered the internal audit report at a special meeting in January 2010 and agreed to the actions set out in the report including compulsory training for all elected members appointed by the council to act as company director. The council also agreed to inform the external auditors and the Scottish Government of developments.
23. In March 2010, the council approved an action plan detailing a range of actions aimed at preventing similar situations arising along with target dates and the officers responsible. Steps include: training and awareness sessions for elected members and council managers to highlight weaknesses in governance of the CHaP project and to share the lessons learned; and exploring the possibility of legal action against individuals and others connected with the company. There is also an action for an independent review of the possibility of a disciplinary investigation to consider whether those officers still employed by the council failed to perform their duties in a professional and competent manner. All actions are to be addressed by 30

September 2010 and this timetable will allow the external auditors to assess and comment on progress in their report on the 2009/10 audit in October 2010.

Overall conclusions

24. The purpose of my report is to bring to the attention of the Accounts Commission and the public the serious and wide ranging deficiencies in the Council's dealings with Caithness Heat and Power. The internal and external audit reports point to serious weaknesses in governance and accountability and, in particular, failure to comply with the 'following the public pound' principles.
25. I note that the council has responded to the serious concerns in the internal audit report and that officers have implemented and continue to implement remedial action for which they are accountable to elected members. I am informed that most officers involved in the project have left the council and I am content to allow those thought to be responsible and still employed by the council to be held to account through any investigatory and disciplinary process which it considers appropriate.
26. The external auditors will assess the progress made and the effectiveness of revised arrangements as part of their planned audit work and will report in the usual way. I will monitor the position and may report again in due course.

CAROLINE GARDNER
CONTROLLER OF AUDIT
7 June 2010

**THE HIGHLAND COUNCIL: CAITHNESS HEAT AND POWER
SUMMARY OF KEY EVENTS**

August 2002	Locally based council officers report to Caithness Area Committee proposing Community Energy Initiative
2002 – 2004	Project development, including site visits to help establish the scope of the project. Reports mainly to Area Committee
March 2004	Area Committee approves project in principle
October 2004	Council approves project, including establishment of Caithness Heat and Power Limited
December 2004	Caithness Heat and Power Limited incorporated
2004 – 2008	Requests to council for funding: capital funding, bridging finance and, latterly, emergency finance
August 2008	Council agrees to take ownership of company due to significant financial and technical difficulties