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## Inquiry into the Mangawhai community wastewater scheme





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# Inquiry into the Mangawhai community wastewater scheme

This is an independent assurance  
report about an inquiry carried out  
under section 18 of the Public Audit  
Act 2001.

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## Auditor-General's overview

This report describes how Kaipara District Council (KDC) managed the Mangawhai community wastewater scheme between 1996 and 2012, as well as the role played by other agencies, including my Office.

The matters this report covers are long and often complex, but the overall picture is simple. I summarise it as a woeful saga. Overall, the inquiry found that:

- KDC failed to attend to its fundamental legal and accountability obligations.
- KDC effectively lost control of a major infrastructure project.
- Some of the work done on behalf of the Auditor-General has fallen short of the standards I expect.

### Why I agreed to carry out this inquiry

The Commissioners and staff at KDC, together with the community they serve, have to find a way forward on the challenges facing them. No inquiry by this or any other office can do that for them. What this report can do is:

- tell the story of what happened; and
- draw out lessons for the sector, so other communities can avoid facing similar challenges.

When KDC asked me to carry out this inquiry, it told me that it did not think it and the community could move forward effectively without an objective account of what happened. It was also clear to me that my Office could identify important lessons for the sector. These were the two public-facing purposes of our work.

However, there was a third purpose. Questions had been raised about the quality of the work done by KDC's auditors. That work is done in my name by people I appoint. The role of Auditor-General is an important and long-established constitutional safeguard. As the current holder of that office, I have an obligation to maintain the health, capability, and reputation of the organisation. If there were problems, I wanted to understand and fix them. I therefore wanted to put the spotlight on my own organisation and scrutinise the work being done in the name of the Auditor-General. I considered that I needed to do that formally and publicly.

### What happened with the wastewater scheme?

After 20 months of carefully collecting and analysing evidence, this inquiry has made some clear findings about what happened. The positive findings are that:

- the decision that Mangawhai needed a reticulated wastewater scheme was well founded; and
- the wastewater scheme that has been built works effectively and has appropriate capacity for population growth.

The other findings are more sobering.

Overall, KDC has ended up with a wastewater scheme that works, but it has come at a significant cost. The fact that we cannot put a precise figure on that cost is indicative of KDC's poor management.

KDC's records did not contain good or systematic information on the total amount spent. However, our best estimate is that the total cost was about \$63.3 million.

The overall costs are not just financial. They include a failed council, councillors who have been replaced with commissioners, the departure of a chief executive, a severely damaged relationship between the council and community, an organisation that has needed to be rebuilt, and much more.

### **KDC had poor governance, management, and records**

This report sets out the facts that we have been able to establish and provides our comments on them. However, our work has been made much more challenging by the poor state of KDC's records. My staff went to considerable lengths to obtain information from other sources, but there are many points where we have simply been unable to establish exactly what happened. These points are highlighted in the report.

KDC's decision-making processes were also poor throughout the entire 16 years of the wastewater project. KDC relied too heavily on its professional advisers and had a practice of receiving briefings and effectively making decisions in informal workshops. The governance and management arrangements put in place specifically for the project were also inadequate. In our view, these underlying problems made it harder for KDC to deal with the problems that emerged as the project progressed.

### **Out of depth with public private partnership decision**

KDC decided that it wanted to explore a public private partnership (PPP) approach, to keep the debt "off the balance sheet" and to put as much risk as possible on to the private sector provider.

In my view, this decision took KDC out of its depth. It followed all the right basic steps when it initially went to the market for advisers and put the project to tender, but it did not fully understand the complexity of what it was doing. The early decision to use a PPP approach put too much emphasis on achieving a certain accounting outcome and the transfer of risk, and not enough on value for money and affordability. KDC's decision-making about the PPP was not consistent with the good practice guidance that was available at the time.

In late 2002, the enactment of the Local Government Act meant that KDC could not proceed with the type of PPP contract that it had gone to tender with. It decided that it could proceed with the preferred provider that had been selected for negotiation and modify the basis for the negotiations. The new legislative constraints should have prompted a more fundamental reconsideration of how the project was being approached.

### Poor contracting

Contract negotiations were well advanced with one company when its parent company went into voluntary administration in 2005. KDC decided to negotiate directly with EarthTech, one of the other tenderers from 2003. That decision left KDC unable to assess whether the contract it negotiated was cost-effective or competitive.

KDC's approach to funding the project was inadequate. It did not do enough to check the appropriateness of the policies it was adopting. The changes KDC made to its Treasury Management Policy meant that it effectively had no borrowing limit for the wastewater project. It also implemented its debt segmentation policies badly.

The contract was signed in 2005 without an identified disposal site for the effluent. This was unwise. It created a significant risk for the project and left KDC in a weak bargaining position when purchasing a site. The 2005 contract allowed \$361,000 for disposal costs, but the total costs ending up being about \$14 million. KDC had entered into legal commitments to proceed without having a good understanding of the total cost of the project.

The contract was revised substantially in 2007. Changes included provision for a pipeline and associated works that were needed because KDC had bought a farm as a disposal site that was some 11 kilometres away from the treatment plant. We identified many flaws in the way KDC went about approving the contract and in the detail of the contract itself. We question whether the final contract achieved KDC's original financial and risk management objectives.

I am also concerned that KDC does not appear to have regarded the disciplines and checks in the contract about the construction and handover process as particularly important. In my view, the relatively relaxed approach that was taken to some of these protections, such as the approval processes involved in commercial acceptance and handover of the asset, exposed KDC to unnecessary risk.

## Attempts to spread the cost among more ratepayers

For these and other reasons, the costs of the project increased steadily. KDC assessed affordability by considering the annual cost to ratepayers. It decided to increase the number of estimated ratepayers that would be covered by the scheme and contribute to funding it. KDC increased the scope of the project to cover more properties and adopted new growth projections that assumed more properties would be developed.

We have criticised these decisions on the grounds that they were not based on good information and did not take adequate account of the risk of slower growth. KDC's focus on the annual cost to the ratepayer as a measure of affordability was unfortunate: it meant that it did not fully appreciate the significant increase in capital costs and the effect on the project's overall affordability.

## Making significant changes after consultation

This report also criticises KDC for putting out a Statement of Proposal for consultation in February 2006 based on one set of proposals and then deciding to change the growth projections, the area covered by the scheme, and the cost of the project in October of the same year.

Consultation and communication with the community was good in the early stages of the project. However, it reduced considerably from about 2006, once significant problems started to arise.

## Complicated financing arrangements

As the project proceeded, it became clear that KDC did not understand the detail of what was involved in the complex contractual and financial arrangements or how the various parts related to one another.

This report is particularly critical of how little grip on the financing and borrowing arrangements KDC appears to have had. My staff identified several instances where unwise financial arrangements created additional costs. For example:

- The delays to the start of the project cost KDC an estimated \$450,000 in additional financing costs.
- A swap transaction had to be broken because it did not match with the commercial acceptance dates and expected cash flows under the contract. The swap termination costs were \$840,000.

## The review of the work carried out in my name

### The independent review of Audit New Zealand's audit work

While this inquiry has been under way, many people have suggested that it is inappropriate for me to review the work of my own business unit. I disagree. There are times when the head of any organisation needs to take a hard look at what is being done inside a part of their organisation.

The standard approach is to commission an independent person to carry out the review and provide a report. That is what I have done. I commissioned an independent expert, with a well-qualified peer reviewer, to provide me with his views on the quality of the work that has been done on my behalf.

That process is totally transparent: the terms of reference and the full and independent review report are published as part of this report.

There were problems with the way some of the audit work of KDC was carried out. The review noted that audit quality varied significantly over the period covered by the review, although there was a notable improvement in later years. The review criticises the quality of documentation in some audit files, particularly the documentation that should explain why particular audit judgements were reached. It also finds that, in the years 2006 to 2009, the auditor did not reassess the status of the wastewater project, despite it undergoing significant changes during these years, and did not identify it as an audit risk. Nor did the auditor identify problems with KDC's rates. The auditor relied too much on the information KDC's management provided. As a result, the independent review concluded that the audit work carried out in those years was inadequate.

I am disappointed by these findings.

However, I take comfort from the fact that the independent review did not raise concerns about Audit New Zealand's general systems and methodology. Successive independent reviews of Audit New Zealand in the last decade identified no matters of concern. At a personal level, I also know that Audit New Zealand's leadership and staff have a deep commitment to professionalism, hard work, and the important role that they play in our system of public sector accountability.

In recent years, Audit New Zealand has had a programme of work to improve the quality and consistency of its audit work. The benefits of this work are apparent. However, I consider that more is needed to reassure Parliament, the public, and public entities that they can rely on Audit New Zealand's work. The steps I am

taking to ensure that the lessons are learned and that there is consistent quality across all audits include:

- requiring that Audit New Zealand demonstrate to me that it consistently maintains an appropriate standard of work, by developing an improvement programme that will be overseen by two independent advisers;
- deciding that, until that reassurance is provided, I will not allocate new audits to Audit New Zealand; and
- accelerating the Office of the Auditor-General's normal quality assurance programme so that all auditors of local authorities will have had a review of a local government audit file by the end of June 2014.

Audit New Zealand has agreed that these steps are appropriate. It will continue its quality improvement work with additional focus on the matters raised about KDC.

### **The review of how the Office of the Auditor-General and other accountability agencies responded to concerns**

This report contains a review of the way that the Office of the Auditor-General (OAG) and other accountability agencies dealt with the concerns members of the public raised with us. That part of the inquiry was carried out by Phillippa Smith, the Deputy Auditor-General, because she had not had any significant involvement with matters relating to KDC in the past.

This review acknowledges that many of the concerns that correspondents raised have proved to be well founded. However, it has concluded that the various agencies' responses were generally reasonable, given the role and approach of the agencies and the information available at the time. Nonetheless, it is clear that the OAG can improve how it communicates with correspondents and that there would be value in the accountability agencies working more closely together and pooling information where possible.

I have acknowledged that, with the benefit of hindsight, it would have been appropriate to reconsider the situation more fully in late 2011, in light of the renewed correspondence from ratepayers and the additional information emerging from KDC. If we had done so, this inquiry might have begun a few months earlier.

However, that would not have changed what happened, because the wastewater scheme was already built and operating. An inquiry cannot undo the cumulative results of years of poor decision-making.



## What lessons can we take from this saga?

It is often said that we learn most from our mistakes. This saga has provided many valuable lessons for all those involved and for the sector as a whole. This report highlights lessons about:

- **governance** – such as the need for members of a governing body to have the courage to keep asking questions until they understand what they are deciding, and the benefits of formal processes and records to support decision-making;
- **management** – such as the importance of understanding the limits of contracting out so that organisations do not become too lean, the need to maintain enough financial expertise to manage their financial affairs, and the importance of project governance and management arrangements that ensure that a steady eye is kept on the big picture;
- **PPP arrangements** – such as the need to ensure that entities have the expertise to manage complex contracts, the fact that accounting issues should not drive the decision to enter into a PPP, and that transferring risk has costs and should not be seen as an end in itself;
- **public sector auditors** – such as the importance of understanding the critical risks of an entity (looking beyond the financial statements to the entity as a whole and looking across successive years to consider trends), the need to document evidence and judgements, and the need for good and open communication between the entity and the auditor if the relationship is to be effective and provide value; and
- **accountability agencies** – such as the need to talk to one another and share appropriate information, the need to keep an eye on the developing big picture alongside the detail, and the dangers of inadequate communication and assuming that people are familiar with the details of the agencies' roles and how they work.

There are two other general points that emerge from this inquiry that I highlight here, for everyone in the public sector:

- Legality and accountability must be fundamental to all parts of a public entity's work.
- A public entity cannot contract out all responsibility for what is done in its name.

## **Legality and accountability are fundamental in the public sector**

The underlying issues that are of most concern are the lack of attention that KDC gave to its legal obligations and to its obligation to be able to account to the community for its decisions and actions.

I acknowledge that these issues were at the heart of the concerns raised by ratepayers.

Legislation enacted by Parliament is more than general guidance. Every public entity is exercising the power of the state. The essence of the rule of law is that the power of the state must be exercised in accordance with the law. Compliance with the law is not optional, and near enough is not good enough. There have been too many examples in recent years of public sector entities being too cavalier about matters of legal compliance. All public entities need to pay careful attention to both the spirit and the letter of their legal obligations if they are to retain the trust of the people they serve.

It is also fundamental that public entities should be able to demonstrate what they are doing and why, when that is questioned. Public entities should expect to be tested, whether by members of the public, the media, or the courts.

This is accountability in action, and public entities need to be ready to explain themselves. That has implications for how public entities operate on a daily basis: they need full and proper records of their work that show what decisions were made, who made them, and the basis on which they were made. I was shocked by the state of KDC's records and its loose approach to decision-making.

## **Responsibility cannot be contracted out**

Many public entities contract out parts of their work to other providers. That has always been the case, and it will continue. It is often efficient. However, the responsibility for the work still rests with the public entity. Any public entity that is contracting out work must ensure that it retains enough oversight and control to enable it to give effect to that responsibility. Whether that has been done is usually tested when something has gone wrong and the responsible entity is not ready or able to respond quickly and appropriately. It can be a painful and expensive lesson.

Sophisticated contracting techniques, such as PPPs, enable a careful allocation of risk between the contracting parties. This allocation process creates incentives for efficiency and effectiveness. Public entities need to understand that it does not mean that they are no longer responsible.

## Conclusion

It is important not to lose sight of the practical achievement that sits behind this inquiry: Mangawhai needed a reticulated wastewater scheme, and it now has one that operates well. But that achievement has come at a significant cost. It has exposed significant weaknesses in the way that KDC has been operating. It has also highlighted some challenges for the local government sector more broadly.

It is also important to remember that an audit provides a level of confidence about publicly reported information, but is not a total health check on the finances and performance of an entity. I can't put it any better than this comment to me from a public entity:

*By its nature, there's potential to miss things as you can't audit everything.  
External auditors are indicators. It's still valuable information but [entity]  
processes should provide you with greater assurance.*

Nonetheless, it is clear that some of the audit work has fallen disappointingly short of the standards we and others expect. For this, I apologise unreservedly.

This inquiry has been long and hard for all involved and has taken considerable resource. From my perspective, it will be worth the considerable resource we have invested in it if local and central government use this report as a basis for genuine reflection and debate on how we can do things better. I would like to assure the community that the OAG and Audit New Zealand will be doing this. We have taken to heart the message that we need to do more, throughout all our work, to join the dots.

Finally, I offer my thanks to all those who have been involved in this inquiry – my staff, the consultants who helped us, and the people from KDC, as well as the parties who provided us with information and comment during our work.

My particular thanks go to the Mangawhai community for their patience and willingness to share their information and concerns with my staff.



Lyn Provost  
Controller and Auditor-General

26 November 2013



# Part 1

## Introduction

- 1.1 In this Part, we explain:
- why we began this inquiry;
  - the scope of our work;
  - how we have carried out this inquiry; and
  - other events that took place while this inquiry was under way.

### Why we began this inquiry

- 1.2 Mangawhai is a small harbour on the east coast of Kaipara district, south of Whangarei. It has a small community of permanent residents. However, because it is a popular holiday destination, its population grows significantly during the summer. As the local authority for the area, the Kaipara District Council (KDC)<sup>1</sup> has had to consider wastewater disposal for Mangawhai. Since 1996, the need to construct a community wastewater scheme for Mangawhai has been a significant issue for KDC.
- 1.3 The wastewater scheme has also caused significant concern in the community for many years. Concerns have included KDC's financial management and planning for the scheme, the significant increase in the total cost of the scheme, and the lawfulness of KDC's decision-making processes and the development contributions and rates used to fund the scheme. At various points in the life of the scheme, individuals and groups in the community asked several organisations to investigate different issues.
- 1.4 By the end of 2011, KDC had accepted that there were problems and was carrying out several reviews of the scheme, including legal and financial reviews. KDC decided that a full and independent investigation was needed. In February 2012, it asked the Auditor-General to carry out an inquiry into its decision-making, financial, and contract management processes for the scheme. By this stage, it was apparent that there were probably widespread problems with the project and possibly with KDC's more general financial and management systems.
- 1.5 On 28 February 2012, the Auditor-General announced that we would carry out an inquiry. We released final terms of reference for this inquiry on 16 March 2012, after consulting with KDC, some community representatives, the Minister of Local Government, and the Department of Internal Affairs. Appendix 1 sets out the terms of reference in full.

<sup>1</sup> In this report, we refer to the organisation as a whole as "KDC". We use "the Council" to refer to the formal body made up of elected members.

## Scope of this inquiry

- 1.6 The main purpose of the inquiry has been to examine KDC's development, implementation, and oversight of the Mangawhai community wastewater scheme since the project to construct it began. We have looked at all 16 years of the project's active life – from 1996 to 2012 – including:
- KDC's planning and decision-making;
  - the governance, management, and contracting arrangements;
  - KDC's financial management, monitoring, and reporting;
  - the funding for the scheme; and
  - the overall suitability and cost-effectiveness of the scheme that has been constructed.
- 1.7 However, the problems with this project also raised other questions. Therefore, the terms of reference announced that the inquiry would also consider the roles played by KDC's auditor and other relevant agencies.
- 1.8 The inquiry has not considered questions of legality in any detail. One of the reasons KDC asked us to inquire was that it recognised that it had probably not complied with relevant legislation in setting several rates over the years. It needed to resolve those questions about the basis for its actions itself, without waiting for this inquiry to conclude. In any event, the Auditor-General cannot provide a definitive view on legal questions. Ultimately, these are questions for the courts.
- 1.9 During our work, two other processes began to assess legal questions:
- KDC initiated a Local Bill to address irregularities that occurred in the way in which it had set and assessed rates and as a result of its late adoption of the 2010/11 Annual Report and 2012 Long-Term Plan (LTP).
  - The Mangawhai Ratepayers and Residents Association (MRRA) filed judicial review proceedings in the High Court seeking declarations on the legality of many of KDC's actions during the project.
- 1.10 When we wrote this report, these issues were in the process of coming before the High Court and the House of Representatives for consideration. It would not be appropriate for us to comment on legal questions that these other processes are examining.

## How we carried out the inquiry

- 1.11 Staff in one of the Auditor-General's business units, the Office of the Auditor-General (OAG), carried out the inquiry, with assistance from external advisers as needed. The inquiry was overseen by the Assistant Auditor-General Legal. The

Auditor-General's other business unit, Audit New Zealand, was not involved in the inquiry other than to provide information to enable the inquiry to review its work at KDC in recent years.

### **How we reviewed what Kaipara District Council has done**

- 1.12 To review KDC's work during this project, we brought together a team of our staff with relevant skills and contractors with specialist expertise. The contractors who helped us were Richard Kirby (engineer), John Crawford (engineer), and Rod Titcombe (former local authority chief executive).
- 1.13 This team considered all of KDC's files on the project and on associated decision-making to identify relevant information. A former councillor also gave us all of her papers from her time in office so that we could see what other information had been provided to elected members. We also reviewed the files and information held by Beca Steven (Beca), a division of Beca Carter Hollings & Ferner Limited, which advised KDC throughout the project. Given the length and complexity of the project, this review of documentation was a substantial exercise that took some months.
- 1.14 Early in the process, we had initial meetings with some of the main people involved in the project. Once we had completed most of the document review, we carried out more detailed interviews with people who had been involved, including current and former elected members, KDC staff, and staff from Beca and other companies involved in the project.
- 1.15 Given the depth of community concern, it was also important for us to understand the questions and perspectives of Mangawhai ratepayers. We asked for public submissions when we published the terms of reference and received many responses. Representatives from the inquiry team spoke to a community meeting of about 500 people in Mangawhai in June 2012. We also spent three days in Mangawhai in July, meeting with 93 individuals and groups to hear their individual concerns and perspectives.
- 1.16 Members of the inquiry team also made several visits to KDC's offices, Mangawhai township, the treatment plant, and the disposal site.
- 1.17 All of this work provided us with a great deal of information about the history of the project. We then spent some months analysing this information and preparing a draft report.
- 1.18 In keeping with our standard practice and legal obligations, we provided drafts of sections A, B, and C of this report to those who had been closely involved and who, for natural justice reasons, had a right to see the report before we finalised it. Our

legal obligations meant that this process of seeking comment was carried out in confidence. Therefore, it did not include seeking comment from the MRRA or ratepayers more generally.

- 1.19 The parties who received these draft sections were:
- KDC (the Commissioners and Chief Executive);
  - KDC's previous Chief Executive, who held that role throughout the period we have examined;<sup>2</sup>
  - Beca;
  - representatives from the former company EPS Consultants (International) Pty Ltd (EPS), which worked on the project with Beca;<sup>3</sup> and
  - Water Infrastructure Group (formerly EarthTech).<sup>4</sup>
- 1.20 We asked these parties to comment on whether we had accurately established the facts, to comment on whether our draft analysis, conclusions, and comments were reasonable, and to provide us with any further information they held that supported their comments. We initially allowed the parties one month to comment, but extended this to two months at the request of several of the parties. We regarded this request as reasonable given the length and complexity of the draft sections.
- 1.21 All but one party provided us with substantial comments. Some parties also provided us with information and documents that we had not found.
- 1.22 The representatives of EPS did not provide us with full comments. They advised us that they had significant concerns about the draft sections and that they held further information that was relevant to the inquiry. EPS was an Australian company and its representatives are still based in Australia. We could not compel them to provide this information to us, because our statutory powers do not extend outside New Zealand.
- 1.23 We spent some time negotiating with the EPS representatives about the basis on which we might see the information in their files and receive more detailed comments from them. We offered to travel to Australia to review their files ourselves, to contribute to the costs (including time) involved in retrieving

2 The position title was "General Manager" until December 2000. However, we refer to it as "Chief Executive" throughout this report.

3 EPS Consultants (International) Pty Ltd ceased operations when the project was completed. It was deregistered with the Australian Securities and Investments Commission in 2012. We dealt with two former directors who were closely involved in the work on the wastewater scheme.

4 In July 2008, there were changes in the ownership of EarthTech. Tyco, EarthTech's parent, sold part of that company to AECOM Technology. Tyco retained the part of the former EarthTech company responsible for constructing and operating the wastewater scheme, which became Water Infrastructure Group. To avoid confusion, we refer to this company as "EarthTech", throughout this report, including after it changed its name to Water Infrastructure Group.



information and providing us with comments, and to extend the time frame further. However, the EPS representatives also wanted us to meet the legal costs they had incurred in preparing the initial response, to satisfy themselves that our advisers were “appropriately skilled and unbiased”, and a commitment that we would negotiate and agree with them any changes to the text they would provide. We did not regard these requests as reasonable or appropriate.

- 1.24 By this time, we had spent more than a year on this inquiry. We decided that we could not spend any more time or money trying to gather further information. Instead, we decided to proceed with the information we had been able to gather and to ensure that the report was clear about any gaps in our information.
- 1.25 We carefully considered all of the comments we received and revised the draft sections on this basis. We provided a further draft of the relevant sections to all of the parties, including the EPS representatives, and asked for any further comments and supporting information. All parties provided us with further comments.
- 1.26 We considered the further comments we received and adjusted the report as necessary, before proceeding to finalise the report for printing and publication.

### **How we reviewed the audit work**

- 1.27 The Auditor-General’s different roles can come into conflict if an inquiry has to consider the adequacy of the work another part of the organisation has done. In this inquiry, we needed to consider the audit work that appointed auditors within Audit New Zealand, which is a business unit of the Auditor-General, had carried out. KDC was aware of this conflict when it asked the Auditor-General to inquire.
- 1.28 We engaged an independent person, Mr Neil Cherry,<sup>5</sup> to review the audits of the relevant annual reports and LTPs. Appendix 6 includes the terms of reference for that work. Mr Cherry received logistical support as needed from the inquiry team but worked independently to carry out the review and form judgements, with the support of a peer reviewer. We engaged Des Pearson, a former Auditor-General in Victoria, Australia, to provide peer review support to Mr Cherry. Mr Cherry sought comment from Audit New Zealand and relevant staff on a draft of his report before finalising it and providing it to the OAG. Mr Cherry’s final report is summarised in Section D and included in full as Appendix 6.

<sup>5</sup> Mr Cherry is the current chairman of the New Zealand Auditing and Assurance Standards Board, a board member at the External Reporting Board, and a board member of the Australian Auditing and Assurance Standards Board. He carried out this review in his personal capacity.

### How we reviewed the work of the accountability agencies

- 1.29 We also looked at how the different agencies that people contacted responded to the concerns that those people raised. The relevant agencies were ourselves (the OAG), the Office of the Ombudsman, the Minister of Local Government and the Department of Internal Affairs, the New Zealand Police, and the Serious Fraud Office.
- 1.30 The Deputy Auditor-General led this part of the work. Neither she nor the staff member who assisted her had had any significant involvement in responding to correspondence on Kaipara issues.

### Events while this inquiry was under way

- 1.31 KDC asked us to begin this inquiry because it was becoming apparent that it had some significant problems to deal with. Our task was to look backwards and provide a comprehensive analysis of what had happened to create that situation. KDC still had to continue with its day-to-day responsibilities and find a way to address the problems confronting it. The community also continued to take an active role to ensure that KDC understood the depth of its concerns.
- 1.32 This meant that a great deal happened in Mangawhai and Kaipara while our inquiry was under way, including:
- Several further problems with past and current KDC actions continued to be identified, including matters of legality.
  - Sections of the community withheld payment of their rates. There were a range of reasons for this action, including to protest against KDC seeking payment of rates that it accepted had been set unlawfully.
  - KDC worked to complete its outstanding annual reports, which involved several information and accounting challenges.
  - The Minister of Local Government appointed a review team to assess how KDC was functioning.
  - KDC prepared and consulted on a Statement of Proposal for its next LTP (based on the information it was intending to present in its annual report). This was poorly received by much of the community.
  - KDC adopted a new LTP that started to chart a path for it to work its way back to a better financial position.
  - All of the elected members resigned as soon as the LTP was adopted, and the Minister appointed commissioners to take their place.
  - The Auditor-General appointed a new auditor and audit firm to carry out the audits of KDC once the detailed work on KDC's overdue annual report and LTP had been completed.

- KDC prepared a Local Bill asking Parliament to validate past irregularities in its compliance with the Local Government (Rating) Act 2002 and Local Government Act 2002, to stabilise the financial position of KDC.
- The MRRA filed judicial review proceedings in the High Court seeking declarations that several specified KDC actions were unlawful and asking for relief.

## Structure of this report

- 1.33 The events covered in this report span many years and are complex, intertwined, and detailed. Many people are interested in that detail and want to understand exactly what happened. This report is therefore quite long. However, we have structured it into Sections and Parts to make it easy to navigate and have included summaries at the beginning of each Part. The appendices include a summary time line of events and an explanation of the roles of the main parties discussed in the report.
- 1.34 The report is in five sections:
- **Section A – How the wastewater project began (1996 to 2002):** This Section covers events from 1996, when work on water quality issues began in earnest, until the conclusion of the tender process in September 2002. By that stage, KDC had set up the project, chosen a public private partnership (PPP) approach, appointed Beca as project managers, and run a full tender process to select the preferred bidder to construct the scheme.
  - **Section B – Difficulties getting the wastewater project under way (2003 to 2007):** Between 2003 and 2007, KDC had to deal with a range of problems with, and changes to, the project before it was able to finalise arrangements and start construction. This Section discusses the various major challenges, such as having to change the nature of the partnership approach, working out funding, changing the contractor, finding a disposal site for the effluent after the contract had been finalised, and changing the scope of the project and area to be serviced by the scheme.
  - **Section C – Building and implementing the wastewater scheme (2007 to 2012):** This Section discusses what occurred while construction was taking place, how the scheme was implemented, and how it is now running.
  - **Section D – The role played by external agencies:** The previous Sections focus on KDC and its management of the project. This Section reviews the role other agencies played, including the auditors (Audit New Zealand), the OAG, and the Office of the Ombudsman.

- **Section E – Lessons to be learned:** This final Section brings together our overall conclusions and thoughts on the underlying causes of the problems. We also set out the lessons from this report for all those involved and the sector more generally, and pose some questions about ongoing risks and challenges that warrant further consideration.

