

**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 – FOLLOW-UP REPORT**

Summary

1. This report is in response to the Accounts Commission's direction to the Controller of Audit for further investigations into The Highland Council's involvement in the Caithness Heat and Power (CHaP) project. The investigation involved careful consideration of the role of key individuals in the governance of the project and has provided a fuller understanding of the context in which key decisions concerning the project were made.
2. In summary, I have concluded that:
 - In the period between project approval in October 2004 and May 2008 when the significant problems were identified, only three reports were made to the Council. In each case these were when the CHaP company was urgently seeking funds.
 - The Council failed to establish effective governance for its interests in CHaP. As a result, it was not well placed to deal with key issues as they emerged and only became aware of the full significance of the company's decision in 2006 to procure high risk gasification technology two years later.
 - The former Chief Executive was aware of governance concerns and initiated actions but did not follow through to ensure these actions were effective. For his part, the Director of Finance should have been more forthright in pursuing his concerns about project governance.
 - The elected member on the CHaP company board could have done more at key stages to ensure the Council was aware of the position. The dissolution of the area committee structure and the associated departure of locally based officers meant that he became increasingly isolated.
3. Overall, there was a lack of a co-ordinated, corporate response to governance and ultimately the project, service users and council finances were left exposed. The project is ongoing but it seems likely that it will not achieve all its objectives and that service users will not receive the full benefits anticipated. It is also unlikely that full value for public money will be achieved. However, because the project is ongoing I am not in a position at this stage to identify overall costs or to quantify any losses that may have been, or will be, incurred.

4. I understand from the Council that currently its total commitment to CHaP including provisions stands at £13.77 million and that the total amount spent by it on CHaP is £10.5 million. However, the Council has indicated that this is a moving picture and that it will be required to advance more funds to CHaP soon to keep the company's overdraft within its current approved £0.25 million limit.

Introduction and audit approach

5. In February 2009, the Council considered a report on Caithness Heat and Power (CHaP) and was informed that its internal auditors were undertaking an audit of the project. Internal audit reported to the Council in January 2010, having carried out a detailed, desk-based review of reports, email and other documentation covering the period from August 2002 when the idea for the project first came to light to August 2008 when the Council took direct control of the project.
6. The external auditors' annual audit report to the Council and the Controller of Audit in October 2009 referred to CHaP and highlighted a range of technological, financial and governance problems. In view of the serious nature of the issues the Controller decided to report¹ to the Accounts Commission.
7. The purpose of that report was to highlight to the Commission and the public the serious and wide-ranging deficiencies in the Council's dealings with CHaP and the problems which can occur when councils do not observe the 'following the public pound' principles², which apply when councils decide to deliver projects or services through arms-length external organisations (ALEOs). As such, it was a high level report drawing together the findings from the audit work to date, principally the key issues identified by internal audit. The Controller's initial report was dated 7 June 2010 and is attached as Appendix 2.
8. The Commission considered the Controller of Audit's report at its meeting on 17 June 2010. The Commission directed the Controller to carry out further investigations³ and to report back on project governance and accountability, particularly the roles of the Council's statutory officers and the elected member who represented the Council on the CHaP company board.

¹ The Highland Council: Caithness Heat and Power, report by Controller of Audit under section 102(1) of the Local Government (Scotland) Act 1973, 7 June 2010

² Code of Guidance on Funding External Bodies and Following the Public Pound, Accounts Commission/COSLA 1996

³ Direction by the Accounts Commission under section 3(1)(a) of the Local Government in Scotland Act 2003