1.35 Each Section sets out a summary of what happened and the main facts that we have been able to establish, and includes our comments on those events. Each Section concludes with a Part setting out our overall comments on the matters covered by that Section. We bring all of those individual conclusions together in Section E, to reflect on what can be learnt from these events.

## Part 2

# Did Mangawhai need a wastewater scheme?

2.1 In our discussions with community members, many people asked whether it had really been necessary for Mangawhai to have a reticulated wastewater scheme. Several people suggested that stricter rules on the quality and maintenance of septic tanks would have been able to manage any environmental concerns. Some people suggested that KDC imposed the scheme on the community as part of a “push” for development in the area. Uncertainty about whether the scheme was really needed exacerbated concerns about the cost ratepayers were expected to bear.

2.2 Therefore, we spent some time reviewing the information and events leading to the initial decisions to begin work on a scheme. In this Part, we set out:

- what studies showed about the water quality in the Mangawhai area by 1997;
- how KDC went about considering options for improving water quality;
- water quality results in 2001;
- why septic tanks were not a suitable solution for Mangawhai; and
- our comments on the steps KDC took.

2.3 In summary, we conclude that:

- There was clear evidence that there was poor water quality in the Mangawhai area and that septic tank effluent was the likely cause.
- Septic tanks were not an appropriate way to manage sewage disposal in the Mangawhai area.
- The work KDC carried out in 1998 and 1999 to address the water quality problem was appropriate, and included good public consultation.
- KDC’s conclusion that Mangawhai needed a centralised reticulated wastewater scheme was soundly based and reached through a good process.

### Water quality at Mangawhai by 1997

2.4 Mangawhai is a small harbour on the east coast of the Kaipara district, south of Whangarei. There are two parts to the community: a small village at the southern end of the Mangawhai Harbour and a much larger area of housing at Mangawhai Heads, which is five kilometres north towards the estuary mouth. The two areas are connected by a causeway. The area is a popular holiday destination. Its population can grow significantly during the summer months. In 1999, it was estimated that the permanently resident population was 1290 and that the peak summer population was around 4000.

2.5 As a small and remote community, Mangawhai had no centralised reticulated wastewater scheme. Individual properties used septic tanks, package plants, or

long-drop toilets. KDC proposed communally based wastewater schemes in 1981 and 1988. The community rejected both proposals on the basis that KDC had not adequately demonstrated the need and that costs were too high.

2.6 In 1996, KDC publicly notified its draft District Plan. The Minister of Conservation made a submission asking for more restrictive controls on the use of land because of concerns about the environmental effects of the urban area on the Mangawhai Harbour. KDC accepted only part of the submission, and the Minister appealed to the Environment Court. To settle the appeal, KDC agreed to commission the Mangawhai Planning Study to look at the current and likely future growth of Mangawhai and its infrastructure needs, with a specific emphasis on wastewater requirements.

2.7 This study was carried out in 1997. It identified a potential health risk from using septic tanks in urban areas and highlighted evidence of contamination of the groundwater and the Harbour.

2.8 Around the same time, the Northland Regional Council (NRC) commissioned the Mangawhai Water and Shellfish Quality Study. This study surveyed the surface water quality in the Mangawhai area for levels of faecal coliforms and enterococci.<sup>1</sup> Shellfish were also sampled for enterococci levels. The study showed that, when this work was carried out, there was:

*... ongoing and at times significant faecal contamination of the drains and streams sampled in the Mangawhai Heads and Mangawhai Village areas. This was related to seepage from on-site sewage treatment and disposal system.*

2.9 The study also found that:

*The results of shellfish testing indicate that faecal coliform contamination of streams and drains in the Mangawhai Heads and Mangawhai Village areas is having significant adverse effects on shellfish water quality in Mangawhai Harbour.*

2.10 The NRC study showed that nearly half of the sites had levels of faecal coliform or enterococci concentrations that exceeded the guidelines set by the NRC and the Ministries of Environment and Health.

## Kaipara District Council considers options for improving water quality

2.11 In 1998, KDC commissioned the Mangawhai Infrastructural Assets Study. The aim of this study was to work out what infrastructure would be needed to support continuing growth in Mangawhai, while ensuring that development did not

1 Enterococci are bacteria that are found in the gut and faeces of animals. The NRC's 2001 *Monitoring Results* report notes that "They are used to indicate potential health risks to people using surface waters."

create significant adverse effects for the community, environment, or district. The study was to include options for wastewater treatment and disposal.

- 2.12 Beca was awarded the contract to conduct the study in October 1998. In November 1998, Beca prepared a scoping report setting out how it would carry out the study and outlining expected outcomes. As part of the study, it would prepare an *Issues and Options* report outlining specific infrastructural issues for water supply, wastewater, stormwater, roading, footpaths, and reserves. This report would then form the basis of extensive community discussion and debate.

### ***Issues and Options* report**

- 2.13 The *Issues and Options* report assessed the existing methods for treating and disposing of wastewater (on-site disposal or small treatment facilities). It noted there was “evidence of significant failure of the on-site disposal systems particularly on the poorer soils”.
- 2.14 The report set out three main options:
- a centralised wastewater scheme with a single reticulation network, treatment plant, and discharge location;
  - a decentralised wastewater scheme with a reticulation network and several small treatment plants and disposal sites for different areas within Mangawhai; and
  - improved on-site sewage treatment and disposal, where each property was responsible for treating and disposing of its own wastewater.
- 2.15 Within those three options, the report explained the different possibilities for treating and disposing of wastewater. As well as improved on-site sewage treatment and disposal, the report discussed collecting sewage to one location followed by treatment:
- in oxidation ponds or aerated lagoons, and disposal of the treated effluent to land;
  - in a treatment plant, ultraviolet (UV) disinfection, and discharge at the Mangawhai Harbour entrance; or
  - in oxidation ponds, then discharge to wetlands for further treatment, UV disinfection, and discharge at the Harbour entrance.
- 2.16 The report assessed the costs, environmental effects, and the potential effects on average lot size of each of the options and disposal possibilities.
- 2.17 The report was presented to the community through a series of workshops and a public meeting on 23 January 1999. About 170 people attended this meeting. A newsletter was also sent to all ratepayers that briefly summarised the issues and

options, and sought feedback. Included with the newsletter was a demographic questionnaire. Beca received 309 responses to the newsletter and 324 responses to the questionnaire.

- 2.18 The NRC also provided comments on the report. It advised that, given the problems with water quality, the status quo was not considered desirable. The NRC also indicated that it did not support discharge of treated effluent to the Harbour entrance and preferred sustainable discharge to land.

### *Preferred Options report*

- 2.19 In April 1999, Beca prepared the *Preferred Options* report for a further round of consultation. It also conducted another public meeting in May 1999. The report noted that the community had identified that the current treatment of wastewater by on-site disposal was inadequate and that action was needed. Feedback also revealed strong opposition to disposing of wastewater to water and a preference for land-based disposal:

*Consultation and feedback to Newsletter #3 revealed that disposal of sewage to water is unacceptable to the community of Mangawhai. Feedback also indicated that Iwi find the disposal of sewage to water culturally offensive. In addition, the Regional council voiced a strong preference for land based disposal of sewage effluent. It is noted that the Proposed Regional Policy Statement and Proposed Coastal Plan both provide a clear policy approach away from disposal to any coastal water body. Accordingly as most parties and the relevant consent authority oppose disposal to water and as there is no apparent reason why land based disposal of treated effluent is not feasible, with several potential disposal sites having been identified, sewage disposal to water has thus not been considered further.*

- 2.20 The report evaluated the three options in the *Issues and Options* report in light of technical investigations and the consultation feedback. It set out the environmental, economic, and community costs and benefits associated with each of the options. It identified the conventional wastewater treatment system (which was stated as involving collecting wastewater through a reticulated network, transferring it to a wastewater treatment plant, then treating it in oxidation ponds and disposing of the treated effluent to land) as the preferred option for the following reasons:

1. *Provides the greatest degree of environmental protection*
2. *Provides the greatest degree of reliability*
3. *Provides the longest term sustainable sewage management*
4. *Easiest and most convenient to operate*



5. *Most affordable option for property owners on a community basis*

6. *Potentially the cheapest option.*

- 2.21 Although the report included information about the likely capital cost for the preferred option, we note that it provided two different figures for that cost. On page 99, a table on the summary costs and charges showed that the estimated capital cost would be \$10.84 million. However, on page 46, the report stated that the capital cost of the preferred scheme would likely be about \$7.7 million. The annual operating and maintenance costs of the then-estimated current flows were estimated to be \$61,000. This was made up of treatment costs of \$32,000 and reticulation costs of \$29,000.
- 2.22 The report recommended equitably distributing the cost of a new scheme between existing and future residents. Beca sent out a newsletter in May 1999 seeking feedback from the community on what it regarded as an equitable split. Beca received around 150 responses to the newsletter.
- 2.23 Beca then prepared a summary of the feedback, noting that:
- While the majority of respondents supported a centralised wastewater treatment system, a number of submissions raised concerns about the affordability of this development and it is clear that careful costing and implementation of infrastructural development will be required.*

### The summary report

- 2.24 In August 1999, Beca prepared a draft summary report setting out the preferred options for the various types of infrastructural assets (including for treating wastewater) and outlining implementation plans for their development. The option Beca recommended for treating wastewater was a conventional drainage system to one wastewater treatment plant. Beca proposed to treat wastewater in oxidation ponds, followed by possible disinfection by either UV or chlorination, and then disposal to land. The report states that “It is assumed that the disposal site is arable, well-drained productive farm land some 1km or more distant from the coastline.” This report confirmed that the estimated capital cost would be \$10.8 million.
- 2.25 The Council considered a report from the Regulatory Support Officer about the draft summary report at its August meeting. The Council resolved to consider the draft report at a Council workshop and agreed to make copies of the summary available for the public to comment on.
- 2.26 A public meeting was held on 25 September 1999, where the final report was presented and the next steps discussed.

- 2.27 Beca was asked in October 1999 to prepare a strategic plan for implementing the infrastructure identified in the report, including options for funding, for the Council to consider.

### Northland Regional Council confirms water quality problems in 2001

- 2.28 The NRC carried out some further studies on water quality that were reported in 2001. In those reports, the NRC concluded that:

*Overall historical data from streams and drains flowing into the Mangawhai Harbour shows significant microbiological contamination. The majority of samples show levels of contamination well in exceedance of recommended guidelines by both the Northland Regional Council and the Ministries of Environment and Health. This contamination can be related to seepage from on-site sewage treatment and disposal systems.*

- 2.29 A February 2001 report on water quality monitoring found that the:

*Median concentrations of faecal coliforms and enterococci recorded in water samples from most sites within the Harbour are relatively high. This indicates that faecal contamination of streams in the Mangawhai area is widespread rather than being confined to a few “hot spots”. As these areas are largely unsewered and residential, the likely cause is to be seepage from on-site sewage treatment systems.*

- 2.30 Shellfish testing also indicated that contamination of the streams and drains in the Mangawhai area was having significant adverse effects on shellfish quality in the Harbour. The report also noted that more recent monitoring of the state of the environment had shown that several sites within the Harbour were unsuitable for swimming.

### The need to replace septic tanks

- 2.31 We asked one of our engineers to help us review the use of septic tanks, package plants, and long-drop toilets for disposing of sewage in Mangawhai.

### What makes a good septic tank system?

- 2.32 Septic tank systems generally consist of a tank and a disposal field that allows the effluent to soak into the ground. Package plants also require disposal fields, although the wastewater is treated to a higher standard before disposal.
- 2.33 Septic tanks provide a collection point for solid matter but do not treat raw sewage enough for it to be discharged into the environment. Effluent is disposed

of from the septic tank through pipes into an area of ground known as an “absorption field”. If an absorption field is not working effectively, the effluent will not be absorbed to land appropriately and might come through to the surface of the land or into surface waterways. This exposes the community to the risk of direct contact with the effluent and its pathogens.

- 2.34 The success of a septic tank system also relies on the owner regularly de-sludging their septic tank. This ensures that the build-up of solid matter does not result in overflow into the effluent absorption fields. This would block the absorption field, creating a risk of effluent ponding on the surface, running-off to neighbouring properties, and contaminating the groundwater system.
- 2.35 In addition to regular de-sludging, an effective septic system depends on several different factors, including:
- soil of medium permeability;
  - rainfall of less than 900mm annually;
  - lot sizes greater than 4000m<sup>2</sup>;
  - individual properties having enough unpaved area for adequate absorption drains to be installed;
  - terrain not being excessively steep; and
  - avoiding areas with a high water table or a lot of rock.
- 2.36 The absence of any one of the above factors can cause the absorption fields to fail. The absence of multiple factors increases the likelihood of failure. The most significant factor leading to failure is that an individual lot size is too small.

### Septic tanks in Mangawhai

- 2.37 Most lots in Mangawhai and Mangawhai Heads are around 1000m<sup>2</sup>. Septic tanks do not perform well on lots of this size, because each site is too small for an adequately sized absorption field. The density of development in Mangawhai exacerbates this problem. The cumulative effect of minor inadequacies in multiple neighbouring properties results in contaminated effluent being discharged to surface water and groundwater.
- 2.38 There are a variety of other problems with on-site disposal systems at Mangawhai Heads:
- Some properties have steeply sloping terrain, so effluent drains through the soil into neighbouring properties.
  - Some properties are in areas with a high water table, which leads to effluent entering the groundwater system directly.

- Sandy soils throughout much of the town enable effluent to leach directly into the groundwater system without pathogens dying off.
- Many properties do not have enough unpaved area to allow enough length of drain to be installed to enable effluent to percolate into the soil without water-logging.

- 2.39 Within Mangawhai Village, there is a high water table, the soil has shallow cemented sand layers, and the lot sizes are small. These factors all compromise the capability of the soils to absorb and contain septic effluent.
- 2.40 Our engineer concluded that absorption fields will not be effective or reliable for disposing of effluent in Mangawhai, because many properties have factors that will limit effective absorption. The area's limited ability to retain effluent on site is exacerbated during the summer holiday season, when the population is at its peak. He agreed with the conclusions of the previous assessments of wastewater issues in Mangawhai that the previous systems, largely comprising septic tanks, were not sustainable. He also agreed that the indications were that these systems were having a detrimental effect on the water table and posed risks to people.

### Our comments

- 2.41 In our view, there was reliable scientific evidence that there was poor water quality in the Mangawhai area and that the likely cause of that poor water quality was the sewage disposal methods used in the Mangawhai area at the time. It is also clear that, because of a variety of factors, such as soil type and lot size, on-site sewage disposal methods were unlikely to work effectively and were likely to result in adverse environmental effects.
- 2.42 KDC appropriately recognised that it needed to deal with this issue and carried out a study to determine how best to do so. It considered a range of options and consulted on those options with the community. As a result of this process, KDC decided it needed a centralised reticulated wastewater scheme. In our view, KDC's decision was soundly based and reached through a robust process.
- 2.43 The community and the NRC told KDC they did not support discharging the treated effluent to water, and KDC accepted this. This early decision to limit the disposal options to land-based solutions was reasonable at the time but had a significant effect on the way the scheme developed and on its costs.

## Part 3

# How Kaipara District Council set up the wastewater project

- 3.1 Having decided that Mangawhai needed a reticulated wastewater scheme, KDC then had to consider the type of contracting approach it would use, how it would manage the project, and how it would fund it. These early decisions shaped the rest of the project, and so we wanted to understand how and why they had been made.
- 3.2 In this Part, we discuss:
- the initial advice KDC received on how to deliver the wastewater scheme and its funding constraints;
  - initial KDC decisions to select a project manager through a tender process and to set up project governance arrangements;
  - how KDC decided to proceed with a PPP approach; and
  - our comments on this stage of work.
- 3.3 In summary, we conclude that:
- KDC's decisions to contract an expert project manager and to do so by tender were reasonable. Beca preparing the tender documents and then submitting a tender created the risk of a conflict of interest. Beca told us that it took steps to manage this risk.
  - KDC did not fully explore all its available options for funding the wastewater scheme. It concentrated on ways of borrowing and PPP arrangements involving private sector financing rather than considering whether it could also increase its revenue to pay for the scheme. As a result, KDC's high-level analysis of the methods available to deliver the project was flawed.
  - KDC was unduly influenced by financial considerations and did not fully evaluate its options for the delivery of the project, and their risks and benefits, when it decided to proceed with a PPP approach.
  - KDC's record-keeping in support of the project and its decision-making processes were poor.
  - Important decisions appear to have been taken informally.
  - KDC does not appear to have fully appreciated the responsibilities it was taking on as the ultimate purchaser of the advisory services and the scheme. The scope of services the project managers would provide under the contract was limited, and KDC needed to ensure that it had enough overview of the project to understand its broader risks and need for additional advice. Instead, it seems to have proceeded on the basis that the project managers would deal with every aspect of the project.
  - KDC failed to identify how it was going to manage the project. No group or individual within KDC was responsible for the project. By default, this later became the role of the Chief Executive personally.

## Initial advice about how to deliver the wastewater scheme

### Advice about levels of debt

- 3.4 Since 1996, the Local Government Act 1974 had required councils to comply with a set of financial management principles, including the principle of maintaining debt at a prudent level. Each council was required to have a borrowing management policy that included any specific borrowing limits set by the council. KDC set out its borrowing management policy in its Treasury Management Policy. It set a limit on borrowing using an income-to-debt ratio of 2.5:1. That is, for every \$1 of debt, KDC needed to have \$2.50 in income.
- 3.5 In June 1999, KDC commissioned a financial consultant, Mr Larry Mitchell, to review its ability to borrow. Mr Mitchell identified that, at that time, KDC's operating expenditure was nearly equal to its income. In 1997 and 1998, KDC had cash flow deficits because it had bought assets. In 1997, the income-to-debt ratio had been 5.5:1, but this changed in 1998 to 3.8:1 and was forecast to be 2.9:1 in 1999. Mr Mitchell also noted that KDC's income-to-debt ratio was forecast to be below its borrowing limit in 2000, unless KDC's income increased.
- 3.6 Mr Mitchell noted that KDC's income and wealth were low compared to other councils. He advised that the fragile nature of the local economy constrained KDC's ability to have higher levels of debt.
- 3.7 Mr Mitchell's report concluded that, based on an annual income of \$16 million, KDC would be able to borrow up to \$5.95 million if it was to stay within its income-to-debt ratio. He noted that KDC's tentative projections at that stage were that it needed \$10 million of debt to contribute to the capital development plans of over \$30 million. His view was that, if KDC wanted to increase its debt levels to \$10 million and stay within the income-to-debt ratio, it would need to increase its income to \$25 million. He noted that:

*The strategies that might achieve higher revenues are beyond the scope of this study. They include all forms of additional revenue from charges and rates. Realisation of investments and reserves would reduce the borrowing necessary. Reductions in working capital would assist. By far the most promising option though, one which does not require such large increases in revenue, is to finance development from development contributions or some other form of third party financing. Based on the calculations of the income to debt ratio, all options will need to be explored with no stone left unturned. Preliminary projections for the next [long-term financial plan] indicate that it will only work if all means of boosting income, including third party financing are implemented.*

3.8 He advised KDC that:

*Given the very significant costs of proposed works and with the realisation that the upper limits of borrowing will likely be tested, alternative funding sources must be fully explored. These alternatives include the more radical forms of third party joint venturing, varying ownerships or proportions of ownership options, franchising, BOOT schemes and other “off balance sheet” strategies.*

3.9 He also noted that:

*It is extremely unlikely even at first glance given the sums involved that Council debt alone will be sufficient to finance the high level of proposed expenditure. Consideration of a combination of a number of sources of funds and consideration of rating increases may be necessary.*

3.10 Mr Mitchell advised that:

*In short the District’s ability to pay is low but the future demands will be high. Taken as a whole the circumstances of the Kaipara District will require financial decision-making which is both cautious and conservative. Prudent debt levels will translate into a balance being set to achieve development but at a rate and of a size that the District can sustain. Even at first glance there appears to be little room for manoeuvre.*

3.11 KDC’s Management Accountant, after reviewing Mr Mitchell’s paper, recommended to the Chief Executive that the concept of third parties and developers funding Mangawhai’s capital development needed to be explored. In his view, “Council’s funding of the entire \$15 million is quite simply unaffordable.” He also reiterated the report’s conclusion that “borrowing will need to be undertaken in a cautious and conservative fashion and should not attempt to test the upper limits”.

### Funding

3.12 Several months after KDC received the report from Mr Mitchell, KDC staff met with Beca in October 1999 to discuss how KDC could construct the infrastructure identified in the Mangawhai Infrastructural Assets Study. The minutes of that meeting record that the Chief Executive advised that:

*Council’s major issue is that the Local Government Act 1974 does not permit the debt levels needed to fund the provision of the infrastructure. Options include BOOT (Build, Own, Operate, Transfer), DBO (Design, Build, Operate), DB (Design, Build, with Council operating), amalgamate with another Council.*

3.13 KDC staff asked Beca to prepare a strategic plan for implementing the infrastructure, including options for funding, for the Council to consider at its

meeting in December 1999. The contract with Beca noted that the funding options identified for the wastewater and water supply systems were:

- funding by KDC;
- PPP with KDC acting as the community's agent; or
- PPP with no direct ongoing KDC involvement.

- 3.14 The Strategic Implementation Plan (the Plan) was actually presented to councillors in April 2000. The Plan Beca provided stated:

*The two major financial issues affecting project delivery are the level of debt funding KDC can provide for the project and the burden overall project funding will place upon existing ratepayers. ... KDC may be able to raise up to \$1.5 million as capital and some further funding may be available through the Harbour Board endowment fund. However this will fall well short of the \$10.9 million dollars (capital expenditure) required for the wastewater reticulation and treatment project.*

- 3.15 Under the heading "Strategic Drivers", the Plan also stated:

*KDC operates within its Treasury Management Policy that sets limits on debt in relation to income. The application of that policy means KDC cannot fund capital expenditure sufficiently for delivery of infrastructure development in Mangawhai under a traditional design-documentation-bid-construct project delivery system.*

### Project delivery methods

- 3.16 The Plan outlined several methods for delivering the project, including the traditional design/construct approach and different types of PPPs. The Plan did not recommend that the Council adopt a particular type of method. Instead, it recommended that more work be carried out to refine the project delivery method. The Plan later stated that:

*The assistance of private sector investment is required for the provision of this infrastructure due to the demands that this level of expenditure places on Council.*

- 3.17 The Plan noted that the strategy proposed:

*... is designed to arrive at the best combination of private sector and public (KDC) participation/risk transfer in the project to achieve the best result for KDC and the Mangawhai community, within governance constraints set by KDC and any legal/regulatory requirements.*

- 3.18 Beca proposed to test that this was the case by comparing it against KDC delivering the project through traditional procurement methods.



- 3.19 Beca advised that the costs for delivering the project using traditional methods (that is, a design/construct approach) were usually in the range of 10% to 20% of the capital expenditure on the project. For this project, that cost would represent around \$1.5 million to \$2.0 million. However, costs using a PPP could be lower. Beca noted that the project delivery costs for previous projects using a PPP had been about 3% to 10% of the capital expenditure on the project. Beca stated that KDC's costs for the project would be expected to be between \$500,000 and \$800,000. Beca also advised that, by using a PPP, cost over-runs could be substantially reduced or eliminated while total project costs (that is, whole-of-life capital and operating costs) could be reduced by up to 20%.

### Other issues

- 3.20 In the Plan, Beca also provided advice about how the project could be managed, an indicative project process if the private sector were to be involved, and a suggested time line.
- 3.21 Beca noted that, if the scheme involved discharging effluent to the coastal marine area, the Minister of Conservation would need to approve it. However, land-based disposal would require only resource consent from the NRC. Beca noted that:
- In the circumstances the strategy should deliberately exclude discharge to sea as a practical option. As with the reticulation and treatment, the strategy should be for the private operator to be responsible for investigation of the site and method options and for seeking consents on behalf of the Council, with the Council undertaking to acquire if need be whatever land is required.*

### The Council's decisions on next steps

- 3.22 Beca presented the Plan to a Council workshop on 26 April 2000. At its next formal meeting on 24 May 2000, the Council made several decisions, including to:
- tender the project management of the implementation of the Mangawhai Infrastructural Assets Study;
  - appoint members to a project steering team; and
  - establish a Community Advisory Group.
- 3.23 Although there was no explicit decision to this effect, the Council implicitly accepted the advice in the Plan to explore PPP options. This was in line with the earlier advice of Mr Mitchell and the views of KDC officers.

### Tender process to appoint a project manager

- 3.24 After the May meeting, KDC staff asked Beca to prepare the tender documents for the project manager role.

- 3.25 The request for proposal (RFP) for this role was advertised in July 2000. It stated that KDC was “seeking experienced Project Managers who have proven experience in delivering infrastructure projects within a rural community using private sector investment, whilst addressing the strategic drivers”. The proposed scope of work was from developing the project scope at the start of the project up to the awarding of the contract to a preferred bidder.
- 3.26 The RFP explained that the exact type of PPP had not been determined. The project manager would be required to analyse potential PPP delivery methods and provide advice to KDC on the most appropriate method for delivering the project. The RFP also noted that “Private sector involvement in the financing and operation of the project are considered essential for the overall success of the project.”
- 3.27 The RFP required each tenderer to submit its tender in two envelopes. The first envelope would contain the proposal and the second envelope the commercial terms and cost. The RFP set out that the second envelope would be opened only after the preferred tenderer had been selected. Negotiations would then begin, based on the terms contained in that envelope. If negotiations were unsatisfactory, KDC could then move to the second-ranked tenderer.
- 3.28 Tenders closed on 7 August 2000. Six bids were received, including a bid from a consortium led by Beca. KDC could not find any documents in its files about how it evaluated the tenders, so we have been unable to check whether KDC used the evaluation process set out in the RFP or assess how well the process was carried out.
- 3.29 Beca told us that, although it provided the draft RFP to KDC, KDC officers managed the procurement process, including evaluating the tenders and selecting the successful tender. Beca told us that it had no dealings with KDC until it was notified that its tender was successful. Beca told us that it was aware of the potential for a conflict of interest and that it took steps to ensure that it had no dealings with KDC during the tender process.
- 3.30 On 15 August 2000, KDC’s Assets Leader and Regulatory Support Officer advised the Chief Executive that the tenders had been evaluated and that Beca had been selected because:
- ... the company has been involved with the study from the beginning, they know Council and the area well, they have extensive experience with similar projects in New Zealand and overseas, and they have the staff with the ability to undertake the management of the project.*

- 3.31 KDC's former Chief Executive told us that:
- The Council found that there was little expertise in the delivery of PPPs and BOOTs in New Zealand. However, there was a great deal of expertise in Victoria, Australia where there was a significant history of the delivery of water and wastewater schemes using the BOOT model.*
- 3.32 At its 27 September 2000 meeting, the Council considered and adopted KDC officers' recommendation to appoint Beca as the project manager. The cost of the project management services was \$617,000.
- 3.33 Beca proposed that a consortium carry out the work. The consortium included three Australian-based organisations: EPS, Blake Dawson and Waldron (lawyers), and an Australian-based branch of PricewaterhouseCoopers (PwC (Australia)) (financial advisers). Their roles were as follows:
- Beca was to supply the project director and technical manager, as well as services including project verification, consenting and communications, and technical evaluation.
  - EPS was to take the lead role in the commercial management, documentation, and contract negotiation phases of the project, and have the role of "commercial adviser".
  - Blake Dawson and Waldron were to provide legal advice with support from Bell Gully in Auckland.
  - PwC (Australia) (apparently with assistance from a New Zealand-based partner of the firm) was to provide financial advice – in particular, detailed financial modelling, taxation and corporate finance advice, and "an overview of risk management and commercial perspectives".
- 3.34 Beca and KDC signed the project management contract on 2 November 2000. As we discuss later in the report, the contract was extended several times to include other work.
- 3.35 Beca told us that, although the contract was between Beca and KDC, all of the members of the consortium provided advice directly to KDC rather than through Beca. It told us that, in terms of the work actually carried out for the project:
- Beca was responsible for providing technical advice, including the engineering description of the benchmark, chairing and facilitating Community Liaison Group meetings, chairing and recording minutes of the Project Steering Committee meetings, technical review of the engineering design of the bids received, technical auditing during construction, providing supporting information for subsidy applications, and providing a person on secondment to act as KDC's community liaison officer.

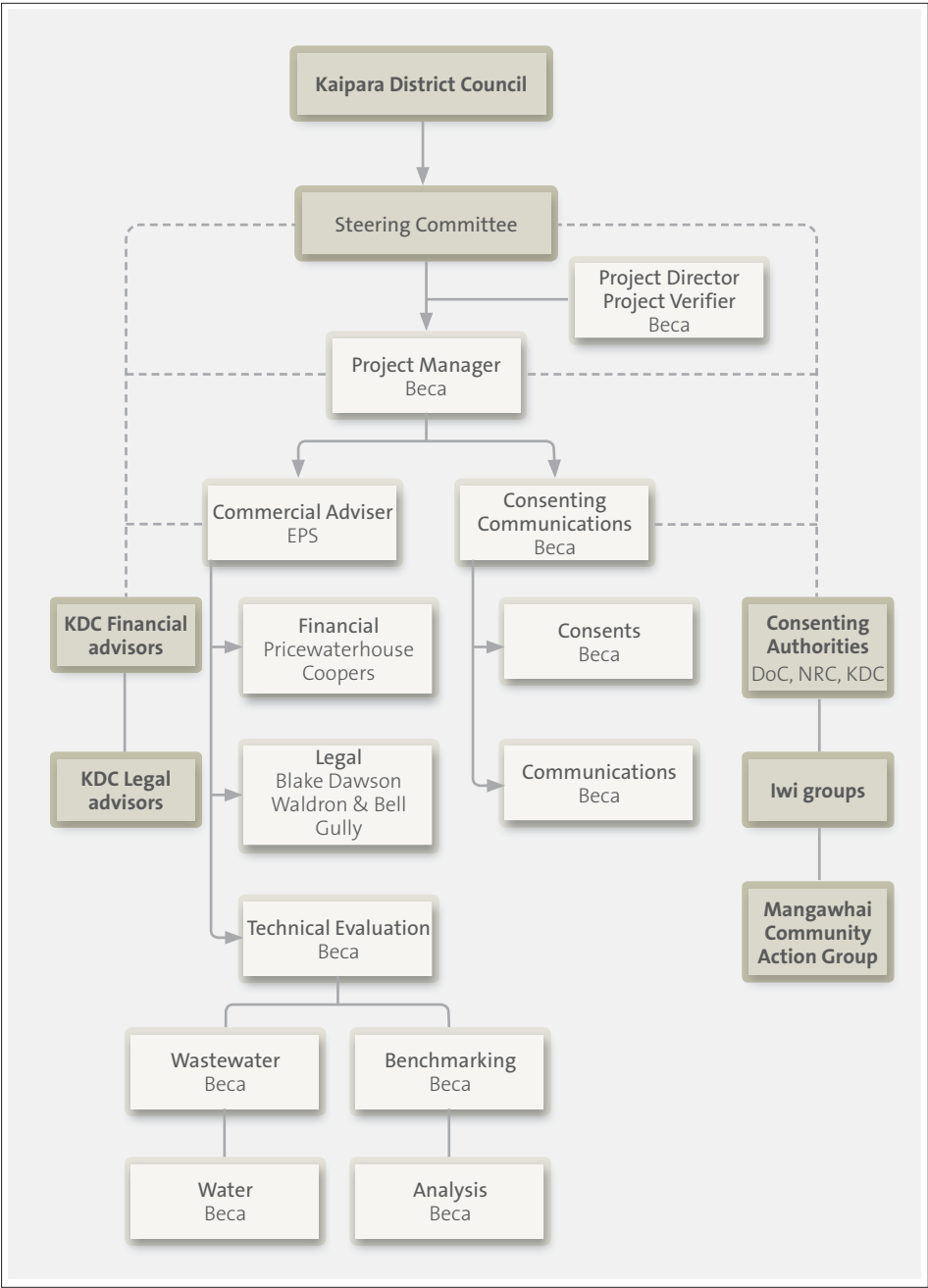
- EPS provided advice about project delivery models (including risk profiles for the different models), provided advice about the “commercial conditions of contract”, managed the procurement process, carried out commercial evaluation of the bids received, negotiated the final contract, and administered the delivery contract by carrying out the Project Director role under the Project Deed.
- Bell Gully provided legal advice about the contractual documentation. We note that the work Bell Gully provided included advice about other issues that were outside the scope of the project management contract.
- PwC (Australia) provided financial modelling.<sup>2</sup>

3.36 Beca told us that, of the total fees it received for the project, 55% were paid to EPS, 9% to Bell Gully, and 1% to PwC (Australia). Beca retained 35%.

3.37 Beca’s proposal also included a proposed project management structure for the project, shown in Figure 1. Under this proposed structure, KDC would have its own legal and financial advisers separate to those the consortium provided. There is no record that the Council discussed the fact that it would need to obtain this advice at the Council’s meeting on 27 September 2000 or at any other meetings in the early stages of the project.

<sup>2</sup> PricewaterhouseCoopers in New Zealand told us that it provided advice about only one technical issue. We saw that advice.

**Figure 1**  
The proposed project management structure included in Beca’s proposal for Project Manager



Source: Beca proposal for Project Manager, Envelope 1, page 10, August 2000.

### Project steering team

- 3.38 The Council agreed at its meeting on 24 May 2000 to establish a project steering team to oversee the implementation of the Plan. At that meeting, the Council decided that the members were to be the project manager (to be appointed), the Deputy Mayor, an individual councillor, the Assets Leader, and both the Mayor and Chief Executive ex officio.
- 3.39 We could find no formally agreed terms of reference, reporting lines, or delegated decision-making authority for this team. The KDC officer's paper to the 24 May 2000 meeting, which recommended the appointment of members, noted that:
- The Project Steering Team will drive the project and will be responsible for continued public consultation. The Project Steering Team will also keep Council involved. Monthly meetings of the Team will be scheduled to ensure timely reporting to Council.*
- 3.40 The team later changed its name to the Project Steering Committee (PSC). Beca told us that it understood that the KDC officer's paper served as the terms of reference for the PSC while it operated. It continued to operate until May 2003. KDC's files did not contain any information to explain why it stopped at that point.
- 3.41 Beca told us that, initially, the PSC would discuss issues, and then the full Council would make decisions about those issues. After the PSC stopped operating, the usual decision-making process involved EPS preparing a draft presentation, which would be provided to the Chief Executive to review and approve. The presentation would then be made to the Council at a morning workshop, with the acceptance of the draft report and any recommendations later ratified at a Council meeting in the afternoon.
- 3.42 Beca told us that, in its experience, the process of working through a council subcommittee with the full council making major decisions is normal practice. It considered that the additional process of discussing and debating matters at a Council workshop before the formal meeting should have allowed highly informed decision-making by the Council.

### Community Advisory Group

- 3.43 At its May 2000 meeting, the Council also resolved to call for expressions of interest for people to become members of the Community Advisory Group. At that point, the role of that Group was unclear. However, it appears that its purpose was to keep the community informed and to ensure that information flowed between the community and the PSC. The advisory group, later called the Community Liaison Group, was to include three to five members.

- 3.44 The PSC appointed the members of the Community Liaison Group. It met from December 2000 until May 2003. Initially, the co-ordinator of the Group was a Beca employee and member of the project team. The other members of the group initially included an iwi representative, four members of the community, and a KDC officer. A ratepayer who was not a resident in Mangawhai, but who owned property there, was appointed shortly afterwards to enable Auckland-based ratepayers to have a contact person.
- 3.45 In the early stages of the project, during 2001 and 2002, there was regular reporting on the project to the Council. Beca provided monthly reports to the Council, and the Council was also provided with copies of minutes of meetings of the PSC and Community Liaison Group. This practice did not continue for the whole period these groups operated.

## The Council's decision to use a public private partnership

### What is a public private partnership?

- 3.46 There is no universally accepted definition of what a PPP is, and the term is used differently in different countries. There are also a variety of PPP structures, which result in different legal relationships and obligations between the private sector partner and public sector partner. In our 2006 report, *Achieving public sector outcomes with private sector partners*, we defined PPPs as:
- A term used in other countries to describe a partnering arrangement where the parties work together for mutual benefit, usually involving private financing... In Australia, the term mainly applies to projects where the private sector partner (usually consortium) makes a financial investment to create or improve an asset, and is responsible for designing, building, maintaining, and operating a facility. The private sector partner receives payments directly from the public sector partner for services provided, and/or income through charges to users.*
- 3.47 The particular type of PPP the Council was interested in is known as a BOOT scheme (standing for Build, Own, Operate, and Transfer). A paper prepared by the New Zealand Institute of Economic Research for Local Government New Zealand in July 1999, *Public vs private ownership of utility infrastructure*, defines a BOOT scheme as involving the public agency:
- ...specifying service requirements and pricing structures over a long period, and invited tenders for private operators to submit bids to:*
- *Design, construct and finance the asset (**build**)*
  - *Retain **ownership** of the asset over the designated period*

- **Operate** the asset to provide the service over the designated period, meeting the service standards and working within the indicated pricing structure
- At the end of the designated period, **transfer** the asset to the public authority at zero or an agreed price.

3.48 Under a BOOT scheme, the private sector partner designs and builds the infrastructure at its own expense. It then owns and operates the infrastructure for some years and charges for its services. The profit it gets from this income covers its construction costs. The result is that the public entity does not need to pay for the infrastructure when it is built. Instead, it simply pays for the services provided by the private sector operator. At the end of the contract period, the infrastructure asset is transferred to the public entity at either no cost or an agreed price. For a public entity with a small income and limited ability to borrow large amounts, this can appear to be an attractive option.

### Why the Council was interested in a public private partnership

- 3.49 We discussed why the Council chose to use a PPP with KDC's former Chief Executive. He told us that the Mayor and several councillors were very keen to use a PPP. The main reason was financial: "It was a way of keeping the debt off the balance sheet." A PPP provided a way for KDC to get the asset built without having to borrow a large amount of money to pay for the construction. With a PPP, the private sector partner also had more room to innovate and carried more of the short-term risks.
- 3.50 KDC's former Chief Executive also told us that "faced with significant costs for the project Council realised it was not able to fund the project under its current borrowing policies and needed to find a way to deliver the project under Council control but funded off balance sheet". He also noted that the Council was looking to minimise the risk of problems during the commissioning stage of the plant and "looking for innovation from the market".
- 3.51 The Mayor from that period told us that PPPs were very topical at that time, and there was a benefit for councils in being able to transfer risk to the private sector. The decision to use a BOOT arrangement was largely due to "balance sheet health", which was an issue at the time.
- 3.52 A review of KDC's files and minutes of meetings showed that the Council considered that the BOOT option was likely to provide long-term cost savings to ratepayers while providing scope for potential bidders to come up with innovative approaches. In line with seeking an innovative approach, the Council agreed, at a workshop facilitated by EPS in February 2001 to discuss risk management for the project, that reuse options and sites would be left flexible to encourage the



bidders to identify sites compatible with reuse opportunities. The Council also agreed to try for a 25-year project to provide further scope for innovation. The aim was to maintain a flexible approach to encourage innovative approaches that might exceed the current standards and provide long-term solutions.

### How the Council decided to use a public private partnership

- 3.53 Although the Council asked Beca to provide information about the different options for delivering the project, we and KDC could not find any such information in its files. There was nothing in KDC's files to show that the Council assessed the variety of PPPs that were available, and understood the risks and benefits of each, before deciding to use a BOOT.
- 3.54 Nor was there any record of a formal Council decision to use a PPP approach to implement the wastewater scheme. However, the minutes of the second Community Liaison Group meeting on 1 February 2001 record the Chief Executive advising that a PPP had been adopted.
- 3.55 Beca told us that EPS facilitated a workshop with the Council in February 2001 to determine the "Council's preferred risk profile for private sector participation". At that meeting, the Council decided that it did not want to carry:
- the design risk;
  - the operational risk;
  - the consenting risk (but it recognised that this could be difficult to transfer); and
  - the funding risk.
- 3.56 Beca told us that this risk profile indicated that a BOOT type of delivery method was appropriate, with KDC retaining the responsibility of dealing with ratepayers. KDC would also be required to retain the risk of recovering enough funding to pay the annual tolls to the private sector operator during the contract.
- 3.57 The notes from that workshop record that its objectives included developing "an understanding of required KDC Management structure for BOOT project (Long Term)". More specifically, the workshop was to determine the allocation of risks between KDC and the private sector partner for the project, the scope of the project to be included in the project brief, and other documents to be put to the market for expressions of interest. By this time, the project was being called the Mangawhai EcoCare project.

- 3.58 The Statement of Proposal KDC issued in 2003 records that the outcome of the workshop in February 2001 was the preliminary adoption of a BOOT project delivery option.
- 3.59 However, there was no formal Council resolution to use a BOOT delivery model or the reasons for that decision. Nor were any papers presented to the Council at a Council meeting that discussed the different project models that could be used for the project.

## Our comments

### Appointing the project manager

- 3.60 The decision to contract in an expert project manager was reasonable, as was running a tender process to decide who to appoint to the role. However, we regard several aspects of what was done as poor.
- 3.61 We question the fact that Beca had provided detailed strategic advice to KDC, was engaged to prepare the draft tender documents, and then went on to submit its own tender. Beca told us that this is quite common practice. In our view, it creates a risk that one tenderer will have an advantage over any other bidders from its earlier work on understanding and documenting what the purchaser is seeking. We appreciate that, in some situations, there is no practical alternative. However, in those cases, we expect to see specific steps taken to manage the risk that the process would be regarded as skewed. Although Beca told us that it took steps to manage this risk, we saw no information in KDC's files to suggest that KDC properly identified and managed this risk.
- 3.62 This problem is compounded by KDC's poor record-keeping. We found no records of the evaluation process, which could have demonstrated that the process was carried out fairly and thoroughly, and that Beca won the tender on its merits.

### What to consider before using a public private partnership

- 3.63 In 2001, there was little New Zealand experience with PPPs and no local guidance on them. However, PPPs were being used in Australia. The Victorian state government established Partnerships Victoria to provide support and guidance on using PPPs to government agencies. Partnerships Victoria published various pieces of guidance on technical issues between 2000 and 2005. It published guidelines on risk allocation and contractual issues (2001) and how to prepare a public sector comparator (2001 and supplementary material in 2003).<sup>8</sup> It published more general policy material in 2003.

- 3.64 We understand that EPS was familiar with the Partnerships Victoria approach. EPS was involved in Beca's consortium because of its experience with PPPs. We have used this early guidance material from Partnerships Victoria to inform our assessment of what KDC did.
- 3.65 An overview of the Partnerships Victoria model published in June 2001 identified three core questions for deciding the most appropriate form of delivering a particular public infrastructure service:
- The core services question – that is, whether government should deliver the services.
  - The public interest question – that is, whether the project will meet the public interest criteria set in the policy. These criteria include “effectiveness, accountability and transparency, equity, public access, consumer rights, security, privacy, rights of representation and appeal at the planning stages by affected individuals and communities”.
  - The value for money question – that is, whether the private sector will deliver value for money and how that value can be optimised. This step involves comparing the bids against a public sector comparator (which we discuss further in paragraphs 4.5-4.29).
- 3.66 The Partnerships Victoria approach applied to the Victorian state government. As a result, it involved various state government agencies, Ministers, and the Treasurer. Figure 2 sets out the major stages in developing a Partnerships Victoria project.

**Figure 2**  
**Major stages in developing a Partnerships Victoria project**

Stage	Key tasks
The service need	<ul style="list-style-type: none"> <li>• Identify service needs</li> <li>• Focus on outputs</li> <li>• Consider broad needs, over time</li> <li>• Allow scope for innovation</li> </ul>
Option appraisal	<ul style="list-style-type: none"> <li>• Consider options</li> <li>• Consider application of Partnerships Victoria</li> <li>• Evaluate financial impacts, risks, and other impacts</li> </ul>
Business case	<ul style="list-style-type: none"> <li>• Confirm the project offers net benefit <ul style="list-style-type: none"> <li>- Quantify risks and costs</li> <li>- Commence development of a PSC</li> <li>- Conduct cost-benefit analysis</li> </ul> </li> <li>• Assess Partnerships Victoria potential</li> <li>• Obtain funding and project approval</li> </ul>

Stage	Key tasks
<b>Decision: Funding approval</b>	
Project development	<ul style="list-style-type: none"> <li>• Assemble resources – steering committee, project director, probity auditor, procurement team</li> <li>• Develop a project plan</li> <li>• Further develop the PSC</li> <li>• Develop commercial principles</li> <li>• Consultation</li> </ul>
Bidding process <b>Decision: Approval to invite Expressions of Interest</b>  <b>Decision: Approval to issue a Project Brief</b>	<ul style="list-style-type: none"> <li>• Develop Expression of interest invitation</li> <li>• Seek approval to issue the EOI</li> <li>• Evaluate responses and develop a shortlist</li> <li>• Develop a Project Brief and contract</li> <li>• Seek approval to issue the Project Brief</li> <li>• Conduct clarification sessions</li> <li>• Evaluate bids</li> </ul>
Project finalisation review	<ul style="list-style-type: none"> <li>• Confirm achievement of policy intent</li> <li>• Confirm value for money</li> <li>• Report to the Minister</li> <li>• Advise the Treasurer of intent</li> </ul>
Final negotiation	<ul style="list-style-type: none"> <li>• Establish the negotiating team</li> <li>• Set the negotiation framework</li> <li>• Probity review</li> <li>• Report to Minister and Treasurer</li> <li>• Execute contract</li> <li>• Financial close</li> </ul>
Contract management	<ul style="list-style-type: none"> <li>• Formalise management responsibilities</li> <li>• Monitor project delivery</li> <li>• Manage variations</li> <li>• Monitor the service outputs</li> <li>• Maintain the integrity of the contract</li> </ul>

Source: adapted from Partnerships Victoria, *Guidance Material – June 2001: Overview*, page 14.

- 3.67 As can be seen from Figure 2, the process involves developing a business case for a PPP. In our 2006 report, *Achieving public sector outcomes with private sector partners*, we summarised much of the emerging good practice guidance on business cases for PPPs. The public entity needs to establish a detailed business case, with financial modelling, to support the decision to go ahead with the project and the preferred procurement method. As part of that business case

or before, the public entity should assess different procurement options. The assessed options should include traditional approaches to procurement. The business case should set out a full justification for the chosen procurement option, including how it supports the public entity's vision and strategic plan. The business case should also outline the procurement process, time line, and costs involved. This was not dissimilar to the Partnerships Victoria model set out above.

- 3.68 Our report explains that the business case should:
- identify clear objectives for the project, including its contribution to the public entity's vision and policy objectives;
  - assess the degree of top-level commitment that will be required;
  - show that the project and the preferred procurement route are in the public interest;
  - assess the likely level of market interest;
  - consider the risks of the preferred procurement route;
  - show an overview of the structure of the proposed arrangements, including arrangements for governance and accountability, project management, and contract management;
  - assess value for money from the preferred procurement route, including a comparison with other procurement options;
  - examine funding options;
  - consider risk allocation (which will inform the value-for-money assessment);
  - examine the affordability and financial implications for the project and preferred procurement route;
  - consider legislative compliance;
  - consider accounting issues;
  - consider the effect on employees;
  - identify important stakeholders; and
  - identify the main information that the public entity will need to receive throughout the term of the arrangement to effectively carry out its monitoring processes and public accountability obligations.

### What the Council considered

- 3.69 We have not been able to find any evidence that the Council carried out any assessment of the options that were available to it to fund the wastewater scheme. The Council believed that it had only two options to fund the wastewater scheme – debt or a PPP. Despite the early advice it received on its financial

situation and options, it did not give equivalent consideration to how it might increase its revenue to pay for the wastewater scheme. This misconception led it to believe that a PPP, where the debt was not on KDC's books, was the only way to deliver the scheme. In short, the belief that the only way to deliver the project was through a PPP was not based on robust evidence or a full consideration of the available options.

- 3.70 The Council did not carry out a systematic or rigorous consideration of the options before it decided to proceed with a PPP. Because of the limits on its ability to borrow created by its Treasury Management Policy and relatively low income, the Council appeared to take an early view that the only way to fund the wastewater scheme was by using a PPP.
- 3.71 In our view, the Council should have carefully assessed all the options for funding and delivering the project that were open to it rather than focusing narrowly on using a PPP. Most guidance on PPPs, including that available at the time, emphasises that funding and accounting issues are only a small part of the issues that a business case should address at this stage. They should not be the dominant factor in a decision to use a PPP approach.
- 3.72 Although there was a lot of discussion about PPPs in New Zealand at that time, they were not being widely used. The Council was therefore deciding to use a project delivery method that was novel in the public sector and that it had no previous experience with. From the information we have been able to find, we do not consider that it paid enough attention to the risks it would need to manage if it followed this approach.
- 3.73 We note that this decision was also characterised by a lack of clear or formal decision-making and documentation. Important decisions seem to have emerged from ongoing discussions and workshops rather than being formally taken at Council meetings or by people with delegated authority.

### **Early lack of clarity about roles and responsibilities**

- 3.74 We also saw evidence to suggest that, in these early processes, the Council did not have a clear understanding of the scope of the services that the project managers would provide and therefore lacked an understanding of the role it would need to play in delivering the project. Even with the project managers, KDC would still have its own responsibilities as the ultimate purchaser of the project managers' services and of the scheme. It could not contract out all responsibility to others.
- 3.75 Beca and KDC entered into a contract for project management services. The contract defined the scope of their respective responsibilities and included a

diagram of how the project was to be managed (see Figure 1). That diagram showed that the PSC (which reported to the Council) was responsible for maintaining an overview of the project and for receiving advice from its own professional advisers alongside the advice PwC (Australia) and Bell Gully provided to the commercial adviser.

- 3.76 In fact, the Council did not set up this system of project governance. The role of the PSC was unclear, and it only operated up until May 2003. In practice, the Council made all decisions on the project through a process of workshops and Council meetings, based on advice directly from the project managers and commercial adviser. No person or group within KDC was charged with monitoring the overall status of the project and its risks. By default, the Chief Executive became personally responsible for this role. The lack of clarity about the roles of KDC, the project managers, and the PSC, and the failure to have a person or group with full oversight of the project, led to significant issues later on. At this early stage, it meant that there was a real risk that issues that were important for the project and KDC would be missed. It also meant that the Council lacked a reliable and routine stream of advice about the project that was independent from the advice it received from its project managers.
- 3.77 The problems are illustrated by the fact that, in the early stages of the project, KDC did not seek independent legal and financial advice about the project. It did not have a clear understanding of the legal and financial issues that would need to be addressed during the project. Therefore, it did not know whether the project managers would provide advice about those issues or whether it would need its own independent advice. We are unsure whether this was because KDC misunderstood the scope of the services the project managers would provide or whether KDC simply failed to identify the need to do this.
- 3.78 Although the project management contract set out the limited nature of the legal services to be provided, it appears that KDC officers thought that KDC was going to be provided with all legal services necessary for the project. This misunderstanding was no doubt reinforced when Bell Gully provided (on request) legal advice about issues outside the scope of the services in the project management contract.
- 3.79 As we set out later in the report, KDC sometimes sought independent legal advice, but this appeared to be on an ad hoc basis. Similarly, Bell Gully provided the additional legal services on an as-required basis and did not provide a systematic overview of the legal issues the project raised.
- 3.80 In our view, this early work to set up the project created several problems for the future. In simple terms, we conclude that the Council did not fully understand

what it was getting into when it embarked on one of New Zealand's first major PPP projects with contracted project managers. In particular, this early lack of a shared understanding about who was responsible for what meant that the Council failed to appreciate that it needed its own direct legal and financial advice about aspects of the project. It also created a risk of legal and financial issues being missed. This risk eventuated several times during the project.

### **Accountability and record-keeping practices**

- 3.81 The Council's practice of effectively deciding issues in project workshops, based on presentations rather than formal papers, meant that the records did not clearly explain the basis for decisions later confirmed at Council meetings. The minutes alone were often not enough to give a clear picture of what had been decided and why. This lack of information has made it difficult for us to assess how robust the Council's decision-making actually was.
- 3.82 More generally, we do not support the use of workshops as effective decision-making forums. Workshops can be an extremely useful addition to formal council meeting and decision-making processes, because they enable more open discussion and exchange with advisers. However, the workshops cannot replace considering properly prepared and circulated papers at formal meetings of the Council.
- 3.83 We are also disappointed that KDC had little or no records to support its procurement activity. Keeping good records that demonstrate the fairness of the process, and how risks were managed, is a basic part of good practice in public sector procurement.



## Part 4

# Tender process to choose a construction partner

- 4.1 By early 2001, the Council had appointed Beca to manage the overall project on its behalf and was committed to exploring the possibility of a PPP. The next step was for Beca to help KDC go to the market to see who might be interested in tendering to build and operate the scheme. This is a major step in any PPP.
- 4.2 In this Part, we discuss:
- the preparatory work that was done in early 2001 before approaching the market;
  - the April 2001 call for Expressions of Interest (EOI) from potential providers and the assessment of responses;
  - the RFP process that began in November 2001;
  - the September 2002 decision to negotiate with Simon Engineering as the preferred provider;
  - preliminary work on funding the construction; and
  - our comments on the overall tender process.
- 4.3 In summary, we conclude that:
- The basic process and steps that KDC took to tender for a provider were reasonable and appropriate.
  - The substance of the work regularly fell short of what was needed for a PPP project of this nature. For example, there was no clear documentation in KDC's files to demonstrate that the PPP would be more cost-effective than traditional procurement.
  - There is a risk that the way the work was carried out increased the price of the scheme and might have made a PPP look more attractive.
  - Record-keeping and documentation of decisions were poor. The Council did not pay enough attention to proper process and appropriate lines of accountability when it made decisions.
- 4.4 Our assessment is that KDC was out of its depth in embarking on a PPP and relied heavily on its project managers for guidance.

## Preparatory work before going to the market

### Good practice steps before tendering a public private partnership

- 4.5 When deciding to use a PPP to construct and operate infrastructure, it is good practice for a public entity to assess the bids from the private sector entities against an estimated cost for the public entity to design, construct, and operate

the infrastructure itself. Partnerships Victoria provides guidance on how to establish what it calls a “public sector comparator”, which is essentially an estimate of what it would cost the public entity to carry out the project using traditional procurement methods. Public entities use the public sector comparator as a benchmark for deciding whether using a PPP would offer better value for money.

- 4.6 Compiling a public sector comparator using the Partnerships Victoria model is complex. There are several components:
- a raw public sector comparator, which is an estimate of the base cost if the public entity were to build and own the asset using traditional methods and should include all the capital and operating costs of building, owning, and operating the asset and of providing the service;
  - an adjustment for competitive neutrality, which is a financial calculation to take account of any inherent price advantages that public sector entities have (such as a different tax treatment) that would be in the raw public sector comparator;
  - a price for retained risk, which is an estimate of the value of the risks of the project that the public entity is to retain; and
  - a price for transferred risk, which is an estimate of the value of the risks of the project that are to be transferred to the private sector partner.
- 4.7 These last two components reflect that the allocation of risks between the private sector partner and public entity is critical for the costs of a PPP. The theory behind risk allocation in a PPP is that the party best able to bear and manage a risk should be allocated that risk. If risks are inappropriately allocated to the private sector partner, the public entity will end up paying a premium for the private sector partner to carry those risks.
- 4.8 One of the advantages of compiling a public sector comparator is that it requires the public entity to determine what the risks of the project are, assess the likelihood of their occurrence, and place a value on the costs of the risk if it were to occur. This process should help the public entity identify which party is best placed to manage that risk and, therefore, where it should be allocated.
- 4.9 Under the public sector comparator, the assessment is of cost over the entire operating life of the project. To do this, a net present costs conversion is applied – that is, the future costs are converted to present-day costs using a discount rate. The Partnerships Victoria guidance on public sector comparators states that “The discount rate reflects government’s time value of money plus a premium for the systematic risk inherent in the project.” In Victoria, advice about what discount rate to use was provided by the Department of Treasury and Finance.