9. The further investigation therefore focussed on senior individuals' involvement in the Council's governance of the CHaP project, between 2002 and 2008. In particular, we interviewed:
- the current Chief Executive (who until July 2007 was the Director of Corporate Services & Depute Chief Executive and the Council's monitoring officer)
 - the current Depute Chief Executive & Director of Finance (who was and remains the Council's proper officer for finance)
 - the former Chief Executive (who retired on 11 July 2007 and was the Council's head of paid service)
 - the elected member who represented the Council on the CHaP company board.
10. Subsequently, in view of his central role in monitoring the Council's interest in CHaP, we also interviewed the Council's current Corporate Manager. He held the role of Caithness Area Manager between October 2002 and April 2007 at which point he was appointed and remains Corporate Manager. As Area Manager he reported directly to the former Chief Executive.
11. Taken together with evidence gathered by internal audit and further information obtained from the Council as part of this investigation, these interviews helped me gain a fuller understanding of the context in which key decisions concerning the project were made and individuals' roles in the governance of the project. The individuals interviewed have had the opportunity to comment on a draft of this report and I am grateful to them and other Council officers for their co-operation in the follow-up audit investigation.
12. My report first considers the background to the project and the reports made to the Council between 2004 and 2008. I then review the steps taken to establish governance over the Council's interests in the project and then the roles of the Council's statutory officers and the elected member who represented the Council on the CHaP company board. Throughout, the focus is on the Council and its interaction with the project and the CHaP company; governance within the CHaP company is outwith the scope of this report.

Project background and reporting to the Council

In the period between project approval in October 2004 and May 2008 when the significant problems were identified, only three reports were made to the Council. In each case these were when the CHaP company was urgently seeking funds.

13. The decentralised area committee structures in place at the time of the inception of the CHaP project in 2002 provided the environment for the project to gain substantial momentum. The Caithness Area Committee envisaged a district heating system fuelled by woodchip that would provide benefits for local housing and business. Centrally, the Council was aware of the initiation of the project, viewing it as a relatively straightforward development financed by monies set aside to improve council housing and consistent with corporate priorities relating to renewable energy and sustainability.
14. The Council's decentralised structure was highlighted in a Best Value audit report⁴ in April 2006. It noted the rationale for these arrangements but concluded that the associated management structures were complex and difficult for officers and elected members to understand and access. The report also noted that the decentralised structures promoted an environment where local priorities predominated.
15. The relationship between the Caithness area and the Council's Headquarters in Inverness (HQ) provides important context to the CHaP project. The Area Committee, and subsequently the CHaP company board, was supported by Council officers based locally who focussed on the project and the benefits it could bring to the area. Officers at HQ observed the decentralised structure, implemented decisions by local elected members and were keen to support local initiatives.
16. When the Council approved the CHaP project and the formation of a company to deliver it in October 2004, it was on the basis that it would involve a free-standing, wood-fuelled plant and waste heat from the local distillery. The report by the Director of Planning and Development noted the prospect of future phases involving gasification⁵ to generate electricity as well as heat. Assurances were provided that each phase would be self-contained and fully funded. In November 2005, the Council committed £1.6 million from housing budgets to support the district heating system. The report, by the Caithness Area Manager, again assured the Council that the project involved distinct phases, with later phases requiring no financial input from the Council.

⁴ Highland Council – the Audit of Best Value and Community Planning, Audit Scotland, April 2006

⁵ Gasification is the reaction of carbon based materials with oxygen and/or steam to produce gas which is itself a fuel. It is potentially more efficient than direct combustion of the original materials.