## The benchmark

- 4.10 There was no copy of a public sector comparator for the project in KDC's files. In KDC's files, we found a *Benchmark Design Report* (discussed further below) and a document titled *Risk Inputs* and headed "Risk summary for total project. Risk allocation between retained and transferred based on design/construct approach as per documents". The *Risk Inputs* document includes a table setting out several risks, providing an assessment of the likelihood of their occurrence, and placing a value on the cost of the occurrence of the risk. The table also set out an analysis of which risks KDC would bear under a design/construct approach and a BOOT approach.
- 4.11 Beca prepared the *Benchmark Design Report* and provided estimated capital and operating costs for a wastewater scheme if KDC were to construct it. The *Benchmark Design Report* states:
- The benchmark is intended to reflect a scheme that would likely have been provided had the project been delivered by traditional means (design/tender/construct). It is to be used to compare both technically and cost wise with offers made for a BOOT, DBO or similar risk transfer schemes.*
- 4.12 The scheme set out in the *Benchmark Design Report* consisted of:
- conventional gravity reticulation to a treatment plant in a rural area south of the Harbour;
  - treatment by aerated lagoon and aerated sludge lagoons with UV disinfection; and
  - effluent disposal by rapid infiltration to the coastal sand dunes.
- 4.13 The estimated cost for the reticulation part of the scheme was based on the estimated population in 2015. The report identified that parts of the reticulation network would need to be upgraded in 2015 to cope with the increased population. The report included an estimate of the costs for this. The report also identified the areas that were to be serviced and noted that, if other areas were to be serviced, the estimates would need to be adjusted. The design capacity for the reticulation system was based on an estimated weekend population of 12,800. The design capacity for the wastewater treatment plan was based on a "typical summer population" of 9200 in 2027.
- 4.14 The report set out that the estimated capital cost for the scheme was \$18 million, made up of:
- |                                 |                |
|---------------------------------|----------------|
| • sewer reticulation:           | \$11.4 million |
| • 2015 sewer reticulation:      | \$3.1 million  |
| • treatment plant and disposal: | \$3.5 million. |

- 4.15 The report also broke down the construction cost this way:
- Cost for present population \$11.5 million
  - Provision now for future population \$3.4 million
  - Future extension \$3.1 million.
- 4.16 It also estimated the annual operating cost would be \$290,000 in 2002 and \$375,000 in 2027.
- 4.17 The *Benchmark Design Report* was not a complete public sector comparator, and Beca told us that it formed only part of a comparator. This was because it did not include any information about retained risks or transferred risks, nor any adjustments for competitive neutrality. The information from the *Risk Inputs* document, together with the *Benchmark Design Report*, could have formed the basis of a public sector comparator.
- 4.18 EPS told us that the *Benchmark Design Report* and *Risk Inputs* document were both used as inputs into the “benchmark” (that is, a public sector comparator). It told us that the benchmark was prepared and sent to the Council’s solicitors, Brookfields, before the tenders were received.
- 4.19 KDC’s files did not show whether councillors were shown the *Benchmark Design Report*, the *Risk Inputs* document, or the benchmark.
- 4.20 The PSC minutes for the meeting in October 2001 record that EPS told the PSC that the benchmark was completed. However, later minutes of the PSC suggest that this was not the case. The March 2002 PSC minutes record that:
- ... [the] *financial model to be used for the establishment of the benchmark and comparative quantitative evaluation of proposals has been completed and presented to J McKerchar and J Lok. The model will be populated with commercial and technical benchmark information and locked away with Councils solicitors prior to bids being opened. Target Date for this Thursday 28 March 2002.*
- 4.21 The April 2002 PSC minutes record that the benchmark had been sent to KDC’s solicitors. We asked KDC’s solicitors for a copy of that document, but they were unable to locate it in their files.
- 4.22 The PSC minutes do not record that the PSC saw the benchmark or had any role in approving it. Nor is there any record in the Council’s minutes of it being provided with the benchmark or being asked to approve it. We discuss further below how the benchmark was used in the evaluation of the tenders.

### How the Council allocated risk

- 4.23 The Council held a workshop in February 2001 to discuss risk management, including the allocation of risks between KDC and a private sector partner. It appears that the results of this process were reflected in the *Request for Expressions of Interest for the Mangawhai Infrastructure Project* document KDC issued in April 2001. We were able to locate only draft copies of this document in KDC's files, not a final copy, so we were unable to confirm that this information about risk allocation was in the final document KDC issued.
- 4.24 In the later RFP for the wastewater project issued in November 2001, the allocation of specific risks was shown in a table. The only risks allocated to KDC were:
- construction cost over-runs caused by KDC;
  - pursuit of legal remedies in the case of illegal discharges and connections;
  - any issues with availability of KDC's sites; and
  - managing the customer interface, including billing and accounts.
- 4.25 KDC and the private sector partner would also share a small number of other risks. These included some risks associated with KDC's sites, such as contamination and archaeological risks, and the community liaison risk.
- 4.26 The RFP document required the tenderers to prepare tenders based on this allocation of risks, which would be included in the Project Deed – the final contract between the successful tenderer and KDC. The table listing the risks and their allocation contained in the RFP clearly showed that KDC was allocating as much risk as possible to the private sector partner (in this instance, called the Promoter).
- 4.27 We asked one of our engineers to review the allocation of risks and provide us with his comments on the appropriateness of the allocation (see Appendix 3). He concluded that the risk allocation would have resulted in a significantly higher bid price. Some of the allocated risks had significant uncertainty, and the tenderers would have priced their bids to protect their commercial position as a result.

### Our comments on the preparatory work

- 4.28 The initial decisions the Council made on allocating risks between KDC and the private sector partner were significant for the cost and efficiency of the project. We reviewed the initial allocation of risks with help from our engineer (see Appendix 3). Our overall conclusion is that the Council shifted too many risks to the private sector partner that it would have been better placed to manage.

Tenderers would have priced these risks into their bids, and so it is likely that, from the start, the prices were higher than they might otherwise have been.

- 4.29 We were unable to evaluate a core part of the preparatory work for the tender process – that is, the use of the public sector comparator. This means that we were unable to conclude whether it provided a robust basis to determine whether it would be more cost-effective to use a PPP compared to KDC carrying out the project.

### Expressions of Interest process

- 4.30 After the February 2001 Risk Management Workshop, a tender process was begun, starting with calling for EOIs for the wastewater project. The EOI document was advertised in April 2001. As already noted, KDC was unable to find a copy of the EOI document that was finally issued. However, we saw draft versions of the EOI document that included information about the project scope, the tender process and timing, risk allocation, and the evaluation criteria.
- 4.31 The draft EOI document set out that there would be a three-stage process to select the preferred bidder. There was to be an initial short-listing of bidders. An RFP and draft contract documents would then be issued to the short-listed bidders for them to develop detailed proposals. These proposals would be evaluated, a final preferred bidder selected, and a contract negotiated with that party.
- 4.32 EPS prepared the draft EOI documents. The PSC minutes for March 2001 record that “Comments on the draft Request for Expressions of Interest been received and input from the workshops had been added. Further minor comments were provided. The document is now ready for issue.” The minutes do not record who the comments were from. We were unable to tell from KDC’s files who approved the final EOI documents for release or what that document contained. Beca told us that the documents for the tender process were submitted to the Chief Executive and that he either acted under his delegated authority or sought approval from the Council.
- 4.33 The draft EOI documents provided that the EOIs would be evaluated on the basis of the bidder’s ability to:
- (a) *develop and manage best practice wastewater and stormwater infrastructure;*
  - (b) *develop environmentally sensitive infrastructure projects and maintain high levels of community service and involvement;*
  - (c) *provide a competitive and commercially acceptable proposal; and*
  - (d) *maintain consistency of approach from Expression of Interest to contract finalisation.*

- 4.34 The draft EOI documents also set out that the bidder's capabilities in other areas would be assessed. These capabilities included the bidder's financial viability, commercial concepts, innovation, technical concepts, and management skills.
- 4.35 It appears that EPS developed a process for selecting the preferred bidder. This process was set out in a document dated 25 June 2001. This included the process to be used during the EOI phase. We were unable to tell who approved this process. There is no record in the Council's minutes of the Council or the PSC receiving this paper. The PSC was provided with information about the evaluation process in May 2001. Again, Beca told us that all the documents for the tender process were submitted to the Chief Executive.
- 4.36 The process set out in the EPS paper included the appointment of a Core Assessment Team to evaluate the tenders and then to make a recommendation to the PSC about the tenderers. The PSC's minutes for May 2001 record that the PSC was advised that KDC's asset manager, two EPS employees, and one Beca employee would evaluate the EOIs.
- 4.37 EOIs were required to be submitted by 28 June 2001. KDC received seven EOIs, five from New Zealand companies/consortia and two from Australia. They were:
- NorthPower;
  - Duffill Watts and King;
  - Fletcher Construction;
  - Earthcare NZ Consortium;
  - Works Infrastructure;
  - EarthTech Engineering (a subsidiary of Tyco); and
  - Simon Engineering (Australia) Pty Ltd (Simon Engineering).
- 4.38 The seven parties that had expressed interest gave presentations to the Core Assessment Team on 31 July and 1 August 2001. Other KDC staff, including the Chief Executive and some councillors, attended the presentations. The PSC report in August 2001 to the Council, recommending which parties be selected as tenderers to go through to the RFP process, noted that the Core Assessment Team had assessed the submissions and presentations of all the parties. There were no documents in KDC's files about how the Core Assessment Team carried out this evaluation, including whether the EOIs were evaluated against the evaluation criteria that had been established earlier.
- 4.39 The Core Assessment Team recommended to the PSC which companies should proceed to the RFP stage. The Committee agreed and recommended that three companies be short-listed to proceed to the RFP stage: NorthPower, EarthTech, and Simon Engineering. The Council confirmed the recommendation on 22 August 2001.

### Our comments on the Expressions of Interest process

- 4.40 On its face, the EOI process appears to have been relatively straightforward. However, our ability to assess it fully was again hampered by the limited documentation in KDC's files.
- 4.41 We are also concerned at the apparent lack of clarity in this phase of work about who was to sign-off documents and who was responsible for particular decisions. We have not been able to establish who saw the EOI documents or who approved them. Again, this suggests that KDC's approach to management and decision-making was too loose for a public entity carrying out a project of this size.

### Request for Proposals

#### Issuing the Request for Proposals

- 4.42 EPS prepared the documents for the RFP, which was issued on 23 November 2001. The PSC minutes for November 2001 record that EPS provided the draft RFP, Project Deed, and schedules to KDC's Chief Executive for review. However, we found no evidence to suggest that these documents or a summary of them were seen or approved by either the Council or the PSC.
- 4.43 A community forum was held on 24 November 2001 so that the community could meet the three bidders in the RFP process. About 150 people attended and presented verbal and written submissions. At the request of the MRRA, a special meeting was also held between the MRRA and the bidders on 10 January 2002.
- 4.44 The original deadline for submissions was 22 February 2002. This was extended to 3 April after two of the bidders asked for an extension of time. Meeting notes show that the PSC discussed this issue, but it is not clear whether the PSC approved the extension or whether the decision to extend had already been made. All three bidders submitted their proposals on 3 April.

#### The evaluation process

- 4.45 In December 2001, the PSC had discussed at its meeting a proposed process for evaluating the tenders. The project managers were asked to prepare recommendations for the process for its next meeting. In February 2002, the PSC discussed the proposed tender evaluation process further. In March 2002, EPS provided further information about the evaluation process to the PSC, and the minutes for March 2002 record that the PSC agreed with what had been proposed. Although the minutes record that information about the broad structure for evaluating the tenders was provided, they do not set out what the evaluation criteria were to be. No copies of the information provided to the PSC were in KDC's files, so we could not establish exactly what the PSC agreed to.



- 4.46 The March 2002 Council minutes record that the Council received a report from the Chief Executive and that the Council adopted the evaluation process recommended in his report. No copy of his report was in KDC's files, so we could not be certain what process the Council agreed to adopt. However, in a monthly report from Beca to the Council, there was high-level information about the tender evaluation process. The report attached a paper setting out more detailed information about the evaluation process for the Council's information. KDC's former Chief Executive told us that he believed that his report would have attached the Beca report to it.
- 4.47 The Core Assessment Team was to conduct the evaluation process, which the Evaluation Overview Team would oversee. The Evaluation Overview Team was made up of councillors, an iwi representative, and two members of the Community Liaison Group. The Core Assessment Team was to make the final recommendation on the preferred proponent to the PSC. Subject to the PSC's approval, the Chief Executive would make the recommendation to the Council.
- 4.48 Beca told us that the evaluation process the Council approved was followed when the bids were evaluated. However, there were only limited records of the evaluation process in KDC's files.
- 4.49 The three tenderers included sites for disposing of the treated effluent. The former Chief Executive told us that none of the sites proposed were suitable to the Council for a variety of reasons.
- 4.50 EPS prepared a report in August 2002 with a recommendation to award preferred proponent status to Simon Engineering. We were unable to determine from the files why the tender evaluation process took over four months.

### **Our comments on the Request for Proposals**

- 4.51 The information we have been able to find suggests that a reasonable evaluation process was developed and followed. However, we cannot be certain, because we have not been able to locate the substantive documents.
- 4.52 Again, we are concerned that the approval and decision-making process appears to have been relatively informal and that the overall RFP process was barely documented. We regard this as inadequate in a public sector context, where accountability for the use of public funds and how decisions are being taken should be basic.

## Simon Engineering selected for negotiation

- 4.53 The RFP document set out the evaluation criteria to be used by the Core Assessment Team. They included legal and commercial matters, financial matters, and technical and operational matters. The tenders were also to be compared against the benchmark developed by EPS.
- 4.54 The Core Assessment Team met with the Evaluation Overview Team and the PSC on three occasions while developing its recommendation. Beca and EPS prepared a report for the Council, *Recommendation to award preferred proponent status*, in August 2002. This report set out how the tenders were evaluated and provided an overview of the three tenders. It included a document that compared the major items between the three tenders. The proposed capital cost, operating cost, and toll stream (that is, payments to be made by KDC to the successful tenderer during the project to cover capital costs, and operating and maintenance costs) were also compared against a benchmark figure.
- 4.55 The report also assessed whether the project complied with section 122C of the Local Government Act 1974 (see paragraph 5.13). It concluded that the project did comply.
- 4.56 The report stated that all three proposals were technically sound. Simon Engineering offered the best option for disposing of the treated effluent. It also offered the lowest price, bettered the benchmark figure, and demonstrated the best commercial terms for the lowest price. Simon Engineering's proposal included ABN Amro (using New Zealand private investors) as the financier. Simon Engineering's proposal offered a fixed capital cost of \$13.5 million as a guaranteed maximum price, with savings below this being shared 50:50 with KDC. Simon Engineering's proposal involved disposing of the treated effluent to a Carter Holt Harvey forest south of Mangawhai. The report stated that the Core Assessment Team recommended awarding Simon Engineering preferred proponent status, which meant that contract negotiations could begin.
- 4.57 The document comparing the three tenders refers to a benchmark with a net present value of \$25.2 million. This appears to be made up of a capital costs benchmark of \$24.4 million and annual operating costs at the beginning of the project of \$400,000. The RFP was for both wastewater and stormwater systems, and the evaluation does not break down the benchmark figure into costs for both systems.
- 4.58 None of these figures correlate with the figures provided in the *Benchmark Design Report* for wastewater or stormwater prepared by Beca or in the *Risk Inputs* document. The comparison of major items document does not provide any information about how the net present value calculation was arrived at – in particular, it does not specify what discount rate was used.

- 4.59 Although we were unable to determine how the benchmark figures used to evaluate tenders were derived or what they included, EPS told us that the *Benchmark Design Report* and the *Risk Inputs* document were inputs into the benchmark. EPS also told us that the tenders were assessed against the benchmark. It also told us that a common discount rate was applied to the benchmark and the tenders, although not what that rate was.
- 4.60 Because we were unable to obtain a copy of the benchmark, we were unable to assess properly how the Core Assessment Team concluded that Simon Engineering's proposal was going to be cheaper during the wastewater scheme's operation, compared to KDC building and operating the scheme itself.
- 4.61 Simon Engineering proposed to dispose of the effluent from the wastewater scheme to land leased by Carter Holt Harvey at Te Arai Point. This land was in the Rodney Council district and would require consent from Rodney District Council and Auckland Regional Council. The recommendation for preferred proponent report notes that it had the best disposal option of the three tenderers.
- 4.62 Determining the location of disposal of treated wastewater is one of the main decisions for a wastewater scheme. The location of disposal will determine the method of disposal, the standards the wastewater needs to be treated to, and therefore the design of the wastewater treatment plant. This means that location can have a significant effect on the overall costs of a wastewater scheme. Until the location is decided, the potential costs of the scheme remain uncertain. If the Council did not agree with the disposal site and required Simon Engineering to find another site, there was a real risk that the cost would increase and that it might be higher than that included in the other tenders.
- 4.63 The Core Assessment Team briefed the Council at a workshop held on 14 August 2002. In addition, a public meeting was held on 17 August 2002 to provide information to the community on the recommendation, before the Council made its final decision on the preferred proponent.
- 4.64 The Council agreed with the recommendation from the PSC that Simon Engineering be offered preferred proponent status to enable negotiations to take place before a final recommendation was taken to the Council. The Council noted that preferred proponent status did not mean that Simon Engineering had been awarded the contract. Simon Engineering was formally notified on 10 September 2002 that it had been awarded preferred proponent status.

### Our comments on the selection process

- 4.65 Again, the overall process for evaluating the tenders and selecting a preferred proponent was reasonable. KDC took the right steps with its Core Assessment Team, comparative work, oversight arrangements, and briefings to the Council and community.
- 4.66 However, we have many questions about the detail of the evaluation work that was done and how it related to the benchmark material put together in the preparatory phase. We could not see how the two were related because the benchmark itself was not in KDC files. We have already noted our concerns about whether the preparatory work created a risk that the price would be higher than necessary. In our view, these risks might have been increased by the way the evaluation was carried out. For example, we have not been able to establish what discount rate was used for the discount costs conversion in the comparison. This is an important element, because the PPP will look more attractive if too high a rate is used.
- 4.67 Also, the Council did not appear to understand that going to the next stage of the tender process with an unsuitable disposal site was risky. At a minimum, it meant that the Council had no certainty about the costs of the scheme or whether they bettered the benchmark.

### Preliminary work on funding the construction

- 4.68 The RFP provided that the BOOT scheme would last 25 years. That meant that Simon Engineering would build the wastewater scheme and then operate and maintain it during that 25-year period. KDC would pay annual payments to Simon Engineering during that period. The payments, referred to as the toll payments, would cover the capital costs of construction, as well as the finance and operating and maintenance costs for the scheme.
- 4.69 EPS, with assistance from PwC (Australia), using information from Simon Engineering about the toll payments to be made during the 25 years, then developed an initial model of one-off charges and annual charges that ratepayers would pay to KDC to match the toll payments to be paid to Simon Engineering. The report to the Council recommending Simon Engineering stated that:

*An initial model reflects that the following charge structure could fund the Mangawhai EcoCare project:*

CHARGE/FEE	\$
Wastewater Charges	\$800 + GST
One Off Service Provision Charge	
• Current Sections	\$1,000 + GST
• Future Sections	\$6,000 + GST

- 4.70 The report does not specify what the legal basis for these charges was – that is, whether they were to be rates and, if so, what type. The first charge in the table was an annual payment, and the charges below were one-off charges. It was proposed that the charges would increase over 25 years in line with inflation. The report also noted that feedback from the community had been that the one-off service provision charge could be set at \$10,000 to \$12,000 for future section owners. This would have the effect of reducing the annual charge.
- 4.71 The report also suggested that KDC might “... wish to fund part of the initial capital cost utilising lower interest rates than those available in the Simon proposal.” The Council’s decision on 28 August 2002 to award preferred proponent status to Simon Engineering was made subject to Simon Engineering “acknowledging the ability for KDC to consider the provision of some equity or funding”.

### **Our comments on the early funding work**

- 4.72 It was important for the Council to focus on how it would pay for the scheme from the start. These early calculations show that it recognised this as an issue. However, this initial thinking was relatively sketchy. We note, in particular, that there was no analysis at this stage about how the proposals would fit with the legal rules governing the types of rates or charges that the Council could impose.

### **Our overall comments on the tender process**

- 4.73 In our view, the basic process and steps that the Council took to tender for a provider were reasonable and appropriate. It put effort into preparation, an EOI, and then a full RFP process to evaluate proposals provided by three short-listed bidders.
- 4.74 We were unable to assess how robust the public sector comparator was, including how it related to the documents that were inputs for it. Therefore, we were unable to assess whether the conclusion that the PPP was a more cost-effective way for delivering the project was correct. We note that, even if the public sector comparator was robust, once the Council had decided it did not want to go ahead with any of the disposal sites put forward by the tenderers, there was little point evaluating the tenders (with the unacceptable disposal sites) against the public sector comparator. This was because the cost of a proposal with an acceptable disposal site was likely to be different.
- 4.75 By deciding to carry on with the process, the Council created a significant risk. It did not know how much the scheme with an acceptable disposal site would cost to construct or whether it would be cheaper for it to use a PPP rather than other forms of project delivery.

- 4.76 The Council should have paid more attention to proper process and accountability when it made decisions, by being clear about who was responsible for which decisions and making sure that decisions and the reasons for them were adequately documented. Even when using a contracted project manager, the Council still needed to know and to be able to explain what was being done on its behalf. A public entity cannot contract out its accountability obligations.
- 4.77 Our overall assessment is that the Council had weak governance of this stage of the project. There was a lack of clarity about who within KDC was to have oversight and ownership of the project. The Council accepted the information presented by the project managers that the PPP would be more cost-effective, without anyone in KDC really understanding the basis of that information or testing it. In effect, the Council relied on its project managers to have answered this issue correctly.
- 4.78 At this stage, there is also no evidence that the Council focused on the overall cost of the scheme. The tender price and the benchmark price were significantly higher than the figure included in the *Preferred Options* report in April 1999, some four years earlier.

## Part 5

# Discussions with the community when the wastewater project began

- 5.1 We have already described some consultation or interaction with the community in previous Parts:
- The consultation was good when the Council initially decided that a reticulated scheme was necessary.
  - The Council established a Community Liaison Group in 2000 as part of the project's governance arrangements.
  - A community forum, as well as a separate meeting with the MRRA, was held in November 2001 as part of the RFP process to let the three bidders meet the community.
  - There was a public meeting in August 2002 before the Council confirmed the decision to negotiate with Simon Engineering.
- 5.2 In this Part, we discuss:
- the general communication with the community;
  - community concerns expressed during the tender process;
  - requests for some independent assurance about what was being done; and
  - our comments.
- 5.3 In summary, we conclude that KDC's work to communicate with the community and understand its views during this initial phase of work was reasonably good.

## Overview of other communication with the community

- 5.4 In January 2001, while KDC and Beca were carrying out the preparatory work needed to go to the market for providers, the MRRA made a submission to the Community Liaison Group requesting that more information about the proposed scheme be given to the community. The submission asked for a public meeting to discuss the options and hear opinions. It also asked for a referendum so that the community could vote on what scheme it preferred. The Community Liaison Group considered the submission and advised the MRRA that final decisions on the nature of the scheme had not been made at that point.
- 5.5 During 2001, KDC used various mechanisms to communicate with the community. These included:
- regular Community Liaison Group meetings;
  - regular articles placed by the PSC in the Mangawhai Memo – a fortnightly community-based newsletter;
  - EcoCare Newsletters – a quarterly bulletin produced by the Community Liaison Group with the PSC; and

- public forums, including a stakeholders forum on 5 April 2001 and a community forum on 24 November 2001.

5.6 During the project, KDC also issued press releases, sent out individual letters to ratepayers, publicly notified Council meetings and public workshops, and published agendas, minutes, and related information on its website. Several Council meetings were held in Mangawhai so that the community could attend.

### Community concern during the tender process

- 5.7 In February 2002, KDC received over 100 form letters from ratepayers asking KDC to reconsider its approach to the scheme. The ratepayers wanted the tender process suspended and a system design to be developed with the local community. The letters also requested that responsibility for implementing the scheme be transferred to a community trust or other such entity specifically set up for that purpose.
- 5.8 The Council decided to hold a special Council meeting in Mangawhai to discuss details of the consultation and decision-making process. This meeting was held on 16 March 2002 and included time for members of the public to put their views to the Council. At the next Council meeting on 27 March 2002, one councillor proposed notices of motion to suspend or cancel the entire process. The Council decided not to suspend the process. The reasons given for the decision were that “It is not commercially realistic to suspend the process at this stage, of the tendering for proposals, and the Council is satisfied that the project will deliver the best solution for Mangawhai.” The Council also voted against cancelling the project.
- 5.9 In April 2002, the MRRA again sent a submission to the Council asking the Council not to take any binding decision on the scheme without a referendum or poll of ratepayers endorsing that decision.
- 5.10 The Council held a public meeting about the project on 17 August 2002. Several councillors, the Mayor, the Chief Executive, and representatives from Beca attended the meeting, along with about 180 members of the public. At the meeting, the MRRA presented a written submission outlining its concerns about the affordability and suitability of the proposed scheme. Other members of the public raised several other concerns, including whether the Local Government Bill then before Parliament would allow local authorities to contract out wastewater treatment services to private sector providers.
- 5.11 At its meeting on 28 August 2002, the Council considered a request from the MRRA to carry out a poll before the Council “... made a binding decision on the



EcoCare project”. The MRRA also provided a list of the issues that it wanted addressed. The Council declined the MRRA’s request to carry out a poll and decided to offer Simon Engineering preferred proponent status.

### Requests for some independent assurance

- 5.12 In September 2002, the Chief Executive decided to carry out a process to provide him with reassurance about the process used for the project to that date, including assessing whether legal requirements had been met and whether best practice was being used. The Chief Executive employed Mr Larry Mitchell to carry out this work. The terms of reference for the work, as set out in Mr Mitchell’s report, involved reviewing a report prepared for the Council by the project managers on whether the scheme met the requirements of section 122C of the Local Government Act 1974.
- 5.13 Section 122C of the Local Government Act 1974 provided that councils were to apply the following six principles of financial management in managing their revenues, expenses, assets, liabilities, investments, and financial dealings generally:
- (a) *All revenue, expenses, assets, liabilities, and investments are to be managed prudently, in the interests of the district of the local authority or of its inhabitants and ratepayers, and only for lawful purposes:*
  - (b) *Adequate and effective provision for the expenditure needs of the local authority, as identified in the annual plan and the long-term financial strategy, is to be made, as the case may require, in the annual plan and the long-term financial strategy:*
  - (c) *The benefits and costs of different options are to be assessed in determining any long-term financial strategy, funding policy, investment policy, or borrowing management policy, and in making any decision with significant financial consequences (including a decision to take no action):*
  - (d) *The identified expenditure needs of the local authority are to be funded by such lawful funding mechanisms as the local authority considers on reasonable grounds to be appropriate, having regard to the provisions of sections 122D and 122E of this Act and to all other relevant considerations:*
  - (e) *Debt shall be maintained at prudent levels and in accordance with the relevant provisions of the borrowing management policy:*
  - (f) *Except as provided in section 122J of this Act, operating revenues in any financial year shall be set at a level adequate to cover all projected operating expenses.*

- 5.14 Mr Mitchell was also asked to review the process and models the consultants used to select the preferred proponent to ensure that they complied with the Victorian state government standards. He was also asked to report on whether such models were reasonable in the New Zealand environment and to cover the effect of the treatment of risk.
- 5.15 Mr Mitchell prepared a report called “Kaipara District Council ‘EcoCare’ project position paper and points outline” in November 2002. He noted that the paper was prepared in a “points outline format” to enable EPS and the Chief Executive to comment. He also pointed out that the terms of reference had not actually required the preparation of a report. He noted that only “tentative conclusions or observation are possible, given growing, but by no means fully developed familiarity of the process having been reached at this point”. He concluded that the project had been managed in keeping “with all relevant and essential elements of the Vic State PPP process” and that the PSC benchmark had been properly constructed (although he noted that there was no competitive neutrality adjustment). He also noted that some parts of the Partnerships Victoria approach were missing – for example, a probity auditor had not been appointed.
- 5.16 He noted that he had reviewed the PSC modelling. However, this testing:  
*...fell well short of a high level of assurance on all material. In spite of these limitations good results were achieved. Based on the (reported) extensive and well proven/tried use of this model (supplied by PwC (Australia)) ‘good’ results could be confidently expected when the PSC results were used to assist in the evaluation of the bids.*
- 5.17 He noted that KDC had not carried out any due diligence on Simon Engineering at that stage. His paper records that he was told that no due diligence process had been conducted because KDC had not requested one.
- 5.18 EPS provided critical comments on the paper prepared by Mr Mitchell. KDC’s Chief Executive prepared a file note in late November 2002 setting out his conclusions on the work done by Mr Mitchell and the assurance he took from the work. It does not appear that the paper prepared by Mr Mitchell was ever finalised or that his position paper or the Chief Executive’s file note were ever provided to the PSC or to the Council. However, the Chief Executive included some information about Mr Mitchell’s report in his monthly Chief Executive’s report to the Council for December 2002.
- 5.19 In that report, he noted that:  
*Larry Mitchell has completed his draft report, as peer reviewer of the project and its processes. I am pleased with the outcome that generally states that the*

*process has been well managed. However, as I asked for the review to be carried out from an independent audit basis there are some areas where additional work may be necessary. This is relatively minor. The major item is the possibility of using Council's auditor, Audit New Zealand, to carry out a compliance audit.*

- 5.20 In the meantime, the MRRA complained to the OAG, expressing concern about whether KDC had complied with its legal obligations under section 122C of the Local Government Act 1974 and whether the funding mechanism (BOOT) was in keeping with the Council's Treasury Management Policy.
- 5.21 The OAG asked Audit New Zealand, when carrying out its work on KDC's annual audit, to focus on the funding mechanism the Council had selected and whether the Council had taken all relevant considerations into account in selecting it. The auditor was to report back by the end of January 2003.
- 5.22 However, this plan was overtaken by the passing of the Local Government Act in December 2002. The Local Government Act 2002 contained a set of principles for local authorities to follow when consulting with their communities. The OAG noted that, in light of these new requirements and the Council's stated desire to hold a public consultation process under section 83 of the Local Government Act 2002, it would no longer be enquiring into the issue. In any event, as we describe in Part 8, the Local Government Act 2002 meant that KDC had to change the way in which the project was structured and funded.

### Our comments

- 5.23 The Council is obliged to make sure it has good information on community views before it makes big decisions. It does not have to find a consensus or do what the community says it wants.
- 5.24 We consider that the Council's engagement with the community in this first phase of the project was good. It made extensive efforts to understand community views and to keep the public informed. The Council disagreed with those in the community who did not think a reticulated wastewater scheme was needed. For this reason, engagement with the community about what it was doing and why was important but also challenging.
- 5.25 It is not surprising that KDC reduced its communication while the tender process with the market was under way. This type of commercial process always involves some constraints on communication. We consider that the community briefings and forums that were arranged at different points were good initiatives.
- 5.26 It is unsurprising that the MRRA and others who opposed the scheme strongly expressed concerns during this period. That is common whenever a significant

milestone is approaching, such as the Council selecting and contracting with a preferred provider.

- 5.27 The community sounded warnings and concerns that later proved to be well founded. The fact that the Council chose not to heed them does not detract from the fact that KDC engaged quite fully with the community while the wastewater project was getting set up.

## Part 6

# Our overall comments on how the wastewater project began

- 6.1 In our view, the initial work that KDC did to establish whether Mangawhai needed a reticulated wastewater scheme was carried out well. The work was thorough and careful, and included good consultation with the community. We consider that the decision to begin the project was soundly based.
- 6.2 Two decisions in this early phase were critical to how the project progressed:
  - the preference for disposal of effluent to land rather than water; and
  - the decision to use a PPP.
- 6.3 Although the RFP did not rule out disposal to water, it made it clear that this was not preferred by stakeholders and that the risk of gaining consent for this method of disposal sat with the private sector contractor. The preference for land-based disposal options reflected the community's views and also the restrictions in the regional planning documents. The consequence of this preference was that the disposal options were limited early in the project.
- 6.4 The tendering process failed to produce a tenderer with a disposal site that was acceptable to the Council. As a result, KDC had no reliable information about what a scheme with an acceptable disposal site would cost or whether such a scheme would be cheaper than the benchmark. It was risky for KDC to carry on with the tender process without resolving this issue. As we discuss later in the report, the disposal site for the scheme was not identified or secured until quite late in the project and added significant costs.
- 6.5 We do not consider that the decision to use a PPP was well founded. Although there was reasonably well-developed Australian guidance available by 2001 and the Beca consortium included an Australian company with specialist expertise in PPPs, we do not consider that KDC's work to assess the merits of a PPP was carried out well. The information we have gathered shows that the decision was largely driven by financial considerations and the perception that a PPP would keep the debt off KDC's balance sheet and enable KDC to get around its borrowing restrictions. In our view, KDC should have done more work to consider the full range of options available to it.
- 6.6 KDC followed the right steps to go to the market for a private sector partner, but the quality of the substantive work at each stage was not adequate. KDC's approach to decision-making was also too informal, so it is not clear who was responsible for making important decisions or why they were made.

- 6.7 It is also clear that, at this stage, KDC had not given any careful thought to how it might raise revenue to pay for the project. In particular, we saw no consideration of the legal tools available for KDC to raise revenue from ratepayers.
- 6.8 Our overall view is that KDC had good reasons for believing that it had to do something about disposing of sewage in Mangawhai and that it was trying to do the right thing. However, we consider that it did not set up adequate governance structures for the project, because it did not appreciate what work it needed to do in addition to the work that its project managers carried out. Nor was any group or person within KDC responsible for the project and maintaining oversight of the work of the project managers. As a result, KDC was out of its depth with the financial, legal, and commercial complexity of a project of this type and size. It was overly reliant on its advisers and was not able to effectively assess the information or advice it received.
- 6.9 We are particularly concerned that KDC appears to have had a weak appreciation of its accountability and legal obligations. The essence of accountability is the ability to explain what is being done with public money, the decisions that are being made, and the reasons for them. Good records provide the foundation for that accountability. We found that KDC's records were very poor and, in some cases, non-existent. We spent a great deal of time working with KDC staff and KDC's contractors trying to locate or recreate important pieces of information.
- 6.10 That approach to record-keeping is not acceptable. Even when working with contractors, all public entities have an obligation to maintain full and accurate records consistent with normal business practice. Local authorities also have to be able to produce that information if it is requested under the Local Government Official Information and Meetings Act 1987 or through any other accountability process. Ultimately, responsibility for these types of operational and administrative systems rest with a chief executive.

## Part 7

# Changing to a different kind of project

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- 7.1 In September 2002, the Council had selected a preferred provider, Simon Engineering, and was ready to begin negotiating the final contract. All of the work to this point had been based on a proposed BOOT scheme, under which:
- The private sector partner would build the infrastructure at its own cost.
  - The partner would then own and operate the wastewater scheme for 25 years.
  - KDC would pay toll payments to the partner once the scheme was operating.
  - At the end of the 25 years, ownership would transfer to KDC with no further payment.
- 7.2 Between September 2002 and the end of 2007, when construction was able to begin, KDC encountered several significant difficulties and many changes were made to the project. This Section examines those five years and assesses how well KDC responded to the changing circumstances. Although the events we describe in this Section often occurred simultaneously, we deal with each issue separately to make it clearer.
- 7.3 In the Parts that follow, we discuss:
- the steps taken to fund the project;
  - the change to contracting with EarthTech instead of Simon Engineering;
  - the need to find a disposal site for the effluent;
  - the decision to increase the scope of the project;
  - other significant changes to the project;
  - how the community was kept informed; and
  - our overall comments.
- 7.4 In this Part, we discuss:
- the effect of the enactment of the Local Government Act 2002;
  - the advice provided to the PSC on how the project could be reshaped and continue;
  - the Council's decision to continue to negotiate with Simon Engineering on a revised basis;
  - what the change to the delivery method meant for the proposed contract; and
  - our comments.
- 7.5 In summary, we conclude that the enactment of the Local Government Act 2002 should have prompted a more fundamental reconsideration of how the project was being approached. That is, the Council should have asked whether a PPP was still the best option; if so, what models were now available and their relative

merits; what options were available for funding the purchase; and so on. Instead, the Council very quickly decided it could carry on with the current parties, after negotiating some adjustments to the contracting terms. In our view, this decision was based on inadequate information and analysis.

### What did the Local Government Act 2002 do?

- 7.6 During 2001 and 2002, the Government had been working on major reforms to the Local Government Act 1974. A Bill was introduced into the House on 18 December 2001, and one of the many points of public debate was the ownership and control of infrastructure for basic functions such as water services. The Bill was reported back from the select committee on 10 December 2002 with new provisions inserted on this issue. The Local Government Act passed by Parliament in December 2002 stated that councils could enter into contracts to provide wastewater services with private sector entities for only 15 years. Councils also had to own the wastewater infrastructure.
- 7.7 Effectively, this meant that KDC was no longer able to proceed with the BOOT scheme, which was premised on the private provider owning the asset for the 25-year life of the contract.

### Immediate advice to the Project Steering Committee

- 7.8 In January 2003, Beca and EPS prepared a report for the PSC outlining the major effects of the Local Government Act 2002 on the project and recommending next steps. The advice was that the project could proceed, but it would need to use a different approach. The costs would also change.
- 7.9 Under the proposed new approach:
- Simon Engineering would build and finance the scheme through the “nominated period”.
  - Ownership of the scheme would transfer to KDC once it was built and “commercial acceptance” had been achieved (that is, once the scheme had been tested and proven capable of providing the required services to the required standard).
  - KDC would have to pay for the scheme at that point.
  - Toll payments for operating and maintaining the scheme would be made to Simon Engineering for the remainder of the contract period.
- 7.10 The report noted that the price for construction would probably increase because Simon Engineering would not be able to take advantage of taxation benefits from owning the assets. The project managers suggested that KDC could offset



the increase in costs by using funding from the Government's Sanitary Works Subsidy Scheme (SWSS), which had been introduced in March 2002 to help small communities afford wastewater schemes. EPS later quantified the increased costs as possibly being \$530 for each property each year.

- 7.11 The report also noted that the changes resulting from the Local Government Act 2002 would affect the risk profile that had been previously agreed. The project managers concluded that minor changes only would be needed. The report noted that the requirement to own the asset affected "the extent Council is involved in longer term sustainability of the disposal options".
- 7.12 Although the report discussed the risk profile, it is not clear that the full risk matrix and allocation of risk from 2001 were reviewed. In theory, the risk allocation under a BOOT type of PPP should differ from the type of contract proposed now. As previously discussed, the allocation of risk can have a major effect on the price.
- 7.13 Beca told us that a complete risk review was not carried out. However, both Beca and EPS considered that the risks associated with the change in contract type were addressed. Beca told us that the major change was that KDC would not be able to respond to prolonged poor performance by taking ownership of the asset as a remedy of last resort. Instead, it would have to rely on guarantees or sue to recover any losses. We discuss these questions about allocation of risk in more detail shortly.
- 7.14 The report does not explicitly discuss how KDC would fund the purchase of the scheme on commercial acceptance. However, it seems that the proposal was to fund this through a loan from Simon Engineering/ABN Amro.
- 7.15 The report considered the effect that the change to KDC owning the assets after the construction period would have on the process used to evaluate the tenders. The project managers considered that the evaluation criteria and weightings used to select Simon Engineering were still relevant.
- 7.16 The paper recommended that negotiations with Simon Engineering proceed on the basis that the operating period would be for a maximum of 15 years, although the financing for the project could be over a longer period.

## The Council's decision to continue negotiations on a revised basis

- 7.17 The PSC accepted the recommendations in the report from the project managers. The minutes record:
- Following this discussion it was determined to progress negotiations with Simons/ ABN on the basis of ABN providing competitive risk weighted financing option which would then be compared with a risk adjusted Council borrowing rate.*
- 7.18 The Chief Executive presented a paper to the Council that set out the PSC's recommendations and attached the report from the project managers. This paper stated that:
- ... [the] Council is able to proceed with a Design, Build, Finance and Operate option with operations over a 15 year term and financing over a term of 15 years or longer, possibly 30 years. However, this does mean that Council's Treasury Policy will not be complied with.*
- 7.19 The paper noted that:
- A key driver behind the use of Build, Own, Operate and Transfer was to provide the Mangawhai community with an affordable wastewater scheme that would eventually be owned by Council and to meet the borrowing guidelines of Council's Treasury Policy. That Policy indicated that, under conventional approaches, Kaipara did not have the capacity to borrow sufficient funds to fund this project.*
- Council has however identified that it wishes to review this and has identified that debt segmentation may provide the answer to this problem. The key issue for Council being the ability of the consumers to pay rather than the constraints of what could be considered to be an artificially constructed Treasury Policy.*
- Council may have to consider this project as an exception, for sound reasons, to its Treasury Policy.*
- 7.20 The Council's minutes do not record that the Council explicitly agreed to change from a BOOT type of PPP to a Design, Build, Finance, and Operate (DBFO) scheme. However, this is implied by it accepting the PSC's recommendations and by subsequent documents that refer to a DBFO process. The Council resolved at that meeting:
1. *That negotiations proceed initially to:*
    - *Secure best risk weighted financing arrangement possible from ABN Amro; and then*

- Compare it with Council's interest rates (risk adjusted) to determine most appropriate approach; and then
- Complete negotiations with SEA based on outcome of the above.

2. That negotiations now proceed based on a 15 year maximum operating period and a range of financing options that may include a 25-30 year financing period, and a residual value if appropriate.

6. That Council notes the revised method of funding the EcoCare Project as recommended by the Project Steering Group breaches its current Treasury Policy and accepts this recognising that the most important factor is the ability of the community to pay for the scheme and its operations and this is to be part of further consideration of this project by Council. In addition Council is considering amending its Treasury Policy to enable communities who are able to meet the costs of such infrastructure to fund that infrastructure by way of loan.

- 7.21 KDC's former Chief Executive told us that the Council was "keen on the finance element because they believed the market would bring a better finance deal than normal local government sources". KDC's files did not contain any analysis of this issue.
- 7.22 There are no precise definitions of what a DBFO is. At its simplest, it involves the promoter designing, building, financing, and operating an infrastructural asset. Some definitions suggest that ownership of the asset and the financing risk remain with the promoter for the life of the contract. In such cases, the public entity effectively pays for the asset and the services that it provides through regular toll payments. However, given the restrictions in the Local Government Act 2002, that was not the case here. KDC had to purchase the asset as soon as it was built. The important point is that the risk profile in a DBFO of this kind is different from that of the BOOT arrangement that had been worked on until this point. This affects the costing, allocation, and management of the project risks.
- 7.23 Beca told us that there is a general understanding that a DBFO excludes the promoter owning the asset, and therefore the "finance" in the DBFO refers to construction phase finance, not finance over the nominal life of the asset.
- 7.24 Although the Council was told about the core parts of DBFO as set out above, KDC's files contained no evidence to suggest that the Council was given any explanation of the risks and benefits of a DBFO. However, both KDC's former Chief Executive and a former councillor told us that there was much discussion about the change to a DBFO both at the PSC and Council meetings.

- 7.25 The Council agreed to continue negotiations with Simon Engineering, on the basis that a contract would be for a 15-year maximum operating period with financing over a term of 25-30 years.
- 7.26 In March 2003, after the PSC and the Council had decided to change to a DBFO, a PSC meeting discussed how the project was to be financed. It also appears that the meeting discussed the issue of whether to use a DBFO or design/construct project delivery method.
- 7.27 As set out above, under a BOOT contract, KDC had no involvement in how the construction or operation of the scheme was to be funded. It simply paid a monthly toll for services provided. However, under the DBFO approach, it needed to work out how it would finance the purchase of the scheme. Although Simon Engineering would finance the initial construction, these financing costs would become part of the purchase price to be paid at the end of construction.
- 7.28 A presentation prepared for the PSC discussed the different loan options that Simon Engineering had put forward. The presentation noted that the interest rates Simon Engineering proposed took account of the fact that it bore the interest rate movement risk, the construction finance risk, and the costs of arranging the loan. It stated that these costs would be \$200,000 a year.
- 7.29 The presentation had a slide headed “Issues” that set out:
- *Can KDC borrow approx. \$14.5 M at significantly lower than 7.8%?*
  - *Is KDC prepared to carry interest rate risk?*
  - *Is KDC positioned to carry Construction cost risk and largely supervise design & construction?*
  - *KDC will need to answer all these questions and provide surety in additional project management to manage a D & C or DBO style contract.*
  - *Simon Engineering have assessed the above risks to them (and ABN Amro) as being some \$200,000 per annum based on 5 year contract.*
- 7.30 The minutes of this PSC meeting record that the PSC decided to pursue a five-year fixed interest rate loan, with interest only to be paid. The paper also stated that:
- Simon Engineering has confirmed they will accept all construction finance risk. KDC will not be exposed to cost over runs on the project, nor for costs in delays during design and construction, material price increases, site issues or industrial relations risk once Consents have been achieved. They will also take change in interest rate risk. Construction finance charges will be capitalised and included into the Project capital costs.*

## What the change to the delivery method meant for the proposed contract

- 7.31 Under the BOOT approach and the proposed contract terms set out in the RFP, Simon Engineering had strong financial incentives to build a cost-effective plant that would operate efficiently and be well maintained over the 25-year period. These incentives included that:
- Simon Engineering was to own and operate the scheme over 25 years, so it was in Simon Engineering's interest to construct a plant that would operate efficiently over that period of time without needing too many repairs.
  - The scheme had to be built so that its various components would meet their specified design lives. An independent specialist was required to prepare asset condition reports during the operation of the scheme. These would report on the condition of the components of the scheme and how this compared to the design lives. Simon Engineering would be required to carry out remedial work if the components were not meeting the design life.
  - Simon Engineering was required to maintain and repair the scheme to ensure that the scheme met the operating performance standards in the contract.
  - If the scheme did not meet the performance standards for operation in the Project Deed, KDC could reduce or not pay the toll. The monthly toll payment included the costs of both operating and constructing the scheme, so this sanction provided a strong financial incentive to maintain performance.
  - If the scheme did not meet the performance standards for operation in the Project Deed, KDC could take over the asset from Simon Engineering in limited circumstances.
  - Simon Engineering was required to provide warranties and indemnities in the proposed contract with KDC.
  - Simon Engineering was required to have its parent company, Henry Walker Eltin (HWE), provide a guarantee to KDC that Simon Engineering would carry out its obligations under the contract.
- 7.32 With these protections, which are reasonably standard under the BOOT model, KDC was reasonably well protected if anything went wrong. It was not KDC's asset, and KDC had several ways in which it could both recover any losses it suffered and impose sanctions on Simon Engineering. These overall protections in the BOOT model meant that KDC did not need to have strong oversight of construction of the scheme. The contract put strong financial incentives on Simon Engineering to get construction right.

- 7.33 This is one of the major differences between the BOOT model of contracting and the more traditional “design and build” type of contract. The two sit at different ends of the spectrum of contracting models. If the purchaser simply buys and pays for the asset at the end of construction, the purchaser needs more assurance that the asset has been properly constructed. Common contractual requirements to manage this risk include:
- an engineer to the contract appointed by the purchaser: this role can include providing directions to the contractor and certifying payments, inspecting and testing the works being carried out, and requiring work to be fixed or redone if it is not satisfactory;
  - a contractor’s bond: the purchaser holds a sum of money provided by the contractor to ensure performance of the contractor’s obligations under the contract;
  - a proof of performance period: payment to the contractor is not due until the asset has operated satisfactorily for a specified period of time;
  - defects liability period: a period of time after construction, during which the contractor must repair any defects found in the asset that are due to poor workmanship or materials;
  - retentions: the purchaser keeps back some of the contract payment for a period of time until after the end of the defects liability period;
  - liquidated damages for late completion: the contractor has to pay the purchaser money for the loss it suffers if the works are completed late; and
  - indemnities: a commitment to reimburse the purchaser for losses suffered because of poor work or failures by the contractor.
- 7.34 The DBFO approach that the Council decided to use sat a little further along the spectrum towards a traditional design/construct contract. Simply using the contractual mechanisms from either approach would not be appropriate. The Council needed to consider the precise risks the DBFO approach created so that the contract could include appropriately tailored mechanisms for managing the risks.
- 7.35 One of the project’s core risks was construction risk – that is, the risk that the scheme was not constructed properly or failed to operate as intended. As we set out above, under the proposed contract terms based on the BOOT approach, KDC did not bear this risk and was reasonably well protected if problems arose.
- 7.36 Those protections reduced somewhat under the DBFO approach. KDC had to pay for and own the asset after construction, and the operating period was shorter, so the long-term financial incentives for Simon Engineering to build and maintain

the plant well were weaker. The ability to withhold toll payments now only affected the contractor's operating costs, not their construction costs. However, this still meant that about \$1 million was at risk each year.

- 7.37 KDC's other main protections against poor construction and maintenance were now the warranties, indemnities, and guarantee from the parent company. These protections involve making a claim and taking enforcement action, rather than the direct imposition of a sanction.

### Our comments

- 7.38 The enactment of the Local Government Act 2002 came at an unfortunate time for KDC. It was largely unexpected, although we note that the possibility had been raised during community consultation and that there had been some media coverage of the debate in the select committee. We consider that the Council did not recognise how significant the change was.
- 7.39 One of the Council's main reasons for taking a PPP approach had been to avoid having to borrow to fund the capital costs of construction up front. That was achieved with a BOOT arrangement that left ownership with the private partner for the length of the contract. The law change meant that was no longer possible. KDC would have to own the infrastructure as soon as it was built, and it would have to find a way to pay for it at that point.
- 7.40 The Council very quickly decided it could carry on with the current parties after negotiating some adjustments to the contracting terms. In our view, this decision did not recognise how much of the landscape had now changed. The Council needed to reconsider whether the proposed contractual terms were adequate to manage the increased risks it would now bear. In particular, the Council needed to consider whether those mechanisms adequately managed the risk of the scheme not being constructed properly or not working as intended. The documentation we have seen does not suggest that this careful a process was followed.
- 7.41 The other major change was to the capital cost of the project. Under the BOOT type of PPP that was initially negotiated, ABN Amro provided financing to Simon Engineering to construct and operate the scheme over its life. KDC had no direct exposure to the financing arrangements needed for the scheme. Now that KDC had to own the scheme once it was built, it had to finance that purchase itself. The obligation was now on KDC to acquire that financing, rather than on Simon Engineering. That is, the risk of financing had shifted from Simon Engineering to KDC. The Council had a range of possible options for financing the purchase, but there is no evidence that it considered any other options before it decided to obtain a loan from ABN Amro – the financing party already at the negotiating table.

- 7.42 The January 2003 resolutions refer to KDC comparing ABN Amro's financing against KDC's interest rates to determine the best approach. The Chief Executive's report to the Council for March 2003 stated that:

*An indicative range of interest rates has been provided and these are comparable to market rates. They also include the construction risk factor which will ensure that Council is supplied with an effectively operating, efficient treatment plant and reticulation system.*

- 7.43 KDC's files show that, in March 2003, the Finance Manager obtained likely interest rates from the Bank of New Zealand (BNZ). BNZ advised that the indicative interest rate would be 6.22% for a loan of \$13 million for a five-year fixed term. A report from the PSC to the Council in May 2003 advised that the indicative financing rate from ABN Amro was 7.62%, although the amount of the loan was unspecified. However, the report estimated that the capital costs would be \$15 million. It is difficult now, some nine years later, to determine whether the ABN Amro financing proposal was competitive and offered value for money at that time. However, on its face, KDC ignored an estimate from the BNZ that could have resulted in a saving on interest costs of 1.4% a year. Based on an estimated capital cost at that time of \$15 million, this equated to about \$210,000 a year. Importantly, KDC failed to obtain information to enable it to make an informed decision on whether the offered financing was appropriate.
- 7.44 In short, we conclude that the Council was too keen to keep the process moving and so looked for ways to adjust and carry on as quickly as possible. In our view, the change to the legislation should have prompted a more thorough reconsideration of how the project was being approached and funded.
- 7.45 KDC's former Chief Executive told us that the Council considered that a PPP was still the best option because it still met the criteria the Council had set for the project. However, we could not locate any KDC records to show that any substantial analysis had been carried out or formally submitted to, and discussed by, the Council. We consider that the complexity of the changes warranted more careful consideration than the records suggest took place.



## Part 8

# Funding the wastewater project

- 8.1 KDC now had to find a new way of funding the project. Although the private sector partner would still fund the construction costs for the first five years, KDC had to fund it after that. KDC's Treasury Management Policy meant that it could not simply borrow the money. In the first half of 2003, KDC brought together several different mechanisms to fund the project. It summarised the expected costs and funding mechanisms in the Statement of Proposal that was released for community consultation in July 2003.
- 8.2 In this Part, we discuss the various funding mechanisms that were proposed and the issues that arose with them between 2003 and 2007, as follows:
- KDC borrowing and the policy of debt segmentation;
  - obtaining a subsidy from the Ministry of Health;
  - the 2003 Statement of Proposal and charges to the ratepayers;
  - problems with the July 2004 development contributions policy;
  - changes to financing policies in 2006; and
  - our comments.
- 8.3 In summary, we conclude that:
- There was no evidence that the Council did any systematic planning or budgeting for the funding of the project as a whole.
  - The Council's changes to its Treasury Management Policy in 2006 meant that it effectively no longer had any borrowing limits for the wastewater project.
  - The Council failed to get legal and treasury advice about the change to its Treasury Management Policy.
  - The tools that the Council wanted to use to fund the scheme were operating under new legislative requirements. The Council needed to understand what those requirements were and how they affected its ability to use those funding tools. As funding from those tools was critical to the ongoing affordability of the scheme, the Council needed to ensure that the details of the tools it proposed to use were lawful at an early stage. It did not do this.

## Kaipara District Council's borrowing and the policy of debt segmentation

- 8.4 In 1998, KDC's Treasury Management Policy set its income-to-debt ratio at 2.5:1. This meant that KDC needed \$2.50 of income for every \$1 of debt. Earlier in 2002, the Council reviewed its Treasury Management Policy and concluded that the policy was working well. However, there were some concerns about the

limits imposed on borrowing for infrastructure projects. KDC commissioned a consultant, Mr Larry Mitchell, to investigate the effect that introducing “debt segmentation” might have on borrowing ratios.

- 8.5 Segmentation of debt is basically breaking down total debt into parts. The parts are typically associated with different assets and the different communities that use them. It appears that what was being proposed was that KDC could have a lower income-to-debt borrowing ratio, depending on the extent to which KDC’s debt could be classified (or segmented) as being “fully performing”, “partly performing”, or “non-performing”. Mr Mitchell classified “fully performing” debt as:

*...when “user pays” revenues derived from associated revenue earning asset categories or classes is sufficient to fully recover all costs including the debt servicing costs, principal repayments and interest of the debt attached/associated with the relevant asset classes.*

- 8.6 Mr Mitchell determined that, at that time, 73% of KDC’s total debt was fully performing and that this exceeded other “peer” councils’ proportions for this category of debt. He advised that, provided that the level of fully performing debt did not fall below 65% of KDC’s debt and because the wastewater scheme debt was not included, KDC could change its borrowing limit to an income-to-debt ratio of 2.0:1. This would allow KDC to assume more debt while remaining within the terms of the Treasury Management Policy. The advice to KDC explained why that was appropriate for KDC’s circumstances.
- 8.7 In October 2002, the Council agreed to consult on the proposal to change the Treasury Management Policy by including debt segmentation and changing the income-to-debt ratio as part of the 2003/04 Draft Annual Plan process.
- 8.8 The Council discussed that decision, and that it should soon be able to borrow more, in its January 2003 meeting about how it was going to fund the scheme. This increased ability to borrow was a critical part of the funding plans.
- 8.9 The Council formally adopted the lower income-to-debt ratio of 2.0:1 in the 2003/04 Annual Plan.

## Application for a subsidy from the Ministry of Health

### The Sanitary Works Subsidy Scheme

- 8.10 The Ministry of Health introduced the SWSS in May 2002. The aim of the SWSS was to improve sewage treatment and disposal for small communities that would otherwise not be able to afford sewerage schemes and to meet public health and resource management requirements. The award of a subsidy depended on the

local authority agreeing to match the amount awarded with an equivalent district contribution.