17. Faced with steeply rising woodchip prices, locally based Council officers advised the CHaP company board to combine project phasing and to proceed with gasification, despite the previous assurances to the Council. The company advertised the contract late in 2005 and considered tenders in April 2006.
18. The Council's £1.6 million commitment in November 2005 was based on its understanding that the project involved a relatively straightforward district heating system. Developments soon after that, involving gasification, should have been reported to the Council so it was aware of the shift and to allow it to reconsider its position.
19. It was not until October 2006 that the Council received its next report on CHaP and this referred to the fact that the phases of the project had blended into one. The report, by the Director of Finance, noted a risk with gasification but that the company's heating consultant was confident the technology would provide heat and power as anticipated. The Council agreed to provide short term finance to the company in the form of a £0.55 million loan facility, to meet cash flow requirements until Energy Saving Trust grant instalments were received and bank loan finance secured.
20. In April 2007, the former Chief Executive reported to the Council that the company's bank was pressing for further safeguards relative to the loan it was providing to part-fund the project. To secure funding for the project he had exercised emergency powers⁶ to extend existing guarantees, firstly the period over which the Council would guarantee the Company's £3 million bank loan and secondly the ongoing guarantee of the Company's overdraft facility to £1 million for the year to July 2008. As was the case in October 2006, the report referred to gasification and the possibility that the equipment would not meet expectations and in the extreme case might fail. However, the report stated that this risk had been minimised as far as possible, for example, by the company's engagement of an acknowledged energy expert.
21. By summer 2007, the equipment was in place and it was envisaged that the project would be successfully delivered. There were delays in commissioning but there was no indication at that stage that the technology would fail.
22. In January 2008, emerging financial difficulties became apparent. In light of this, the current Chief Executive initiated work to obtain a clear understanding of the financial and technical position and this led to a report to the Council in May 2008. In that report the current Chief Executive and Depute Chief Executive & Director of Finance updated the Council on its commitments to CHaP and informed it that the Chief Executive had used

⁶ Emergency powers as provided for within the Council's Financial Regulations and Scheme of Delegation.

emergency powers to increase the Council's level of guarantee for the company's overdraft, from £1 million to £1.2 million. The Council agreed to this and to further increase its guarantee for the overdraft up to £1.9 million. The report highlighted problems in commissioning the gasification plant.

23. The current Chief Executive and Depute Chief Executive & Director of Finance reported again to the Council in June 2008 advising of the need for the Council to cap its financial support for CHaP and of the failure to commission the plant. These officers reported again in August 2008, at which point the Council considered options to protect its interest and agreed to take control of the company. It was only at that point, in August 2008, that the Council had the opportunity to assess full information on the technical position and the options available to it.
24. The key reporting events set out in this section are summarised in Appendix 1. In the period between project approval in October 2004 and May 2008 when the significant problems were identified, only three reports were made to the Council, in November 2005, October 2006 and April 2007. In each case these were at points when the company was urgently seeking funds. There was no reporting to the Council on attempts to commission the gasification plant or on the impact on the company finances and ultimately, the impact on the Council's finances.

Steps taken to establish governance

The Council failed to establish effective governance for its interests in CHaP. As a result, it was not well placed to deal with key issues as they emerged and only became aware of the full significance of the company's decision in 2006 to procure high risk gasification technology two years later.

25. Governance is about clear direction and control and is central to the success of all organisations. In cases where councils decide to deliver projects and services through an arms-length organisation such as the CHaP company, it is vital to establish sound arrangements from the outset and to ensure that these are applied effectively in practice. This section of the report considers steps taken to establish governance for CHaP; the following sections consider the roles of individual statutory officers and the elected member who represented the Council on the CHaP company board.
26. In approving the CHaP project in October 2004, the Council gave the Caithness Area Manager a clear remit to ensure that the project complied with all legal, financial and contractual requirements. His role was to take an overview of the Council's involvement in the company and to maintain a watching brief to represent the Council's interests. However, he was not suitably active in this role and did not give the project sufficient

attention at key points, including at the time of the Company's decision to procure high risk gasification technology and when it became apparent that there were problems in commissioning the equipment.