- 8.11 The SWSS guidelines provided that the size of the works eligible for subsidy was based on the estimated population of the “participating community” in five years’ time. KDC was required to agree to ensure that the subsidy’s benefits were passed on to the “participating community”.
- 8.12 There was a three-stage process for an application to the Sanitary Works Technical Advisory Committee (SAWTAC):
- a preliminary application, to establish whether the project would be likely to qualify or whether it needed more work, and the percentage of the capital cost that was likely to be available through the subsidy;
  - an application for provisional acceptance, which required a proposal that would enable the amount of subsidy to be identified and funding to be reserved for a set period while consents were obtained and financing confirmed; and
  - the final application for subsidy had to be submitted for final endorsement once the detailed engineering design was completed, resource consents issued, all funding arranged, and the applicant was ready to commit to construction contracts.

### **Kaipara District Council’s preliminary application**

- 8.13 In late 2002 and early 2003, KDC had a policy of users paying for the costs of infrastructure they benefited from. This conflicted with the requirement in the SWSS guidelines that the local authority provide a contribution from across the district. The PSC acknowledged that KDC’s user-pays policy did not enable a district-wide contribution. In a briefing paper prepared for a meeting with the Ministers of Local Government and Health, KDC noted that “For a large predominantly rural Council with isolated communities this approach would be politically unacceptable.”
- 8.14 At its January 2003 meeting, the Council decided to submit an application to test its eligibility. It also resolved to consider its position about the issue of district-wide subsidies while developing a negotiation strategy with which to lobby the Government to modify the guidelines.
- 8.15 Beca managed the SWSS application on behalf of KDC. It submitted a preliminary application to the Ministry of Health in March 2003. It was approved in May 2003.

## The provisional application

- 8.16 KDC submitted a stage 2 provisional application on 1 July 2003. The estimated capital costs of the scheme were listed at \$15 million, broken down as follows:
- treatment plant, \$2.6 million;
  - reticulation, \$11.3 million; and
  - disposal system, \$1.1 million.
- 8.17 Initially, this provisional application was not approved. This was because it did not contain a design report or a programme/cash flow and because the estimated cost of the scheme was not designed for a projected population in five years' time. SAWTAC was also concerned about the apparent uncertainty with the method and long-term security of effluent disposal (at that stage, the site for disposing of the treated effluent had not been determined). It was also concerned about the proposed methods of managing the risk that the asset would not be in the condition required under the contract at the 15-year handover point. It invited KDC to submit a revised application.
- 8.18 KDC provided further information in November 2003. Estimated capital costs had now increased to \$16 million (excluding the estimated \$2.5 million of costs to connect individual properties). KDC provided details of the interim guaranteed maximum price of \$16.8 million agreed with Simon Engineering (\$800,000 of which was KDC costs) and the annual initial operating costs of \$600,000. In the application, KDC also stated that the DBFO process it had adopted meant that there could be no cost increases outside its direct control.
- 8.19 The application provided the statistics in Figure 3 about the then-current population and KDC's growth projections until 2009. The statistics assumed a 6.7% annual increase in population and dwellings.

**Figure 3**  
**Beca's population projections, November 2003**

	2003	2004	2005	2006	2007	2008	2009
No. of dwellings	1272	1357	1448	1545	1649	1759	1877
Week day population	2786	2972	3171	3384	3611	3853	4111
Weekend population	3116	3325	3548	3786	4039	4310	4599
Summer peak population	5622	5999	6401	6830	7287	7776	8297

Source: Additional information provided to SAWTAC for SWSS Application, November 2003, Section 9.

- 8.20 On 25 November 2003, SAWTAC recommended provisional approval of a subsidy of \$6.63 million, including GST. The subsidy was based on an estimated capital cost of \$20.8 million (\$18.5 million excluding GST) and amounted to 31.89% of the capital cost. The approval noted that the scheme was based on a population of 5622, the summer peak population in 2003. The Ministry of Health advised KDC on 16 December 2003 that the Minister of Health had approved the provisional application and agreed to provide a subsidy of \$6.63 million. The Ministry also advised that the SWSS criteria had been amended to allow local authorities to determine how their districts would meet their contribution (equivalent to the SWSS subsidy).
- 8.21 The SWSS subsidy reduced KDC's funding requirement. This meant that KDC now needed to borrow \$6.63 million less or could reduce its other funding sources.

### **First Statement of Proposal and charges to the ratepayers**

- 8.22 KDC needed to prepare a Statement of Proposal on the scheme to consult the community with. The draft Statement of Proposal was provided to the Council at its meeting on 23 July 2003, where it was adopted for public consultation.
- 8.23 The Statement of Proposal set out that the wastewater scheme proposed by Simon Engineering was a "fully reticulated scheme with a single centralised treatment plant and disposal to land with the opportunity for beneficial reuse". It noted that Mangawhai's ability to fund the required works was limited and that this "...has undoubtedly been a contributing factor for some in the community to object to any proposed scheme".
- 8.24 The Statement of Proposal provided information about how the proposed wastewater scheme was to be implemented, how much it would cost, and how it would be funded, including the rates and charges that ratepayers would pay. It set out that the project to implement the scheme would be a DBFO type of PPP.
- 8.25 The Statement of Proposal included a section headed "Cost". This section stated that Simon Engineering had "provided the lowest Net Present Value cost for the project and also demonstrated the greatest flexibility in being able to adjust its payment schedule to meet Council requirements". It stated that the pre-tender estimates were for capital costs of less than \$17 million and annual operating costs of \$800,000 (with adjustments to be made for inflation and population growth) and that Simon Engineering's tendered costs were within that. It is unclear what these figures were based on, because they were not the same as the benchmark figures. In particular, the annual operating cost in the benchmark had been estimated to be \$290,000 in 2002, rising to \$375,000 in 2027.

- 8.26 The Statement of Proposal noted that KDC had required Simon Engineering to finance the cost of construction for the first five years of operation only, with KDC then needing to refinance the capital cost after that time. It stated that Simon Engineering had provided the estimated costs of operating the scheme over the 15-year life of the contract. KDC had then developed a model to calculate the “start-up fees” (which would fund the capital cost of the scheme) and annual rates (which would fund the annual operating costs) that ratepayers would pay over 25 years.
- 8.27 Section 11 of the Statement of Proposal set out how this mix of “start-up fees” and annual rates would fund the scheme, as shown in Figure 4.

**Figure 4**  
**Fees and annual rates included in the 2003 Statement of Proposal**

Fee and annual rates	Current ratepayer	Future ratepayer
Start-up fee	\$1,450 inc GST	\$16,312.50 inc GST
Annual rates 1-2 pans	\$483.75 inc GST	
Annual rates 3+ pans	\$483.75 inc GST + \$50 per extra pan in excess of 2	

- 8.28 The model assumed that \$5.5 million of the debt associated with funding the capital costs would remain owing after those 25 years and that the \$5.5 million would be paid off over the next 15 years. That is, the model assumed that the debt associated with funding the capital costs would be paid off over 40 years. The Statement of Proposal noted:
- The assumption of a 40 year period to completely fund the initial scheme addresses the issue of intergenerational equity. This means that a future generation which benefits from capital investment in infrastructure now, will also contribute to the cost of that infrastructure.*
- 8.29 The model also incorporated the annual operating costs.
- 8.30 The Statement of Proposal noted that the Council had decided the assumptions on which the funding model was based after receiving feedback from the community. It stated that:
- The primary consideration in this respect has been that current ratepayers should not carry the full burden of funding the proposed scheme to the benefit of future ratepayers.*

### The proposed annual rates for operating costs

- 8.31 As Figure 4 shows, the proposed annual rates would be differentiated on the basis of the number of pans on a property, regardless of the type of property. This was not consistent with the Local Government (Rating) Act 2002, which provided that, if rates were to be differentiated on that basis, then a residential property was to be treated as having one pan, regardless of the number of actual pans on the property.
- 8.32 After consultation, the Council changed the proposal so that only commercial properties would pay a differentiated rate depending on the number of pans. It also changed from talking in terms of current and future “ratepayers” to current and future “sections”. A section was defined as a section with a “separate title” as at 22 October 2003.

### The proposed “start-up fees”

- 8.33 Although the Statement of Proposal did not specifically refer to development contributions, it seems that the “start-up fee” for future ratepayers was intended to be a development contribution. It was described as “a charge of contribution levied under the Local Government Act 2002 to fund the infrastructure at the time of connection to the service”.
- 8.34 The Statement of Proposal noted that “all existing undeveloped sections (properties without a habitable dwelling and or existing system) within the area will be considered as future sections for charging Start Up Fees”.
- 8.35 The Statement of Proposal also explained that the proposed rates and fees did not include the costs of connecting existing premises or households to the scheme. It set out that owners of properties would be responsible for getting the plumbing work done to connect their properties, although it noted that KDC might look at this issue again.
- 8.36 The Statement of Proposal set out three options for existing residents to pay the start-up fee:
- pay in full at March 2004 (and receive a \$100 discount);
  - pay in full by March 2005; or
  - make four payments during 2004/05.

- 8.37 The Statement of Proposal set out what areas were included in the drainage district – that is, the areas that would be serviced by the scheme. It outlined the risk allocation and noted that “The Project Deed or contract between the Kaipara District Council and Simon Engineering will clearly spell out the responsibilities allocated to each party and the associated risks.” It also noted that, although Simon Engineering had considered a range of disposal sites for the treated effluent, the disposal site was still to be decided.
- 8.38 The process KDC used for the 2003 Statement of Proposal is set out in more detail later in this Part. The Council set up a Hearings Committee to hear and consider submissions. The Council considered the Hearings Committee’s recommendations on 22 October 2003 and confirmed that it would continue with the scheme.
- 8.39 The Council made several changes to the Statement of Proposal because of the Hearings Committee’s recommendations. These included changing the terms “current and future ratepayer”, the boundaries of the drainage district, and how the annual rate for residential and commercial properties would be levied. The Council changed the annual rate so that residential properties paid a uniform rate regardless of the number of pans on the property. Commercial properties paid a differentiated rate depending on the number of pans on the property.
- 8.40 In late 2003, EPS sought advice from Bell Gully about several issues with the proposed rates and development contributions. Beca told us that this was done as a variation to the original scope of the services that the project managers would provide under the contract. Bell Gully provided its final advice in February 2004. That advice confirmed that, generally, KDC could use development contributions if they were provided for in a development contribution policy and if the amount of the contributions met the requirements of the Local Government Act 2002. The Chief Executive provided this advice to the Council at its 25 February 2004 meeting.
- 8.41 A report to the same Council meeting included a table (as shown in Figure 5) setting out an updated proposed charging regime. This regime no longer mentioned start-up fees. Instead, it referred to uniform standard charges and development charges, with the development charges increasing for sections with titles issued after 1 July 2004.



**Figure 5**  
**Funding regime proposal**

NO	CLASSIFICATION	ONE OFF CHARGES		TOTAL	PAN CHARGES	
		Uniform Standard Charge	Development Charges		Residential	Non residential
1	Current section	\$1,450.00	\$0.00	\$1,450.00	\$483.75 per section	\$483.75 per pan
2	Future section Resource consent & Title issued prior to 1/7/04	\$1,450.00	\$14,862.50	\$16,312.50	\$483.75 per section	\$483.75 per pan
3	Future section Resource consent granted prior to 1/7/04 but title not issued		\$16,312.50	\$16,312.50	\$483.75 per section	\$483.75 per pan
4	All other future sections		\$16,312.50	\$16,312.50	\$483.75 per section	\$483.75 per pan

Source: Paper to the Council on Mangawhai EcoCare Project, *Confirmation of Preferred Proponent and Agreement to Proceed*, dated 17 February 2004, page 3.

8.42 The reasons for decision in the Council minutes stated:

*The proposed regime has been legally checked and complies with all statutory requirements while being the proposal considered most appropriate by Council following its deliberations during the special consultative process.*

## Problems with the July 2004 development contributions policy

8.43 Beca prepared a draft policy for KDC providing for the collection of development contributions for the wastewater scheme. We could not establish from KDC's records whether KDC officers were involved in preparing this policy. However, Beca told us that the draft policy was prepared in full consultation with the Chief Executive and KDC officers. The policy does not seem to have been legally reviewed. The Council consulted on the policy using the special consultative procedure under the Local Government Act 2002. The Council adopted the policy, which came into effect from 1 July 2004.

8.44 The 2004 Development Contributions Policy provided that development contributions would fund 60% of the capital cost of the scheme. The policy did not take account of the requirement in the Local Government Act 2002 that

development contributions must be linked to growth and can only be used to recover capital expenditure that was necessary for growth.

- 8.45 Although KDC's 2004 Long-Term Council Community Plan (LTCCP) included the Development Contributions Policy, neither the funding impact statement nor the Revenue and Financing Policy included development contributions as a funding mechanism or the amount to be collected as development contributions, as required by the Local Government Act 2002.
- 8.46 KDC's files show that it soon became apparent that several developers were interpreting the Development Contributions Policy in a way that had not been intended. One problem was confusion about whether the developer or the subsequent purchaser of a section was liable to pay the development contribution. KDC sought legal advice in March 2005. The law firm Brookfields advised KDC to amend the policy. KDC issued a Statement of Proposal amending the policy in March 2005.
- 8.47 Several submitters raised other issues than those KDC had sought submissions on and challenged other aspects of the policy, including its compliance with the requirements of the Local Government Act 2002 and its retrospective effect.
- 8.48 KDC again sought legal advice from Brookfields, who advised that it could "not be confident that the Policy, with or without amendments to the development contributions categories, would survive legal challenge".
- 8.49 In June 2005, after communications from a solicitor acting for several developers, KDC sought further legal advice about the policy. Brookfields recommended that KDC consider suspending the policy and reviewing it. At that point, KDC had not collected any development contributions, even though the policy had come into effect in July 2004. At its meeting on 24 August 2005, the Council resolved to suspend the application of the policy until it adopted a revised policy.

### Changes to financing policies in 2006

- 8.50 It appears that the Council reviewed both the Revenue and Financing Policy and the parts of its Treasury Policies relating to borrowing in 2005. KDC's files and the draft 2006-16 LTCCP are not particularly clear, but it appears that KDC intended to consult on these two policies as part of the 2006-16 LTCCP process.
- 8.51 KDC's Treasury Policies included a "Borrowing Limits Policy". This policy classified KDC's debt into two groups: core debt and segmented debt. The policy then set out the criteria for classifying debt into the two groups. The main borrowing limit in the policy was the income-to-debt ratio of 2:1. However, the policy provided that segmented debt was to be excluded when determining the amount of debt for the purposes of the ratio. This was a significant change from the previous policy.

- 8.52 The rationale for the policy change appears to be that:
- This separation of debt into two broad tiers or categories, (those of “Core” debt and “Segmented” debt) has become necessary due to the significant increases of Council borrowing proposed to finance local (sub-District) infrastructural water and wastewater asset development schemes such as “Mangawhai EcoCare”.*
- 8.53 The policy defined core debt as “the normal and customary level of Council borrowing (loans)”.
- 8.54 The policy defined segmented debt as “debt identified using strict definitions and criteria that meet the tests as set under ‘the Provisions of Segmented Debt’”. The policy further noted that it was finance that “had been raised to fund the development of local sub-District level infrastructural utility assets”.
- 8.55 The Council also amended its Revenue and Financing Policy – in particular, the debt provisions. The amended policy provided detail on when KDC could classify debt as segmented debt. The Revenue and Financing Policy stated:
- The Council has, since its last Revenue & Financing Review (conducted in 2003), entered a new debt-raising environment. This has led to the development of new methods of managing higher debt levels and has been made necessary for the following reasons:*
- *New infrastructure asset developments (for example the Mangawhai “EcoCare” scheme) that involve very large capital requirements and result in major increases in the Council debt.*
  - *Existing Kaipara District Council debt level maxima are exceeded with the inclusion of these added debt-funded developments.*
- 8.56 The Borrowing Limits Policy and Revenue and Financing Policy also provided that those who benefited from the infrastructure asset would repay segmented debt associated with that asset through mechanisms such as targeted rates or development contributions. The criteria for debt segmentation included that the amount recovered through such mechanisms would need to be:
- ... sufficient to meet all scheme funding and servicing costs and is available directly to the Council, as a full recovery of all of the costs of development capital funding as well as costs related to the asset, including depreciation and the costs of debt servicing associated with the asset.*
- 8.57 Mr Mitchell told us that he provided some advice on debt segmentation to KDC but that he was not involved in finalising the changes to the policies. He told us that “the clear purpose of the segmented debt policies was to ensure that debt to finance EcoCare was always matched by Mangawhai revenues derived from the usage charges from the scheme sufficient to support the project’s debt servicing costs”. He also told us that at all times he “cautioned prudent debt levels”.

## Our comments

- 8.58 Our main concern about the work done on funding is that we found no evidence of any kind of systematic planning and budgeting for funding the project as a whole. Work was done on individual issues when they arose, and documents were prepared for individual purposes, such as the SWSS application and the formal community consultation. However, that work did not draw on any internal KDC system for managing the project. We saw no documentation to suggest that a system for planning, management, reporting, or budget purposes existed.
- 8.59 The result has been that it is difficult to get a clear and consistent overall picture of the project's costs and KDC's funding proposals. Different documents use different figures and terminology. The estimated costs changed quickly, and the likely funding sources were not precisely defined. The Council does not seem to have tracked what the estimated costs were going to be or how it was going to fund them within the parameters of the funding sources available and in keeping with KDC policy. We have tried to reconstruct that picture for ourselves during this inquiry, but it has not been possible to do so with any precision. The summary in Appendix 5 shows the quality of the information.
- 8.60 In our view, this level of informality is totally inappropriate for a project of this size and complexity, with the financial constraints that the Council was working under. Although the project managers might have done formal project management for the work they were carrying out, the scope of their services were limited. The Council needed to understand what issues the project managers were not managing and keep general oversight of the project. We could find no evidence that the Council did either.

## Borrowing policy and debt segmentation

- 8.61 The work that KDC did to review its borrowing limits in 1998, and between 2002 and 2004, was careful. It included an analysis of how KDC was positioned compared to similar local authorities. The borrowing limits that required annual income to be two and a half times the amount of debt, and then two times the amount of debt, were conservative but reasonable based on the advice the Council received.
- 8.62 However, the change in the debt policy in 2006 that excluded segmented debt from being subject to any borrowing limits does not seem to have been as well thought through by KDC. We formed this view for a number of reasons.
- 8.63 First, comments in the debt policy noted that KDC had entered a new debt-raising environment and that the debt policy was changed out of necessity. Commenting that the change was made out of necessity, rather than setting out a rationale

for the change, suggests a view that the change had to be made regardless of its merits.

- 8.64 Second, although the provisions in the policy for debt to qualify as segmented looked sensible, there was a level of subjectivity in them, and the provisions did not include borrowing limits for segmented debt. Setting borrowing limits is helpful because it provides an objective measure. At the time, section 104 of the Local Government Act 2002 required the Council to include specific borrowing limits in its policies. In our view, excluding segmented debt from borrowing limits did not comply with the intent of the legislation and reduced the focus on affordability of total KDC debt.
- 8.65 Third, the concept of segmented debt as something quite separate from KDC debt is not accepted practice in any other local authorities. Other local authorities that managed their debt internally by breaking it down into parts did so under an overall council debt strategy with overall borrowing limits applying to total council debt.
- 8.66 Fourth, KDC did not seek independent legal and treasury advice about the change to its debt policy. Given that financing policies are required by legislation, that KDC's policy was different than other local authorities, and that changes to the policy appeared to be driven by necessity, it would have been prudent for KDC to get independent legal and treasury advice.
- 8.67 Fifth, when assessing whether debt is within borrowing limits, it is important to ensure that the right revenue and debt amounts are used. Under KDC's policy, the segmented debt and the associated revenue that would be used to service and repay that debt needed to be excluded from the amounts used. We noted that, when it assessed the borrowing limit on core debt, KDC did not explicitly exclude the revenue associated with the segmented debt. This resulted in the revenue associated with segmented debt being accounted for twice. It meant that the Council was making financial decisions on the basis of artificially inflated revenue to service and repay the core debt. KDC's former Chief Executive and Mr Mitchell both told us that the debt segmentation policy was not intended to be applied in this way.

### Charges to ratepayers

- 8.68 In our view, the Council needed to closely manage the expected cost and funding for the scheme, given that affordability was such an issue. In particular, it needed to understand:
- the funding model that PwC (Australia) had developed;
  - the growth projections that the funding model relied on;

- the mechanisms proposed for funding the cost of the scheme; and
- the risks – for example, if growth did not occur as projected.

- 8.69 KDC's former Chief Executive told us that the funding model was initially fully explained to the Council and that councillors indicated that they had a good understanding of it. He noted that, when additional connections were proposed to be added, the funding model would be reworked and reported to the Council incorporating the new costs. He told us that this was done at workshops "so the Council could be fully informed and ask as many questions as it needed to understand the matter". He also told us that the mechanisms to fund the cost of the scheme, including when refinancing was needed (when the loan expired), the length of time over which the financial model was run, and how each of the elements of the cash flow contributed to this were all explained to the Council initially at workshops and then each time the PwC (Australia) model was reworked.
- 8.70 We discuss the growth projections the funding model relied on, and risks if that growth did not occur, in Part 11.
- 8.71 As we have set out above, there are risks to providing information such as this in workshops when the papers then do not form part of KDC's records behind its decisions. Because there were no records of workshop meetings, we were unable to confirm what KDC's former Chief Executive told us.
- 8.72 The main funding for the scheme was going to come from charges to ratepayers over the life of the scheme. These included development contributions and rates. These revenue tools are tightly constrained by the Local Government Act 2002 and the Local Government (Rating) Act 2002. In our view, the Council should have considered the legal detail of the charging mechanisms available to it from the outset. Instead, the early papers and funding proposals are written in high-level terms using language that does not match the terms used in the Local Government Act 2002 and the Local Government (Rating) Act 2002.
- 8.73 In our view, the Council did not pay enough attention to the need to ensure that its charges complied with the law. The problems with the clarity and enforceability of the initial Development Contributions Policy meant that development contributions were not able to be charged for much of the time during which growth occurred.

## Part 9

# Changing the contractor

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9.1 In late 2002, the Council selected Simon Engineering as the preferred proponent and began negotiations. In early 2003, it decided to continue those negotiations on a modified basis. In this Part, we set out:

- the due diligence work that was done on Simon Engineering and its parent company;
- the Council's 2003 decision to finalise a contract with Simon Engineering;
- the decision in 2004 that the contract was ready to sign;
- the withdrawal of Simon Engineering's status as preferred proponent in early 2005;
- how the Council engaged with the other two bidders;
- the Council's decision to contract with EarthTech;
- what was finally agreed with EarthTech in 2005; and
- our comments.

9.2 In summary, we conclude that:

- KDC did not have good records of the information it relied on when making decisions about the project. The information that we were able to locate was inadequate in some cases. If this was the only information the Council relied on, then, in our view, the Council would not have been able to properly assess what it was being asked to make decisions on.
- KDC's advisers and the Chief Executive understood that there were risks in negotiating with Simon Engineering. It is not clear that the advisers and Chief Executive communicated those risks to the Council.
- The Council's decision to negotiate with EarthTech and NorthPower, once Simon Engineering's parent company went into administration, was not robust.
- The Council had no information to enable it to determine whether the contract with EarthTech was more cost-effective than KDC building and operating the scheme itself. Nor could it determine whether the price was competitive.
- The Council signed the contract without resolving the disposal site issue.
- The Council failed to get independent legal or financial advice about the contracts with EarthTech.

## Due diligence report on Simon Engineering and Henry Walker Eltin

- 9.3 EPS asked an Australian company to prepare a *Due Diligence and Financial Viability Report* on Simon Engineering and its parent company, HWE. The report was provided in May 2003. It concluded that:

*HWE has demonstrated its short term financial viability for the purpose of acting as guarantor of the obligations of Simon Engineering (Australia) Pty Ltd as contractor on the KDC wastewater treatment plant project. Its longer term viability is more problematic and depends on the company's ability to turn around its financial performance. Our generally positive conclusion is conditional on the implementation of the following recommendations:*

- 1. HWE to provide a satisfactory performance guarantee to KDC to support the obligations of Simon Engineering (Australia) Pty Ltd on this proposed project;*
- 2. KDC to continue monitoring the financial position of Simon Engineering (Australia) Pty Ltd and HWE Group generally, including a review of its audited financial statements of the year ended 30 June 2003, before contractual execution (if possible); and*
- 3. KDC to ascertain whether ABN Amro has provided a firm commitment to finance this project, in the light of recent events which may cast doubt upon the creditworthiness of HWE.*

- 9.4 As a result, EPS suggested to the Chief Executive that the same company do a follow-up review of Simon Engineering's and HWE's 2002/03 financial results and that some amendments be made to the Project Deed. It also recommended that, because of the conservative approach taken in the report, the next meeting of the PSC should just be given a summary. The EPS representative would have a copy of the full report with him at the meeting for discussion.

- 9.5 KDC has not been able to locate records of any PSC meetings after 2 May 2003, so we cannot establish whether the report was discussed with the PSC. There was no reference to the report in any minutes of Council meetings. We could not establish what KDC did in response to the recommendations in the report.

## The Council decides to finalise negotiations with Simon Engineering

- 9.6 The Council meeting on 28 May 2003 considered a report from the Chief Executive, prepared on behalf of the PSC, as well as an outline for a Statement of Proposal to consult the community with. The report noted that the Council



intended to proceed with Simon Engineering, using a DBFO type of PPP, provided that Simon Engineering:

*... could demonstrate competitive financing options. This was considered to be the most effective means of progressing the project given the extent of resources committed to date.*

- 9.7 The report discussed the range of financing options that Simon Engineering and ABN Amro had provided. The interest rates payable could be fixed for terms of five, 10, or 15 years. The amount owing at the end of those terms could vary from 100% of the value of the loan being owed at the end of five years (where only interest was being paid) to 0% of the value of the loan being owed at the end of 15 years. The report noted that:

*The high risk period is within the first 5 years and therefore the PSC recommends pursuing a Five Year Fixed Interest rate with 100% residual value.*

- 9.8 The capital costs of the project were now given as \$15 million. Annual operating costs in year 1 were \$500,300, rising to \$1,115,800 by year 25. The report also noted that the disposal site had yet to be finalised. However, Simon Engineering had included in the capital cost the most expensive disposal option at that time, which was discharge to the Carter Holt Harvey forest land south of the estuary.

- 9.9 The report recommended that the PSC:
- conclude negotiations with Simon Engineering and ABN Amro;
  - resolve the preferred disposal site option with Simon Engineering; and
  - prepare a final Statement of Proposal, based on the outline, to consult the community with.

- 9.10 The Council largely accepted the recommendations. It resolved to proceed with a five-year-term loan, under which only interest was paid. At the end of 25 years, 37.5% of the loan would still be owing. The Council agreed that the “start-up fee” would be \$1,200 plus GST for existing residents and \$14,400 for future residents. It also resolved that ratepayers would be responsible for connecting their properties to the scheme.

- 9.11 In February 2004, at a workshop, the Council received a presentation from its project managers about the project. The Council meeting later that day also discussed the wastewater scheme. By this time, negotiations with Simon Engineering had been under way for some time. The Chief Executive sought confirmation from the Council that it wanted to proceed with the project and enter into a contract with Simon Engineering.

- 9.12 The paper the Chief Executive put to the Council set out the process to date, the results of negotiations to date, increases in the construction cost, and the likely rates and development contributions. It also attached advice from Bell Gully on rates and development contributions. The paper also noted that the proposed loan did not comply with the Council's Treasury Management Policy. However, it recommended that the Council use section 80 of the Local Government Act 2002 and treat the debt for the scheme as an exemption to its Treasury Management Policy.<sup>1</sup> It noted that the only outstanding issue in the negotiations with Simon Engineering was the disposal site:

*Simon Engineering does not wish to do any work on this until it has a contract with Council. Council will recall that the Te Ari (sic) Point option was the most expensive and that savings were envisaged. However, as will be noted under the discussion on subsidy some contingency is being allowed.*

- 9.13 When discussing the risk profile and risk matrix, the paper also set out:

*The major changes have resulted from the change from BOOT to DBFO approach with the Council now being required to be the owner of the assets. At the highest level, the inherent commercial risks associated with a DBFO are greater than with a BOOT, as Council must rely on its ability to call the Parent Guarantee if necessary. Under the previous BOOT approach Council would assume ownership of the assets as a first step, with the guarantee called to cover any losses. The assets would always have some inherent value even if performance in some areas was not being achieved.*

*Whilst this change has occurred the key construction risk remains with Simon Engineering and Council will not be required to commence any payments until Commercial Acceptance has been achieved which means at least 2 months of successful operation. Council will then have five years interest only period after which time the Council's risk position will have improved significantly which is expected to lower refinancing costs regardless of which refinancing option is selected.*

- 9.14 The Council adopted the recommendations in the Chief Executive's report. It confirmed that it wished to proceed with the project. It also confirmed that it would enter into a contract with Simon Engineering, subject to several issues, including that the risk profile adopted by the Council was maintained and that the total cost of the project did not exceed \$17.6 million. The Council also resolved to use section 80 of the Local Government Act 2002 and treat the debt of the project as an exemption to its Treasury Management Policy.

<sup>1</sup> Section 80 enables a council to make a decision that is inconsistent with its own policy. As part of the decision, it must clearly identify the inconsistency, the reasons for it, and any intention of the council to amend the policy or plan to accommodate the decision.

## The Council decides the contract is ready to sign

- 9.15 In his monthly reports to the Council, the Chief Executive provided high-level information to the Council on the progress of contract negotiations. In August 2004, the Chief Executive provided the Council with another report on the project. The report noted that there had been “a robust and strenuous negotiation of the contract document” with Simon Engineering. The costs of the project had increased, with construction costs rising to \$16.1 million and fees and interest increasing to \$2.9 million. However, the rates and charges set out in the Statement of Proposal could still be achieved.
- 9.16 The report provided some information about the legal documents that were to be signed. However, it provided very limited information about the proposed financing arrangements. There was no information about the bank fees or interest that would be payable or whether the financing costs were competitive.
- 9.17 The report noted that one of the main changes was that KDC would own the scheme from commercial acceptance. This would mean that KDC would have a greater role “...in monitoring regulatory changes, changes in treatment standards and all proposed reuse arrangements”. The report also included a table on the risks that had been identified as part of the initial risk allocation exercise, who these risks were now allocated to, and how they were dealt with in the Project Deed. However, neither the report nor the table identified that KDC might need to increase the amount of its oversight of the construction process. Nor did they mention that KDC would need to check that the scheme was fit for purpose before it took ownership.
- 9.18 The report recommended that the contract as drafted and agreed between Simon Engineering and the Council be executed and that the project proceed. The Council agreed with this recommendation at its meeting on 25 August 2004.
- 9.19 This decision was subject to the Chief Executive and KDC’s Finance Leader making a final decision about repayment of KDC fees. This related to cash flow difficulties that KDC was having with paying for Beca’s services. In September 2004, KDC’s Finance Leader and Chief Executive recommended to the Council that ABN Amro loan KDC \$800,000 to pay for KDC’s costs associated with the project. It is unclear in that paper whether it was intended that this amount was to form part of the larger loan for purchasing the wastewater assets and when it would be paid. The paper noted that the interest and fees ABN Amro charged on the \$800,000 loan would be slightly lower than those charged by BNZ. This calculation appeared to assume that this amount was the total of the loan. However, if the amount were to form part of the larger loan for purchasing the wastewater assets, the financing costs would likely be different.

## Kaipara District Council withdraws from negotiations with Simon Engineering

- 9.20 By September 2004, the contract had still not been signed. In mid-September 2004, EPS advised the Chief Executive that there had been significant changes at HWE and Simon Engineering. He noted that HWE's website said that the original Simon Engineering business unit had been split up and that Simon Engineering was the loss-making part of HWE's business. He noted that:
- From some of my contacts, the restructure has provided significant staff issues over recent times but it is not being bedded down and the general view is that HWE will be much better for it. Unfortunately all this has occurred since shortlisting although we have always pointed out that [Simon Engineering] would not be as easy to manage thru the negotiations as EarthTech for example but cost has been a major issue...The strong point of the HWE business is its history on delivery of building projects well, and although they are hard players, I believe they will deliver.*
- 9.21 In an email to the Chief Executive dated 27 September 2004, EPS advised that "We are all concerned that, even if a deal is signed with [Simon Engineering], management of the project will now be exceptionally difficult and risky." EPS indicated that it had informally approached EarthTech to see whether that company would be prepared to take up preferred proponent status if it were removed from Simon Engineering. EPS had previously worked with EarthTech on a large project in Australia. The email noted that "They are very professional and I would have great confidence in achieving a good result."
- 9.22 In early October 2004, the Chief Executive went to Australia and met with Simon Engineering's Chief Executive to discuss the project.
- 9.23 It appears that HWE, Simon Engineering's parent company, started experiencing financial difficulties around November 2004. In January 2005, the Chief Executive advised the Council that HWE was "undergoing a refinancing programme" and that a new investor was proposing to make a significant investment in the company, subject to a due diligence process. As a result, Simon Engineering could not yet sign the Project Deed. However, on 31 January 2005, HWE was placed in voluntary administration and trading in its shares was suspended.
- 9.24 On 9 February 2005, the Council held a special meeting. It resolved to withdraw Simon Engineering's preferred proponent status and begin negotiations with EarthTech and NorthPower again. These were the other two companies short-listed in the RFP process in 2002. This meeting took 15 minutes. There are no records of what was discussed at that meeting nor of whether any papers were presented to the Council.

- 9.25 KDC's former Chief Executive told us that the Council had little choice but to proceed with negotiations with the other two bidders:
- Community expectation and opinion was that the Council needed to proceed with the project quickly. There was also official pressure on Council to do this ... Had Council not expedited the project it would have been publicly pilloried.*

### Engaging again with the other two bidders

- 9.26 EPS had discussions with EarthTech before the Council meeting, and EarthTech indicated it was interested. It wanted a 10-week time line for negotiations. EarthTech indicated that it was comfortable with ABN Amro providing the finance until the end of construction. EarthTech was also comfortable with KDC and ABN Amro entering into a separate loan arrangement for the purchase of the assets. EarthTech had also discussed this with ABN Amro.
- 9.27 EPS also had discussions with NorthPower, although we were unable to determine when these took place. In emails in KDC's files, dated after the Council meeting on 9 February 2005, NorthPower also indicated that it was interested. However, a NorthPower email dated 11 February 2005 noted that:
- The commercial rational[e] that motivated NorthPower to submit its original (BOOT) offer, has changed significantly with the changes to a DBO approach. A good starting point to facilitate the negotiations would be to discuss and agree the commercial principles of the DBO approach with the KDC, before further effort goes into modifying our offer and reviewing the Project Deed.*
- 9.28 The Chief Executive advised the Council at its meeting on 23 February 2005 that both companies were interested. The Chief Executive also noted that ABN Amro had indicated that it was interested in providing finance on a similar basis to the arrangements with Simon Engineering, with either NorthPower or EarthTech. The Council resolved to award EarthTech and NorthPower preferred proponent status so that discussions could begin with both parties. The proposed timetable for negotiations was tight.
- 9.29 The Chief Executive sent a letter the next day advising the companies of the Council's resolution and setting out the timetable. Negotiations were to be completed by 8 April 2005, and the contract signed by 22 April 2005. The letter also gave the companies until 4 March 2005 to advise whether they accepted the following terms of negotiation:
- *Acceptance of the amendment from a BOOT style contract to that of a DBFO arrangement*
  - *Acceptance of the amended term from 25 years to a maximum of 15 years in line with the LGA 2002*

- *Acceptance in principle of the current DBFO documentation including Project Deed and Schedules as provided in January 2005*
- *Acceptance of the concept of Guaranteed Maximum Price for the delivery of the capital component of the project.*

9.30 NorthPower declined the invitation on 3 March. The company stated that the commercial rationale that had motivated it to submit its original proposal had changed with the change to a DBFO. It would need to establish a business case, which would require a thorough technical and financial evaluation of the concept. NorthPower stated that it would not be able to do this by the dates specified in KDC's letter. Some informal discussion continued, until NorthPower wrote to KDC on 4 April 2005 advising that it did not wish to be considered a preferred proponent for the project.

9.31 Negotiations continued with EarthTech.

### The Council's decision to contract with EarthTech

9.32 On 1 June 2005, EarthTech presented its "concepts for designing, building and operating the EcoCare system" at a Council workshop. At the next Council meeting, on 1 June 2005, the Council agreed to enter into a contract with EarthTech to:

*...deliver the Design, Build, Finance and Operate EcoCare System based on their presentation with a maximum construction price of \$26,264,000 on a Guaranteed Maximum Price basis and a maximum annual operating cost of \$748,000 plus inflation.*

9.33 The Council resolved that the Chief Executive should:

- have a financial analysis carried out;
- report to the Council on funding options for the project, including connection fees, development contributions, and annual charges;
- provide a recommendation on the preferred funding option;
- have the funding model checked for compliance with the Local Government Act 2002 and other relevant legislation; and
- report on the legal advice as part of his recommendation on the funding options.

9.34 KDC files included an article to be included in the *Mangawhai Memo* in June 2005 that advised the community that the project was back on track with EarthTech. It explained that it was "anticipated that costs to the users will be maintained at the same levels as previously advised although they will be indexed to inflation

to account for the delays in starting the project". It noted that the financial modelling would need to be redone but that the community would be kept informed. Full consultation would be required "if there are any significant changes to any part of the project".

- 9.35 The Council held a workshop on 25 August 2005 to discuss the wastewater project and the proposed contract. The Council meeting was held after the workshop. In KDC's files, we found a one-page paper by the Chief Executive included in the minutes of the Council's meeting and a copy of a draft presentation. We could not establish whether any other papers were provided to the Council at the workshop or the formal meeting.
- 9.36 The minutes of the Council's meeting records that the Chief Executive's paper stated:
- The detail of the Project along with the funding models had been fully explained to Council at the workshop that preceded the Council meeting, The funding model will be dealt with as part of the Development Contributions policy item and had been considered by Council in a public item following this item*
- 9.37 The information contained in the Chief Executive's paper and draft presentation was very brief. In particular, the only information about the financing arrangements was that ABN Amro had offered a loan of \$31 million and that the project team had reviewed this and considered it appropriate.
- 9.38 The Chief Executive's paper advised that:
- EarthTech's proposal was "significantly higher" than Simon Engineering's. This was because of several factors, including higher initial capital costs, inflation, and increased financing costs.
  - The level of charges for ratepayers agreed in June 2005 could be maintained if KDC got additional SWSS funding of about \$3 million. The paper noted that changes to the subsidy scheme meant that the project was likely to qualify.
- 9.39 The draft presentation discussed the effect of the increased costs on the funding options and set out the new proposed charges. We did not find any evidence in KDC's files that the funding options had been legally reviewed, as the Council had asked.
- 9.40 The Council accepted EarthTech's draft offer and gave the Chief Executive delegated authority to accept the final proposal, provided it did not differ adversely from the draft documentation the Council considered. There were no copies of the draft documentation that was provided to the Council in KDC's files. The final proposal included a construction price of \$26,264,000 "and a tolling

arrangement that delivered an annual charge of \$711,050 based on the scope as currently agreed". The scope was for up to 1970 allotments. The Council also agreed to accept the loan facility offered by ABN Amro up to a maximum of \$31 million.

- 9.41 The Council accepted the contract with EarthTech, subject to EarthTech obtaining the necessary resource consents and the Council adopting the funding proposals in keeping with the Local Government Act 2002.

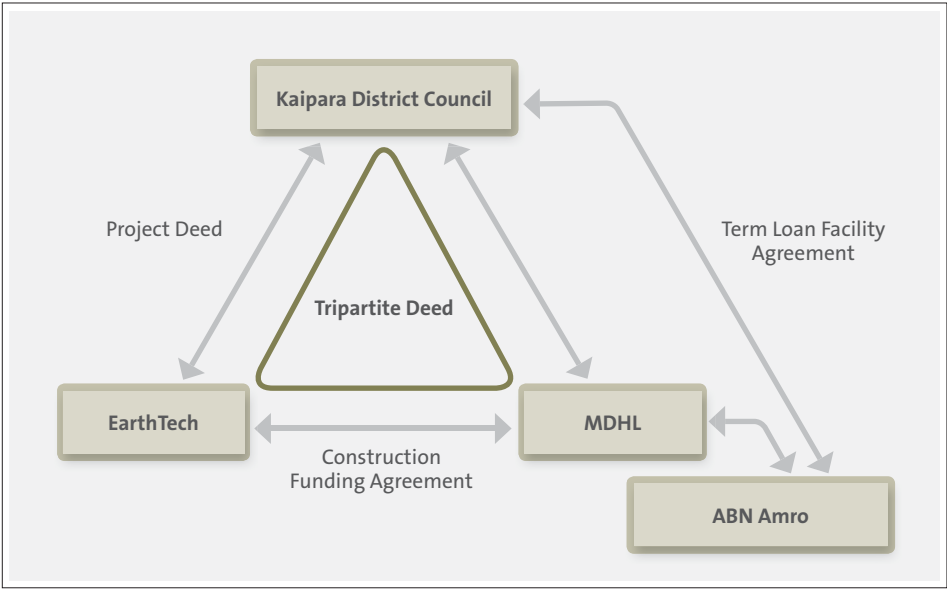
## What was finally agreed with EarthTech in 2005

### What did the contract documents provide?

- 9.42 The main contractual and financing documents for the project were signed on 26 October 2005. The documents were:
- a Tripartite Deed between KDC, EarthTech, and Mangawhai Development Holdings Limited (MDHL – a wholly owned subsidiary of ABN Amro);
  - a Project Deed between KDC and EarthTech;
  - a Term Loan Facility Agreement between KDC and ABN Amro; and
  - a Construction Funding Agreement between EarthTech and MDHL.
- 9.43 Between them, these documents provided that:
- EarthTech would construct the wastewater scheme;
  - MDHL would make progress payments to EarthTech for constructing the scheme and would progressively own the scheme as it was constructed;
  - MDHL would sell the scheme to KDC once the construction was completed;
  - KDC would use a loan from ABN Amro to purchase the scheme from MDHL, secured by KDC's rating revenue;
  - EarthTech would operate the scheme for 10 years, with a five-year right of renewal; and
  - KDC would make annual payments to EarthTech for the operating costs.
- 9.44 The relationship between the parties is shown in Figure 6. Other significant points from the contracts are summarised in Figure 7.



**Figure 6**  
**Contractual relationships between Kaipara District Council, EarthTech, ABN Amro, and Mangawhai Development Holdings Limited**



**Figure 7**  
**Significant points from the contracts**

Significant points from the contract documents
<p><b>Project Deed</b></p> <p>The Project Deed would not be operative until EarthTech had obtained all consents and KDC had completed all procedures required by the Local Government Act 2002.</p> <p>The scheme would include a wastewater treatment plant with capacity to service up to 2500 sections.</p> <p>The scheme would start by servicing 1216 properties.</p> <p>Ratepayers would arrange their own connections to the network.</p> <p>There would be a guaranteed maximum price of \$26,264,923 for construction. If actual costs were lower, EarthTech would get half the value of the difference.</p> <p>Treated effluent would be disposed to Mangawhai Park, but Schedule A noted that “this option will not proceed and the Council will work with the Promoter to identify a suitable alternative site”.</p> <p>Beca and EPS would carry out technical audits of the scheme before ownership was transferred to KDC at the end of construction.</p> <p>There would be standards that EarthTech had to meet when operating the scheme and penalty provisions if those standards were not met.</p> <p>There would be an initial annual operating payment of \$711,050 and a system for annual recalculation of the operating payment.</p> <p>Separately, KDC would pay EarthTech actual power costs plus 10%.</p>

#### **Tripartite Deed**

EarthTech would construct the scheme.

MDHL would make progress payments for construction and take progressive ownership of the scheme as it was constructed.

Interest would accrue on the progress payments.

Once complete, KDC would buy the scheme from MDHL using a loan from ABN Amro.

There would be a formula to calculate the purchase price, using actual construction costs, interest on the construction progress payments, and bank fees. If the project was completed on time and for the guaranteed maximum price, the price would be \$29,811,423, including bank fees of \$1,114,500 and \$1,632,000 in interest payments over a 24-month construction period.

Bank fees included a commitment fee of \$50,000 provided the Project Deed conditions for beginning construction were met within six months. If the conditions were not met by 26 March 2006, additional commitment fees of \$8,333 each month were payable until they were achieved.

#### **Term Loan Facility Agreement**

The loan would be drawn down in one lump sum.

The loan would be used to purchase the scheme from MDHL at the price set in the Tripartite Deed.

Interest only would be payable on the loan.

The loan would be for a five-year term.

The loan would be secured against KDC's rating revenue.

A bank arrangement fee would be payable (based on 1.5% of the value of the loan), as well as bank expenses in preparing the documentation.

- 9.45 KDC's main contractual protections against poor construction and maintenance were:
- the process of endorsement of the design of the scheme;
  - the technical auditing process during construction;
  - the technical acceptance and commercial acceptance at the end of construction;
  - warranties and indemnities provided by EarthTech;
  - the ability to reduce the monthly operating payments if performance standards were not met; and
  - the requirement for asset condition reports and maintenance to bring the scheme up to standard.
- 9.46 The contract was now for only a 10-year period (with a five-year right of renewal) instead of 25 years. Because the capital cost was to be paid at the end of construction, the amount paid for the monthly operation of the scheme was significantly lower. This lessened the financial effect on EarthTech if the

monthly payments were reduced for non-performance. There was also no parent guarantee. The first three mechanisms were available before construction ended, and the last three mechanisms available once construction ended.

### What advice did the Council get?

- 9.47 EPS sought legal advice about the agreements from Bell Gully. Bell Gully provided a letter to KDC's Chief Executive setting out its involvement in preparing each of the agreements. A schedule to the letter summarised the terms of the agreements. Bell Gully set out that EPS had instructed it to assist with some aspects of the project. In particular, Bell Gully assisted EPS with negotiating and completing the core part of the Deed, excluding the schedules. It also advised EPS on the negotiation of the Tripartite Deed and Term Loan Facility Agreement. Bell Gully confirmed that the Project Deed (not including the schedules), Tripartite Deed, and Term Loan Facility Agreement reflected EPS' instructions to it and its advice to EPS. Bell Gully also confirmed that, on that basis, the documents were appropriate for the Council to execute and rely on. Bell Gully noted that the confirmation assumed that the Council was satisfied with:

*...the structure of the Mangawhai EcoCare Project, the matters in respect of which KDC will need to satisfy itself, the commercial terms of each of the Project Documents, and the risks and obligations assumed by KDC under the Project Documents... We have not been privy to the full background of the Mangawhai EcoCare Project or all of the business drivers relevant to it.*

- 9.48 There was no information in KDC's files to show the nature of the legal advice EPS sought from Bell Gully. The Council did not seek its own legal advice about the agreements before signing them. This meant that there was no legal review of the schedules to the Project Deed, which contained core aspects of the agreement.
- 9.49 Beca told us that the contractual documents were based on similar documents that were used in Australia. EPS had been part of the consortium to bring expertise in these arrangements to the project. Beca noted that the review by Bell Gully had been qualified because Bell Gully had not been directly involved with the Council in risk workshops and similar meetings, so it was not able to know what risks the Council was prepared to accept. Beca stated: "Again there was a reliance on the Chief Executive to obtain advice and recommend a way forward to Council."
- 9.50 EarthTech told us that, in its experience, the contractual documents were not unusual or inconsistent with what was used in the market.
- 9.51 The financing arrangements contained in the Tripartite Deed and Term Loan Facility Agreement were complex. There were very few documents in KDC's

files about the financing arrangements, which EPS negotiated on KDC's behalf. We found no evidence in KDC's files that KDC staff or EPS sought independent financial advice about the financing arrangements. Nor did we find anything to suggest that there had been any assessment of whether the financing arrangements offered by ABN Amro were competitive or provided value for money. There was no information in KDC's files to show what the Council was told about the financing arrangements at the Council's August 2005 meeting.

- 9.52 As we set out later in the report, some of the bank fees – the commitment fees – started running from the date the financing arrangements were signed. To avoid incurring higher fees, the Council needed to ensure that the project deadlines in the financing arrangements were met. However, this did not occur. Given the lack of information about the financing arrangements given to the Council, it is possible that it did not understand that decisions affecting the timing of the project would also increase the financing costs.

## Our comments

### **Kaipara District Council's record-keeping was poor**

- 9.53 We are disappointed at the state of KDC's records, both for regular Council meetings and for this project. Time and again, we have been unable to locate basic documents or to establish what papers were provided at meetings. For something as significant as the wastewater project, this is not acceptable. Records for regular and formal business, such as Council meetings, should also be complete.
- 9.54 One particular issue highlighted in this inquiry is the practice of providing information to the Council at workshops. Workshops can be a very useful forum for open discussion, but councils can only legally make decisions in council meetings. In our view, there are risks if the council is given information in workshops that is not also provided in some form in the council meeting where the decision is made. Such a practice means that decision-making is not transparent and that accountability is weakened. The public cannot readily understand the reasons for decisions or the information the council relied on in making those decisions.
- 9.55 In this case, these problems were exacerbated by the very poor records associated with Council meetings.

### The Council did not have good enough information when it made decisions

- 9.56 This contracting process revealed numerous examples of the Council making important decisions with very little information formally before it. We usually expect a council to have full information about all important matters relating to the contract before making a decision. These matters include:
- the full costs of the contract;
  - a precise description of what was to be delivered;
  - the process for making variations to the contract;
  - roles and responsibilities for managing the contract while work was under way;
  - the financing arrangements and their cost;
  - assurance that appropriate expert checks had been carried out and were satisfactory; and
  - copies of any legal advice that had been provided.
- 9.57 In our view, the information that the Council had formally before it when it took the decision to finalise negotiations with Simon Engineering was not adequate. In particular, it had very little information about the financing costs.
- 9.58 The decision in August 2005 to accept the terms that had been negotiated with EarthTech was based on even less information. In June 2005, the Council resolved that the Chief Executive provide it with information about the financial analysis, funding options, and legal compliance. This was not done. All we found on the files for the 25 August 2005 meeting was a one-page paper and a draft presentation. The Council does not seem to have objected to the fact that the Chief Executive had not provided it with the information it had asked for.
- 9.59 We do not consider it satisfactory that, given the large amount of money involved and the long-term nature of the contract, there was not a written paper setting out in some detail the arrangements that the Council was being asked to consider. If the Council had only the information contained in the one-page paper and the draft presentation, the Council could not have had enough information to make an informed decision about whether to contract with EarthTech or whether to obtain loan financing from ABN Amro. Yet, as the Chief Executive noted in the agenda paper for the workshop on 25 August 2005:
- This will be one of the largest undertakings this Council will commit itself to and it is essential that all members of Council are fully informed and understand the information provided before the Council considers making a decision.*

- 9.60 When we spoke with some people who had been councillors at the time, they commented that they thought they had good information and were kept informed. We acknowledge that it is possible that a great deal of information was provided to the Council through the regular workshops. However, there are no records of these. We repeat the point that, for accountability purposes, information needs to be clearly provided to the Council as part of the formal meeting process and recorded in the Council's files.

### **The Council took a risk with Simon Engineering**

- 9.61 Many people expressed concern to us that the Council did not do enough due diligence on Simon Engineering and should not have negotiated with it because there was some risk. Having reviewed what was done, we are satisfied that KDC's advisers carried out reasonable checks, understood the risks associated with this potential partner, and monitored developments. Beca told us that EPS advised KDC not to enter into the contract with Simon Engineering until the due diligence exercises had been completed. Beca considered that this was proved to be sound advice with the voluntary administration of HWE.
- 9.62 We have not been able to establish how much information was disclosed to the Council about the risk of continuing negotiations with Simon Engineering from May 2003 (when EPS received the due diligence report). We conclude that KDC took a risk that simply did not pay off.

### **The decision to negotiate with EarthTech was not robust**

- 9.63 When negotiations with Simon Engineering fell through, KDC approached the two other bidders from the previous tender process. When NorthPower advised that it was not interested, KDC moved to direct negotiation with EarthTech.
- 9.64 In our view, this was not a sound process. The tender process had taken place three years before and was based on a very different type of arrangement. The information the tender process had provided on the market and what was competitive was unlikely to be very relevant or reliable. We did not see any evidence to suggest that the Council considered going back to the market and running a fresh tender process using current information. The Council had missed the opportunity to rethink its approach when the Local Government Act 2002 changed the nature of the commercial arrangements, and it missed a similar opportunity here.
- 9.65 In any event, in 2002, EarthTech's bid had been the most expensive and had exceeded the benchmark figure. The purpose of the benchmark is to determine whether it is more cost-effective for the public entity to construct and operate

the asset itself compared to the private sector. It was also clear that the cost and affordability of the wastewater scheme was a significant issue for the Mangawhai community. There was no information in KDC's files to suggest that KDC had assessed EarthTech's bid in 2005 against a revised benchmark figure.

- 9.66 We have concluded that, when the Council agreed to the contract with EarthTech, it had no way of knowing whether the contract provided better value than KDC building and operating the scheme itself or whether the price was competitive.

### **The contract was signed with a major issue still unresolved**

- 9.67 A major issue was left unresolved in both the contract negotiated with Simon Engineering and the contract signed with EarthTech. The Council was agreeing to pay for a sewerage scheme when a disposal site had not been identified. This created a large degree of uncertainty for the rest of the project. Resource consents could not be applied for, the design of the wastewater treatment plant could not be confirmed, and, most importantly, the costs remained uncertain. This risk was not discussed in the papers that were presented to the Council in August 2005.
- 9.68 EPS told us that:
- All parties understood the risk, however Council elected to proceed as they could lock in the base price for the treatment plant based on EarthTech original proposal. This mitigated the risk of additional cost increases from EarthTech.*
- 9.69 One of the main benefits of PPP approaches such as the BOOT model is that purchasers can avoid detailed specification and checking of requirements along the way, because they are buying "the whole package". Instead, the contract specifies and enforces the outcome or service being purchased. That benefit was undermined in this case, when the contract was signed with a major issue still unresolved. The Council was buying roughly two-thirds of what was needed to deliver the services. This significantly changed the benefits and risks of the arrangement. The Council does not appear to have appreciated that it was increasing its own risks by taking this step.

### **The contract documents had not been properly reviewed**

- 9.70 In our view, the Council should have had the contract documents reviewed by its own legal and financial advisers before it signed them. The partial advice that Bell Gully provided to EPS when the documents were negotiated was explicitly caveated. It was not a substitute for the Council obtaining its own advice.
- 9.71 Similarly, we found no evidence in the files to suggest that the Council or the consultants considered whether the financing arrangements provided by ABN

Amro were competitive with financing that was available in the local government sector at the time. If the information given to the Council on the financing arrangements was restricted to that contained in KDC's files, then, in our view, that information was woefully inadequate.

- 9.72 We identified several possible concerns with the contract documentation. These concerns suggest that the detail might not have been properly reviewed by anyone. For example:
- The size of the treatment plant specified in Schedule A is much bigger than the size of the scheme specified elsewhere in the documents.
  - As we discuss later in the report, the capacity of elements of the wastewater treatment plant were significantly oversized for the anticipated flows, and their capacity was significantly reduced in the 2007 Project Deed.
  - The time allowed for fulfilling the conditions in the Project Deed was probably unachievable. In practice, it took an additional 17 months to reach that point, resulting in additional costs.
- 9.73 We also consider that the legal arrangements and documentation were overly complex. The speed with which the Council moved from the proposed BOOT arrangement and associated contract documents meant that the parties continued to use those documents as a starting point. Indeed, KDC required that as a condition when it approached the other parties. However, the arrangements were now quite different and much simpler. In our view, the failure to start again when the basic arrangement changed in January 2003 meant that the project worked with unnecessarily complex legal and financial arrangements and documentation.