27. The Council operated a Joint Ventures Board (JVB) of senior officers from across services to monitor a range of significant projects which the Council delivered with partners and this acted as a forum to bring together specialist technical, legal and financial interests.
28. At a JVB meeting in October 2004, concern was expressed regarding the lack of control over CHaP and the need for proper governance arrangements was noted. Further concerns were expressed at the JVB in December 2004 and the former Chief Executive felt there were sufficient reasons for a 'full audit' of the scheme and how it was managed. In April 2005 the JVB noted that the scheme was moving too quickly; further phases were being worked on and it was felt that the focus should be on ensuring that the first phase was a success. In June 2005, following concerns from senior staff in his service about how best to secure the governance of the project, the Director of Finance suggested a written paper should be presented to every JVB setting out on an ongoing basis progress and proposals, as a means of keeping everyone up to date and informed and to allow consideration of the implications.
29. However, following discussion at the JVB meeting in April 2005, there was no further consideration of CHaP at the JVB. We were unable to determine why this was the case. The current Chief Executive and the Director of Finance are of the view that CHaP should have remained on the JVB agenda but they were not clear why the Board lost sight of the project. The former Chief Executive, who we understand controlled the JVB agenda, is of the view that CHaP was a housing project to provide heating to council houses and that dealing with this through the usual Committee channels (other than the JVB) for such projects was consistent with the scheme of delegation. He also informed us that a project to provide a district heating system for council houses with proven technology was not the kind of project that the JVB would have taken forward given its housing purpose and then scale.
30. As indicated, in December 2004, as a result of discussion at the Joint Ventures Board, the former Chief Executive requested the Director of Finance to undertake an audit of CHaP. Early in 2005, a group of officers met to discuss the 'following the public pound' requirements set out in the Accounts Commission/COSLA Code. The former Chief Executive was informed about the outcome of those discussions in January 2005 and his advice was sought on whether he wished to proceed to a full audit of the project. However, actions were not formalised and were not addressed, no further follow-up

action was taken and the former Chief Executive did not respond to the question about a full audit.

31. At its meeting in October 2006 the Council agreed that as a condition of providing the bridging finance and/or any future guarantee, the former Chief Executive should negotiate with the company about the suitability of its governance structure. The former Chief Executive called a meeting in December 2006 to discuss governance and in advance the Director of Finance highlighted a range of issues to be addressed. Later that month the former Chief Executive set out six fundamental issues which needed to be resolved including completion of contracts between the Council and CHaP, the need to strengthen business and technical expertise on the CHaP board and the separation of Council and company interests in the role of Council officers.
32. In April 2007, the Caithness Area Manager who was responsible for overseeing the Council's interests provided assurance by email that actions had been taken across the six points raised by the former Chief Executive. Around the same time, the Director of Finance provided the former Chief Executive with a less positive picture of the outstanding governance issues by email and flagged a clear need to agree how the Council might seek to protect its interests and its exposure to the financial guarantees. The Director of Finance raised further concerns by email in May 2007 indicating that it would be useful to discuss the position on governance as he was unclear as to the position. This was not followed up by the former Chief Executive.
33. Reference was made to CHaP at a senior managers' Weekly Business Meeting early in June 2007 during discussions about the agenda for the Council meeting later that month. The Council agenda item related to an appointment to the CHaP Board resulting from the formation of the new Council following the May 2007 elections. However the Weekly Business Meeting minutes show that it was agreed the Corporate Manager (formerly the Caithness Area Manager) would review the measures taken to improve governance and provide advice to the former Chief Executive, the Depute Chief Executive and the Director of Finance before papers were sent out for the Council meeting. However, there is no evidence that any action was taken and this was not followed up.
34. Between 2004 and 2007, locally based officers became closely involved in the day to day running of the project. The Area Development Manager and the Area Finance Manager attended the majority of the Company Board meetings. In effect, they took on the role of professional managers of the project and were more aligned to the company than the Council.

35. The combined effect of inactivity on the part of the Area Manager in his role as the main link between the project and the Council, ineffective governance at HQ and the lack of appropriate separation between the role of local council officers and the CHaP company meant that at key stages the Council was not aware of developments. The fact that CHaP ceased to feature in discussions at the JVB is central. In principle, discussion at the JVB would have provided the opportunity for a coordinated, cross-service approach at the formative stage of the project, before the Council had committed substantial funds and guarantees. The JVB could also have provided or ensured effective governance over the Council's involvement in CHaP. No alternative cross-service scrutiny arrangements were put in place. Consequently, project oversight fell to the Chief Executive's service through the project monitoring and reporting responsibilities assigned to the Area Manager who was accountable to his line manager, the former Chief Executive.
36. Significantly, at the crucial point in 2006 when the company decided to take a fundamental change in direction and combine project phasing and procure high risk gasification technology, council officers did not realise the full extent of the risks involved. Even when they became aware they did not realise the full significance and the implications. It was only in 2008 that the full extent of the technical problems became apparent. At that point the Council took an informed decision that it was not in its interests to see the project fail given the serious consequences for those council tenants already connected to the part-functioning heating system and the scale of the loss the Council would incur.
37. Over the course of the Council's involvement, the Council and its officers realised that strong governance was required to protect the Council's interest in the project. Key events are set out in Appendix 1. However, despite an acknowledged need for improved governance, the Council failed at the outset and over a long period to establish effective and co-ordinated governance to monitor its interest in CHaP.
38. Strong governance would not have guaranteed the success of the project but it would have provided earlier identification of concerns and a more immediate, co-ordinated response. The Council would have been more aware and could have been given the opportunity to consider the position in more detail and reassess the extent and nature of its involvement.

The roles of the Council's statutory officers

The former Chief Executive was aware of governance concerns and initiated actions but did not follow through to ensure these actions were effective. For his part, the Director of Finance should have been more forthright in pursuing his concerns about project governance.

39. Statutory officers have specific powers and responsibilities as set out in local government legislation. The Controller's June 2010 report states that senior officers should have exercised greater influence, to varying degrees, on the governance of the project through the application of their statutory roles. This section of the report builds on this by considering the statutory roles and those senior officers' wider responsibilities for the governance of CHaP.
40. The roles of head of paid service and monitoring officer are defined tightly in statute. In summary, the head of paid service is responsible to elected members for council staffing and management structures. The monitoring officer is responsible for reporting to the council if it appears that a proposal or decision is likely to contravene legislation. On those strict interpretations, there appears to have been no reason for the statutory officers to have applied their statutory roles in relation to CHaP.
41. The statutory 'section 95' proper officer role for finance is much broader, with overall responsibility for the council's financial affairs. While the role is personal, it requires supporting structures which allow oversight of all aspects of council finances, including in relation to the council's involvement in arms-length external organisations.
42. In addition to their statutory duties, senior officers have wider responsibilities. In particular, the chief executive has a central role and ultimately has responsibility for all aspects of the management of the council and for ensuring that other statutory officers have appropriate access and influence in carrying out their roles⁷. Senior officers also have an important role in promoting and enforcing strong corporate governance. This depends on clear roles and accountabilities and clear instructions and processes for checking implementation, including through strong staff supervision.
43. The previous section of this report shows that the former Chief Executive initiated action to establish governance arrangements for CHaP. However, there were a number of occasions on which he did not follow through to ensure these actions were effective. For example, in December 2004 following discussion at the Joint Ventures Board he requested an audit of the project. Initial work was carried out and was reported to him,

⁷ Roles and working relationships: are you getting it right?, Accounts Commission, August 2010

but no further action was taken. Also, in response to the actions identified by the Council in October 2006 he called a meeting to discuss governance and in December 2006 issued an email setting out the actions required. However, by that time the project was at an advanced stage and, in the event, key actions were not implemented.

44. The Director of Finance and his team raised concerns with the former Chief Executive about CHaP governance on a number of occasions. For example, the Director of Finance emailed the former Chief Executive in December 2006 and identified a range of governance issues to be addressed. In April 2007, the Director of Finance reminded the former Chief Executive by email that there was a clear need to agree how the Council might seek to protect its interests and its exposure to the financial guarantees as the project moved forward. In May 2007, the Director of Finance emailed the former Chief Executive again expressing uncertainty about the position on governance.
45. Operationally, the Caithness Area Manager reported directly to the former Chief Executive. When the project was approved in October 2004, the Council gave the Area Manager what should have been a central role in its governance arrangements for CHaP. At interview, the Area Manager reported that no steps were taken by the former Chief Executive following the Council meeting to establish what the monitoring role for CHaP involved and the reporting arrangements. It is clear that the Area Manager attached less significance to the CHaP related aspect of his role than the Council minute envisaged. Taking account of his other responsibilities and other officers' involvement, he was content to adopt a less active role.
46. The former Chief Executive initiated actions to establish and strengthen governance. However, these were not effective and he could have done more to ensure a coordinated and effective response to known governance concerns. He should also have attached more importance to the concerns raised by the Council's statutory officer for finance. Following the shift away from the Joint Ventures Board, his service carried responsibility for project monitoring and he should also have done more in terms of his line management responsibilities to ensure the Area Manager was more effective in that aspect of his role.
47. As indicated, the Director of Finance expressed concerns to the former Chief Executive in December 2006, April 2007 and May 2007 about the way matters relating to CHaP were developing. Before that, in January 2005, the Director of Finance was aware that a senior member of his team had asked the former Chief Executive whether the initial audit work should move towards a full audit and in June 2005 the Director of Finance suggested to the same member of his staff that he take concerns about governance to the forthcoming JVB. The Director of Finance was therefore aware of the need for action

and he should also have been aware when no action was taken or when the action taken was ineffective.

48. The report to the Council in October 2006 was made in his name but at interview he reported that he had been on holiday at the time the report was prepared and returned to find the report on the Council agenda. He said that his lack of involvement in either the discussion or drafting of the report prevented him contributing to the nature and style of the report submitted. Later, in spring 2007, there was discussion between the former Chief Executive and the Director of Finance about in whose name the April 2007 report to Council should be made. In the event, the report was made in the Chief Executive's name only. This was on the Director of Finance's advice, because the report concerned the former Chief Executive's personal authority in applying delegated emergency powers. However, it is apparent that the Director of Finance had misgivings about the reports to the Council in October 2006 and April 2007. In terms of the April 2007 report, it is interesting to contrast the position with the report in May 2008, when under the new management structure the report seeking ratification of the current Chief Executive's use of emergency powers was made in the joint names of the current Chief Executive and the Director of Finance.
49. Operationally, the locally based finance officer who reported indirectly to the Director of Finance was able to take on the role of CHaP company Treasurer without the knowledge of the Director, resulting in conflict of interest and blurring the boundaries between the Council's finances and those of the CHaP company. For example, in January 2006 the locally based officer was involved in the detailed financial review which concluded that the gasification technology should be pursued. If detected earlier, it would have allowed a more objective assessment of the direction the project had taken and the financial consequences for the Council as project funder and guarantor.
50. As the proper officer for finance, the Director of Finance was clearly concerned about the project and governance weaknesses. He raised concerns but did not follow these through. Ultimately, these concerns proved to be well founded. As proper officer for finance he should have been more forthright, either in discussion with the former Chief Executive or, if he felt it appropriate, through alternative channels in the Council. These may have included for example, informal and formal discussions with internal and external audit, discussions with other senior Council officers, more formal exchanges with the former Chief Executive and, ultimately, raising matters with elected members.
51. In summary, the former Chief Executive was aware of weaknesses in governance and should have done more to establish effective, corporate governance over the Council's interest in the CHaP project. Specifically, the former Chief Executive should have

attached more importance to the concerns raised by the Director of Finance and taken action. For his part, the Director of Finance was aware of governance concerns and that these were not being satisfactorily addressed. He should have been more forthright in pursuing his well founded concerns about project governance and finance.

The role of the elected member who represented the Council on the company board

The elected member on the CHaP company board could have done more at key stages to ensure the Council was aware of the position. The dissolution of the area committee structure and the associated departure of locally based officers meant that he became increasingly isolated.

52. When appointed to the boards of companies and other arms-length external organisations (ALEOs), elected members take on additional responsibilities which sit alongside their responsibilities to the Council⁸. In the case of CHaP, one of the local elected members was appointed to the CHaP company board which at that time consisted of three directors i.e. representatives from the Council, the distillery and the Pultneytown People's Project (a local community group). From that point, in addition to his ongoing responsibilities as an elected member of the Council, as a Board member he had responsibilities to the company. He did his own research to understand the company director role although he also received training from the Council and had some experience from being on the Board of another Council ALEO.
53. As with others based locally, it is clear that the elected member was enthusiastic about the prospects and the potential the CHaP project offered and became one of the main drivers. The elected member was aware that combining the project phases and moving ahead with gasification was risky but took comfort from the advice he received from locally based officers and technical experts. However, the locally based officers were not sufficiently objective and the technical experts appointed by the company had by association a clear financial interest in the project. Had he had independent technical advice to hand, he would have been better equipped to question and challenge at a local level and to protect the Council's wider interests.
54. The position in terms of support for the elected member deteriorated further in summer 2007 when management restructuring took place and when the area committee arrangements ended, leaving him with significantly less Council based support. At interview, he said the project lost the support of HQ based officers at that time. Area based officers closely involved in CHaP either left the Council or took on different, wider

⁸ Roles and working relationships: are you getting it right?, Accounts Commission, August 2010

responsibilities and as a result the direct involvement of Council officers reduced significantly.

55. Having found himself in that position, the elected member became increasingly isolated. The monitoring and reporting arrangements he assumed were in place but in practice were neither systematic nor robust, no longer existed. The elected member had concerns about progress, particularly in the period between July and December 2007, and relied on assurances from the consultants that plant commissioning was imminent but this proved not to be the case. He informed us that during that time he contacted various officers informally to inform them about commissioning but in doing so he also indicated he was confident the problems would soon be overcome.
56. In summary, the elected member appointed to the CHaP company board was not sufficiently supported in the role, specifically in terms of independent technical advice which was essential at key stages throughout the development of the project and when the area based structure ended. His role required him to balance his responsibilities to the Council with his responsibilities to the company. At key stages, particularly as it became apparent from the summer of 2007 that there were serious problems in commissioning the plant, he could have done more to ensure that the Council had a balanced picture of the position.

Conclusion

57. The CHaP project gained strong local momentum which was encouraged in the then area based structure. Corporately, the Council did not establish effective governance and as a result, when the company decided in spring 2006 to pursue gasification, the significance was missed. There was a lack of a corporate, joined-up approach and as a result there were no effective mechanisms for monitoring events as they unfolded. Actions to improve governance came too late and were not effective and, ultimately, the project, services and public funds were not subject to the degree of scrutiny and protection required.
58. As the Accounts Commission's report on roles and working relationships makes clear, statutory officers have a vital role in supporting good governance and decision making. It is particularly concerning that when the need for action aimed at establishing and improving governance for CHaP was identified and when individuals expressed concerns, these were not effectively followed through. Ultimately, the Council found itself in the position where it considered its only option was to take control of the company and the project.

59. The key test of the strength of governance arrangements is at times of pressure and tensions, such as in the case involving CHaP. In light of the information he was receiving about weaknesses in governance, including from the statutory proper officer for finance, the former Chief Executive should have done more to ensure effective and co-ordinated corporate governance. This is particularly so in a context where the only mechanism for systematic and regular review of the project rested with his department through the Area Manager, for whom he had direct line management responsibilities.
60. The Council's proper officer for finance clearly had concerns but he did not bring to bear the influence attached to the proper officer for finance role. I accept there are additional complexities in applying the proper officer role when funding is provided to an ALEO but, in my opinion, had the proper officer for finance been more forthright in that role this may have led to more effective intervention at an earlier stage.
61. The local elected member who took on additional responsibilities on the CHaP company board became a strong advocate for the project but at key stages did not fully discharge his ongoing responsibilities to the Council due in part to a lack of support and technical expertise. At key stages he should have reassessed the balance between his responsibilities locally and to the company and his corporate responsibilities to the Council as a whole.
62. It is clear that the Council has taken this matter seriously and has approached the earlier internal audit and subsequent investigations by me in an open and constructive manner, with the overall aim of learning lessons from its involvement in CHaP and seeking to avoid any recurrence. The Council is also seeking to find a solution that best protects local people and services and its overall financial position.
63. The initial report by the Controller set out steps which have been taken at the Council in terms of awareness sessions for managers and elected members on lessons learned from the Council's involvement in CHaP. Through this officers and elected members should now have a stronger sense of what is required of them in terms of governance and scrutiny. The management culture has also changed, with a more collective approach and a stronger focus on responsibilities and accountabilities.
64. The Council's approach is consistent with the most recent Best Value audit report⁹ which found that the Council has strong managerial leadership and the current Chief Executive promotes a positive and inclusive management approach by setting out clear accountabilities and responsibilities. The report also highlighted that changed political and management arrangements have strengthened corporate working and reduced the

⁹ The Highland Council, Best Value 2 pathfinder audit, Audit Scotland, May 2010

inconsistency between the former district council areas while retaining a local focus and sense of identity. Overall, the audit report concluded that the Council is now demonstrating that it is 'improving well' and it is 'well placed to deliver future improvement'.

65. The Council's discussions with a new provider continue. I have requested the external auditors to monitor the position, including the action the Council is taking to protect its interests.

FRASER McKINLAY
CONTROLLER OF AUDIT
9 FEBRUARY 2011

APPENDIX 1

CAITHNESS HEAT AND POWER: REPORTING, KEY EVENTS AND GOVERNANCE 2002 – 2008

	Council reports/key events	Governance
August 2002	Locally based officers report to Caithness Area Committee proposing project. 8 reports up to August 2004	
October 2004	Council approves project	Council report identifies monitoring role for Area Manager JVB ¹⁰ – concerns expressed over lack of control, need for proper governance noted.
December 2004	CHaP company incorporated	JVB – further concerns expressed, former CE requests audit
January 2005		'Following the public pound' discussion
April 2005		JVB – noted that scheme is moving too quickly
June 2005		Director of Finance suggested papers on CHaP to future JVB meetings
November 2005	Council commits £1.6m from housing funds	
April 2006	CHaP considers gasification tenders and approves.	
October 2006	Council approves bridging finance of £0.55m - governance is a condition of financing	
December 2006		Former CE issues six point email
April 2007	Council homologates CE's use of emergency powers to extend guarantee (loan guarantee £3m, now for 10 years; overdraft guarantee for year to July 2008 £1m)	Area Manager provides assurances on governance. Director of Finance offers different view raising concerns in April and May 2007
June 2007		Weekly Business Meeting - Area Manager to review governance
July 2007	CHaP – first attempts to commission equipment	
January 2008	CHaP – commissioning and financial problems become apparent	Current CE initiates action, leading to operational team review and clarity on financial and technical position
May 2008	Council homologates CE's use of emergency powers to extend overdraft to £1.2m, agrees limit of £1.9m	
June 2008	Council receives update, including details on commissioning failure	
August 2008	Council considers options and agrees to take control of CHaP	

¹⁰ Joint Ventures Board

**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 clawback of Energy Saving Trust grant	2.9
	—
Overall actual and potential costs	<u>13.8</u>

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 Code¹¹ 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.

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

¹¹ *The Code of Guidance on Funding External Bodies and Following the Public Pound, Accounts Commission/Convention of Scottish Local Authorities 1996*

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