## Part 10

# Finding a disposal site for the effluent

- 10.1 In August 2005, the Council decided to sign the contract documents and commit itself to the arrangement with EarthTech and ABN Amro. However, it did so with a major issue still unresolved. There was no certainty about how or where the effluent would be disposed of. From the initial community consultation in 1999, the Council had a clear position that disposal should be to land, not water. However, none of the sites that had been considered so far were acceptable.
- 10.2 In this Part, we explain what was done to secure a disposal site and the consequences of those decisions. We cover:
- who was responsible for finding a disposal site;
  - EarthTech's work on possible sites;
  - the Council's decision to buy the farm at Lincoln Downs;
  - reports on the suitability of the farm for wastewater disposal;
  - increases to the purchase price;
  - how KDC paid for the farm; and
  - our comments on this process.
- 10.3 In summary, we conclude that:
- When the Council signed the contract documents in 2005, the disposal site had not been identified. This created a significant risk for the project and left KDC in a weak bargaining position when purchasing a site.
  - The costs for disposal were estimated in the contract signed in 2005 as being \$361,000, but ended up costing an estimated \$14 million.
  - The Council should have resolved the disposal site issue before it signed the contractual documents in 2005.

### Who was responsible for finding a disposal site?

- 10.4 In the early project documents, the risk of finding a disposal site was allocated to the promoter. The 2005 Project Deed stated that the treated effluent was to be disposed of to Mangawhai Park, and there was provision for this in the guaranteed maximum price. However, Schedule A also noted that "this option will not proceed and Council will work with the Promoter to identify a suitable alternative site".
- 10.5 As we discuss below, the documents in KDC's files indicate that EarthTech was actively looking for a disposal site until KDC made the draft offer to purchase the Lincoln Downs farm.
- 10.6 We discussed this issue with KDC's former Chief Executive. He told us that none of the three original tenderers had identified suitable disposal sites, and so the

Council agreed to find a suitable disposal site. This understanding continued with EarthTech. We could find no record of this decision in the Council's minutes. The shift in responsibility for a major project risk does not appear to have been taken into account in the contract documents. There were risks and potentially increased costs in taking back the risk of identifying a suitable disposal site.

### EarthTech's work on disposal site options

- 10.7 In late 2005, EarthTech commissioned some work to identify options for disposing of treated effluent from the wastewater scheme. The commissioned report assessed five locations for disposal and identified the Mangawhai Golf Course and Mangawhai Park as the two preferred options. Preliminary technical studies on the two sites identified potential adverse environmental effects. The Golf Course looked more promising, but more work was needed to decide if it was a feasible option.
- 10.8 By March 2006, EarthTech had prepared its own report assessing treatment and disposal options for the wastewater scheme. EarthTech identified four potential disposal sites: farmland, the Mangawhai Golf Course, Mangawhai Park, and the Mangawhai sand spit. It evaluated each site against a variety of criteria and then assessed the treatment levels required for the different sites. The report concluded that "The only sustainable disposal options that are likely to be readily consentable are those involving irrigation at a farm property."
- 10.9 EarthTech recommended treating the effluent at the wastewater treatment plant at Mangawhai Park, then pumping it to a farm in Brown's Road for irrigation. At that stage, EarthTech had not identified a suitable farm property, although it had considered two properties, including one at Lincoln Downs that was then for sale.

### Kaipara District Council offers to purchase the Lincoln Downs farm

- 10.10 In early March 2006, EarthTech provided a draft of the assessment report to EPS. EPS gave the draft to KDC's Chief Executive on 10 March. EPS noted that, if KDC wanted to purchase the Lincoln Downs farm, it needed to move swiftly. Apparently, an agreement to sell the property to developers was close to being finalised.
- 10.11 On 24 March 2006, there was a meeting between staff from EarthTech, EarthTech's consultants, KDC's Chief Executive, and staff from Beca about disposal options. The minutes record that EarthTech would investigate and report on the "environmental and viability issues re council-owned farm option" and that there were other parties interested in the farm.

- 10.12 KDC's Chief Executive emailed an EarthTech employee on 29 March 2006. The email says that the solicitor acting for the vendors had advised him that KDC had to get its offer in by the end of 30 March 2006. However, the vendors were prepared to accept an offer that was made subject to due diligence. The Chief Executive's email notes that:
- Speaking to my Councillors today they are very keen to proceed with the purchase of this farm for a land based disposal. They see long term strategic advantage.*
- 10.13 There is an email in KDC's files dated 30 March 2006 from EPS to Bell Gully, providing Bell Gully with information to prepare an offer of \$4.7 million to purchase the farm. The email states, "As discussed, [the Chief Executive] understands that for [EarthTech] to purchase the ... property would be difficult due to overseas purchase issues and is therefore happy for Council to make a direct offer on the following basis..." We assume that the reference to "overseas purchase issues" is a reference to the controls on overseas companies purchasing farm land in the Overseas Investment Act 2005.
- 10.14 In KDC's files, we found a copy of the draft agreement for sale and purchase of the farm prepared by Bell Gully on 31 March 2006. There were no copies of the correspondence between Bell Gully and the solicitor acting for the vendors in KDC's files, so we could not establish whether this agreement was provided to the vendors. The draft agreement was made subject to the "approval of the relevant finance committee" of the Council after the due diligence period. The approval or refusal by the Committee was a matter within the "Committee's absolute and unfettered discretion".
- 10.15 The draft offer included a purchase price of \$4.75 million. It is unclear how KDC decided on this amount, because it had not had the property valued at that time. The LIM report obtained by KDC in October 2006 recorded that the capital value for the property was \$3 million, with improvements of \$800,000. It was also unclear how KDC would fund the purchase of the farm.
- 10.16 The Chief Executive emailed a copy of the draft agreement to the Mayor and Councillor Tiller on 4 April 2006. He noted that "[The vendors] seem to have accepted the offer subject to due diligence." A later email from Bell Gully in July 2006 notes that "The contract was only ever agreed 'in principle' but they would not sign until the roading issue was resolved." We discuss the roading issue further in paragraphs 10.28-10.29 and 10.34.
- 10.17 KDC's former Chief Executive told us that there was a workshop with the Council where he received instructions to purchase the farm. ABN Amro would provide the

financing to keep the total financing of the project inside the contract. There were very few records of workshop presentations in KDC's files generally, and we were unable to find any copies of workshop presentations about the purchase of the farm. As a result, we could not confirm these matters from KDC's files.

### The Council provisionally approves the purchase

- 10.18 At the Council meeting on 24 May 2006, the Chief Executive presented a paper to the Council about the disposal site issue. The paper referred to work EarthTech had carried out on the disposal site options. The paper noted that the sand spit, Mangawhai Park, Mangawhai Golf Course, and another property (which was considered for irrigation only) had disadvantages. The Lincoln Downs property did not have these disadvantages.
- 10.19 The minutes of the meeting refer to EarthTech having provided a "confidential technical report" supporting the recommendation to purchase the farm. The report was not in KDC's files. We do not know what the report was or whether it was actually provided to the Council.
- 10.20 The Chief Executive's paper advised that a conditional agreement for sale and purchase had been signed and attached a copy of the draft agreement. The minutes record that the Council approved in principle the purchase of the Lincoln Downs property as the final disposal site, subject to a full report being provided to the Council to enable it to finally approve the purchase. The full report was to address:
- the technical acceptability of the site;
  - the use of the rest of the property; and
  - how the purchase would be funded.
- 10.21 The draft Statement of Proposal on the wastewater scheme, issued for community consultation in February 2006, noted that the exact location of the disposal site was still to be determined and that both KDC and EarthTech were "investigating possible reuse options to minimise the amount of discharge required". It explained that the process would be completed as part of the preparation for the application for resource consents.
- 10.22 On 24 May 2006, the Council knew that it had a conditional agreement to buy a particular property. It knew the proposed purchase price and that there would be additional capital expenditure to make the disposal site feasible. There is no reference to this updated information in the LTCCP that was adopted on 7 June 2006.

## Reports on the suitability of the Lincoln Downs farm

- 10.23 In June 2006, EarthTech prepared a report on disposal options that included work that consultants had carried out for it. The report considered three disposal options – the Mangawhai Golf Course, the sand spit, and farmland – and concluded that disposal to:
- the Golf Course was neither practical nor sustainable;
  - the sand spit would be difficult to obtain consent for, and the wastewater would be likely to discharge across the beach above low-tide levels; and
  - the Lincoln Downs farm land was the “primary consentable option”.
- 10.24 Although the farm was the best option, the report noted some problems:
- The specialist advice to EarthTech was that the irrigation capacity of the farm was limited. The maximum irrigable area on the farm was about 50 hectares, because the bush area on the farm was not suitable. However, the projected needs were:
    - In 2015, 110ML of storage capacity and 60 hectares of pasture for irrigation; and
    - In 2027, 153ML of storage capacity and 91 hectares of pasture for irrigation.
  - A geotechnical report advised that the proposed dam site would need significant engineering work to make it suitable for storing the treated wastewater.
- 10.25 The report also noted that, if disposal was to farm land, the scheme would need to include increased disinfection at the treatment plant, a transfer pipeline, a storage dam, and an irrigation network. The estimated capital cost for this option, including the purchase of the farm, was \$10 million.
- 10.26 KDC’s former Chief Executive told us that the Council saw the report. Again, we were unable to confirm this from KDC’s records.
- 10.27 As we set out in the next Part, in September 2006 the Council considered a paper from Beca and EPS on growth assumptions and sizing of the scheme. That paper noted that the reuse site was predicted to reach capacity in 2014 if the population growth was 3.5%. The paper set out that, when capacity was reached, additional storage volume and additional irrigation area could be constructed. The paper also noted that additional reuse agreements could be entered into with users.

## The purchase price increases

- 10.28 In August 2006, the Council considered a paper from the Chief Executive setting out that the vendors were seeking to increase the purchase price for their land. The vendors had been subdividing another part of their land, and the subdivision consent issued by KDC required that the vendors upgrade a road that had not been constructed to the appropriate standards. The vendors' consultants estimated that the upgrade to the road was going to cost \$332,721.90.
- 10.29 The Chief Executive's paper set out that the vendors maintained that the road upgrade "increased the value of the property the Council was buying by providing high quality access right around the property. Consequently they were now asking for this amount to be added to the purchase price." The Chief Executive stated that "The [vendors] in the past have said if they cannot get the money they require from the land they will withdraw from the sale, something they can do." The purchase price was now \$5,113,396.90. This included the original purchase price, the additional \$332,721.90 requested, and other fees of \$30,675.
- 10.30 At its meeting on 23 August 2006, the Council agreed to the revised purchase price, subject to due diligence being completed.

## How Kaipara District Council paid for the farm

- 10.31 The Chief Executive asked Beca to investigate whether the farm land KDC was purchasing could be subdivided, so that KDC could sell land that it did not require for irrigation or the dam site. Beca investigated this possibility and advised in September 2006 that the costs of developing the subdivision were likely to be more than the sections could be sold for.
- 10.32 EPS had been discussing the need to extend the financing facilities for the wastewater scheme with ABN Amro. In September 2006, the Chief Executive received a proposal from ABN Amro for revised financing, which included funds for purchasing the farm. ABN Amro required KDC to provide a copy of the valuation of the farm and a copy of the sale and purchase agreement. In an email to EPS, the Chief Executive noted that KDC did not have a sale and purchase agreement or a valuation at that time.
- 10.33 KDC had the farm valued later in October 2006. It estimated that the capital value of the land and buildings was \$4.1 million, more than \$1 million lower than the amount the Council had agreed to pay.
- 10.34 The Council agreed to execute the agreement for sale and purchase at its meeting on 22 November 2006. There was no record in KDC's files of any papers on this issue being provided to the Council at the meeting. KDC's former Chief Executive

told us that “The Council was fully informed on these matters. A purchase would not have been authorised if this information was not available and the Council satisfied.” KDC signed the final agreement for sale and purchase in December 2006. The final purchase price paid was less a sum of \$302,721 kept by KDC for roading works that the vendors had not completed and a bond of \$151,630 for those works.

- 10.35 The deposit of \$300,000 (plus \$10,000 for ABN Amro’s legal fees) was payable in January 2007. KDC had arranged financing from ABN Amro to purchase the farm. The Term Loan Facility Agreement agreed in October 2005 was amended so that KDC could draw down the deposit amount in January 2007. The Term Loan Facility Agreement was amended again in April 2007 to enable KDC to draw down the balance of the purchase price (\$4,934,406), the vendor’s other fees (\$34,509), and ABN Amro’s legal fees of \$5,625. Interest was payable on the amounts drawn down, and this interest was capitalised into the cost of the scheme.
- 10.36 The Amendment to the Term Loan Facility Agreement included an acknowledgement by the parties that the amendment was an interim solution to KDC’s financing needs and that the parties intended to enter into a future loan arrangement.
- 10.37 We did not find any papers in KDC’s files indicating whether KDC staff or the project managers assessed whether ABN Amro’s proposal for providing finance to purchase the farm was competitive with finance available in the local government market. There was also no evidence that the Council discussed the financing arrangements for the farm. As we discuss in paragraphs 12.34-12.43, the arrangements for financing the farm purchase were changed in December 2007.
- 10.38 Because of the farm purchase, the wastewater scheme required additional works. These included constructing an 11km pipeline from the treatment plant to the farm, adding a UV disinfection process to the wastewater treatment plant, constructing a dam to store the treated effluent, and installing an irrigation scheme on the farm. Although it is not clear from KDC’s records, we estimate that these costs and the purchase of the farm (and financing costs for purchasing the farm) added another \$14 million to the cost of the scheme.
- 10.39 We note that the Project Deed signed in September 2005 included \$361,000 for disposal costs. The \$14 million was additional cost for KDC, which needed to be funded.

## Our comments on the purchase of the farm as a disposal site

- 10.40 The way the Council dealt with the question of a disposal site is a striking example of the poor overall planning for, and project management of, the wastewater project. Our understanding is that it is usual for the disposal site to be the starting point for developing a wastewater scheme. This is because the disposal system affects so much of the design of the rest of the scheme, including the location and specification of the treatment plant and cost. To leave this issue unresolved until after a contract for the rest of the project had been signed created significant risk for KDC. It also left KDC in a very poor bargaining position when purchasing a site because it needed a site urgently and had no other options. We have already commented that, in our view, it also undermined much of the benefit of a PPP contracting approach.
- 10.41 Beca told us that the disposal site proved to be problematic from the beginning of the project. The issue was constantly raised and was difficult to resolve before the scheme's design had substantially progressed. The Council rejected EarthTech's original proposal of irrigating the treated wastewater to Mangawhai Park, which was adjacent to the treatment plant. As a result, the Council was left with a remote land-based disposal site.
- 10.42 The 2005 Project Deed suggests that identifying a disposal site was a shared risk, but KDC ended up negotiating and purchasing the Lincoln Downs farm – in part, because of the legal restrictions on its Australian-based partner buying rural land. However, we confirmed that the contract price did not include any provision for actually purchasing land for a disposal site, so there was no double payment of this sum.
- 10.43 We consider that KDC's processes for making this decision were poor:
- The records are partial at best. For example, the written records do not show whether the Council was given all the information about the limited capacity of the site.
  - Decisions seem to have been taken informally (for example, we do not know what formal authority the Chief Executive had to make the initial offer to purchase).
  - KDC did not obtain a valuation for the farm until the bank required it to.
  - We did not see evidence of appropriate work to consider financing and borrowing options, and the value for money of the proposed financing arrangements.



- 10.44 We estimate that the total additional cost arising from the purchase of the farm and associated work was \$14 million. This was a substantial change to a project that was, at that stage, estimated to cost about \$35 million. In our view, the Council should have had information about the full cost of the proposed disposal site before it decided to proceed with the contract. That information should have prompted the Council to stand back and reconsider its approach to the project.
- 10.45 In particular, the increase in capital cost should have caused the Council and community to reconsider their views on disposal to water or land. There was a strong community preference for disposal to land when that question was considered 10 years earlier, but it was now clear that that preference carried a substantial cost. Ideally, people should have been given an opportunity to comment. However, because the rest of the project was already developed and committed to, the Council did not consider that to be feasible. This highlights that the disposal site should have been one of the first issues determined, not one of the last.
- 10.46 We comment on the overall suitability of the farm as a disposal site in Part 19.



## Part 11

# Increasing the scope of the wastewater project

- 11.1 Because of the decision to purchase the farm and the additional infrastructure that was required, the estimated capital costs of the scheme increased. The Council needed to consider how it was going to fund these increased costs over the long term. The guaranteed maximum price in the 2005 Project Deed was \$26.3 million. In October 2006, Beca estimated the costs of the additional infrastructure and the purchase of the farm to be \$11.1 million (excluding financing costs associated with purchasing the farm).
- 11.2 In this Part, we look at the work that was done on possible changes to the scope of the project and the effect on funding. We discuss:
- the 2006 Statement of Proposal put to the community for comment;
  - work to review the assumptions about population growth;
  - the Council's decision in October 2006 on growth assumptions, scope, and charges; and
  - our comments on the decision to change the assumptions and increase the scope of the project.
- 11.3 In summary, we conclude that:
- The Statement of Proposal put out for consultation in February 2006 estimated the capital costs at \$35.6 million, but by October 2006 these had increased to \$57.7 million.
  - As the estimated capital costs increased, the Council sought to keep the scheme affordable by increasing the number of ratepayers paying for it.
  - The data about growth assumptions supporting the increase in the number of ratepayers paying for the scheme was not robust.
  - There was no evidence that the Council considered the risk that growth might be slower than its projections, and therefore it had no plans to manage that risk if it eventuated.
  - It was not appropriate for the Council to put out a Statement of Proposal for consultation in February 2006 and then make significant changes to the scope of the works and cost of the project by October of that year.
  - The Council's focus on the costs to the ratepayer meant that it failed to appreciate the significant increase in the capital costs of the project and the effect on its overall affordability for KDC and the community.
- 11.4 We have not commented on whether the decision not to consult with the community on the increase in the scope of the project complies with the Local Government Act 2002, because this matter is before the High Court.

## The 2006 Statement of Proposal

- 11.5 On 22 February 2006, the Council considered and adopted the draft Mangawhai EcoCare Statement of Proposal, as well as the draft Development and Financial Contributions Policy, for release as part of its draft LTCCP 2006/16 process. The Statement of Proposal recorded that the estimated capital costs for the project were now \$35.6 million, excluding GST but including capitalised interest and fees. The Statement of Proposal attributed the increased costs to general inflationary pressure and the change to EarthTech.
- 11.6 The Statement of Proposal set out how KDC proposed to fund the works. It noted that “In addition to the capital costs the cost of financing the loan must also be addressed as this was a significant component of the overall cost.” The Statement of Proposal did not specify the annual operating costs. The Statement of Proposal included several options for financing the project. KDC’s preferred option was to recover operating costs through uniform annual charges, which would also contribute towards the capital costs. Capital costs were to be funded by debt and then recovered using a combination of uniform annual charges, development contributions, and uniform targeted rates.
- 11.7 The proposed uniform annual charge was \$630.00 (including GST) for residential properties and \$630.00 (including GST) for each pan for non-residential properties.
- 11.8 The Statement of Proposal described the uniform targeted rate (previously called the “start-up fee”) as being:
- ... an “availability charge” for services to the property and access rights to the reticulation network, treatment and disposal process. It will also include the physical connection of existing households to the network.*
- 11.9 It was proposed that the uniform targeted rate would be applied to all sections and would be \$6,862.50 (including GST), except for sections created before 23 March 2002. For those sections, the SWSS subsidy could be applied and the cost was \$2,000.00 (including GST). It was proposed that, for sections created after 23 March 2002, the uniform targeted rate could be paid either as a lump sum or paid off over 25 years. The development contribution would be applied to sections created on and after 1 July 2006 and would be \$11,060.00 (including GST).
- 11.10 Figure 8 illustrates the proposed option.

**Figure 8**  
**The Council's preferred funding proposal**

	Uniform Annual Charges Cost per annum incl GST		Other Charges Cost incl GST	
	Residential	Non residential per pan charge	Uniform targeted rate	Development contribution
Allotment or household unit* created on and prior to 23 March 2002	\$630.00	\$630.00	\$2,000** (one off)	\$0.0
Allotment or household unit created between 24 March 2002 to 30 June 2006 (inclusive)	\$630.00	\$630.00	\$472.50 per annum for 25 years (Year 1 charge only) or \$6,862.50 (one off)	\$0.0
Allotment or household unit created on or after 1 July 2006	\$630.00	\$630.00	\$472.50 per annum for 25 years (Year 1 charge only) or \$6,862.50 (one off)	\$11,060.00 (one off)

\* A household unit in this context refers to subsequent or additional household units above one household unit for each allotment.

\*\* This included the SWSS subsidy.

Source: 2006 *Statement of Proposal*, Option 3.2, page 24.

- 11.11 The Statement of Proposal noted that, after KDC submitted a provisional application, the maximum level of funding possible under the SWSS had been increased from 50% to 90%. The Statement of Proposal advised that KDC had made a revised application to the Ministry of Health seeking an increase in funding.
- 11.12 The Statement of Proposal referred to the draft Development and Financial Contributions Policy that KDC was also consulting on.
- 11.13 The Statement of Proposal stated that the various rates and development contributions were payable for each "allotment or household unit". The term "household unit" was defined as being "subsequent or additional household units over and above one household unit per allotment".

- 11.14 The Statement of Proposal noted that the treated wastewater would be disposed of to land but that the location for this had not been determined. It noted that KDC and EarthTech were also investigating possible reuse options to minimise the amount of discharge required. The Statement of Proposal stated that the estimated capital costs of \$35.6 million included provision for disposal and reuse.
- 11.15 KDC received 271 submissions on its draft LTCCP and heard from 101 submitters. At the meeting on 7 June, the Council adopted its LTCCP with some amendments.

### Reviewing the assumptions about population growth

- 11.16 In late March 2006, around the same time the Chief Executive was putting together the draft offer for the Lincoln Downs farm, he discussed with ABN Amro extending the financing arrangements to cover the additional expenditure on disposal. ABN Amro suggested a repayment regime that followed the increase in the number of ratepayers over time. ABN Amro asked for KDC's projections for ratepayer growth. As a result, the Chief Executive talked to EPS about modelling ratepayer growth.
- 11.17 The 2005 Project Deed provided that the reticulation network would service 1970 allotments and that the wastewater plant would have capacity for 2500 allotments. However, the 2006 Statement of Proposal provided that the total number of sections to be serviced after 25 years was 3300 and that the then-current number of sections was 2000. The Statement of Proposal therefore assumed that the projected growth rate was 2%, or 55 sections, each year.

### September 2006 report on growth assumptions and sizing of the scheme

- 11.18 EarthTech had been carrying out some work to provide KDC with estimates of the cost for the additional work associated with the increased projected growth rate. In August 2006, EPS used those estimates to model the effect these costs would have on rates and development contributions. They based this modelling on different population projections. EPS noted that:

*The modelling demonstrates that the increased costs can be accommodated within the existing rating charges provided the assumptions on the number of ratepayers is increased.*

- 11.19 In an email to KDC's Chief Executive, EPS commented that the figure of 3300 sections after 25 years was conservative, given that there were now 2200 sections. EPS suggested asking EarthTech to use a figure of 3000 sections by the year 2014, which meant an annual growth rate of 7%.

- 11.20 At its meeting in September 2006, the Council considered a report prepared by Beca and EPS about the sizing and growth assumptions EarthTech used for design purposes.
- 11.21 EarthTech assessed the current population and estimated past growth rates. The report estimated that the current permanently resident population was 1650. Using previous census data and the estimate of the present population, it estimated that the annual average population growth rate during the preceding five years had been 6.1%.
- 11.22 EarthTech's work noted that 172 houses had been built between 2001 and 2006. It assessed the subdivision and construction data, and estimated that the growth rate in house construction had been 3% a year during the previous five years. It said that, since 2001, resource consent applications for subdivision had resulted in 875 new lots, although other parts of the report gave different figures. The report stated that "growth has been particularly high during this period and may not continue at this rate".
- 11.23 The report provided to the Council stated that:
- The treatment plant was designed with an initial capacity for 3000 permanent residents and a maximum summer peak of 8100 people for 28 consecutive days.
  - This capacity would be enough until 2014 if the annual population growth rate was 7.8%, and until 2024 if the growth rate was 3.5%.
  - The area to be used for irrigation and storage on the Lincoln Downs farm had a lower capacity of 2200 permanent residents and a maximum summer peak of 5940 people for 28 consecutive days.
  - The storage and irrigation area would reach capacity in 2014 if the population grew by 3.5%, but it would be possible to create additional capacity.
- 11.24 Beca and EPS recommended that the Council accept the proposal designed by EarthTech, adopting the 2014 nominal flows as the basis for designing the storage dam and irrigation network on the farm. The Council accepted these recommendations at its September meeting. EarthTech then submitted its applications for resource consent.

### October 2006 report on growth assumptions and charges to ratepayers

- 11.25 In October 2006, Beca and EPS provided a report to the Council called *Discussion paper on rates and charges*. The paper explained the effect that the proposed changes to the scope of the project would have on the various charges to ratepayers.
- 11.26 The report set out what the proposed changes in the scope of the project were. These included:
- servicing 3000 sections (rather than the 1216 sections provided for in the 2005 Project Deed), which created an estimated additional capital expenditure of \$4.9 million;
  - purchasing the farm and constructing the transfer pipeline, storage dam, and irrigation network, which created an estimated additional capital expenditure of \$11.1 million; and
  - connecting all existing properties, which created an estimated capital expenditure of \$2.35 million.
- 11.27 Other costs had also increased, such as KDC's project management costs, finance costs, and construction price increases and inflation. This brought the estimated project costs to \$57.765 million. The Statement of Proposal that the Council approved in June 2006 had estimated the capital cost at \$35.6 million.
- 11.28 The report also assessed the assumptions about current population and growth. The report stated that the original position the Council adopted was based on a starting number of 1200 sections and assumed a growth rate of 2% each year over 25 years, which resulted in 3300 sections after 25 years. Beca and EPS noted that increased development within the drainage district had resulted in 2784 sections that either were in existence at that time or had submitted resource consent applications.
- 11.29 We note that the figure for current sections in this report was not the same as the figure used by EarthTech or the 2200 figure EPS gave in its email in August 2006. Beca and EPS stated in the report that there were 1216 current sections (the same as in 2001) and 80 miscellaneous developments, as well as what they refer to as 1488 existing developments. They noted that some of the resource consent applications for those existing developments might not be granted. They also discussed that there was possible development immediately outside the drainage district boundaries. We could not establish why different figures were used or which figures were correct.



- 11.30 Beca and EPS then modelled the effects of the increased costs of the project on the various charges to ratepayers. It used forecast section numbers after 25 years of 4000, 4500, 5000, and the original estimate of 3300.
- 11.31 The model assumed that all annual uniform charges would increase by 7% – that is, from \$648.90 (including the Consumer Price Index (CPI) increase from the 2006 Statement of Proposal figure) to \$697.50. The model also assumed that development contributions would increase by 14% – that is, from \$11,391.80 (including the CPI increase from the 2006 Statement of Proposal figure) to \$12,937.50.
- 11.32 The model then provided different figures for the uniform targeted rate depending on the number of sections present after 25 years. Using the status quo projection of 3300 sections, the uniform targeted rate needed to be \$17,276.28. Projections of 4000, 4500, and 5000 resulted in a lower uniform targeted rate.
- 11.33 Beca and EPS recommended that the Council adopt the assumption that 4500 sections would be present after 25 years. This assumption resulted in the following rates and development contributions:
- uniform annual charges, \$742.50;
  - uniform targeted rate, \$8,650.00;
  - uniform targeted rate (before 23 March 2002, with the subsidy), \$3,850.00; and
  - development contribution, \$12,375.00
- 11.34 Beca and EPS noted that there were some risks in using a population projection of greater than 3300. They noted that there was:
- ... some potential that growth rates over time will not achieve the projected number. The risk should be managed by regularly reviewing the growth rates and the level of Rates and Charges received and adjusting the Rates and Charges as required.*
- 11.35 The uniform targeted rate figure for allotments or household units from before 23 March 2002 assumed that the SWSS funds would be applied to the uniform targeted rate for “allotments or household units established prior to 23 March 2002”. The rates and development contributions also included an increase to reflect the annual increase in the CPI. The Beca and EPS report noted that the LTCCP and the Development and Financial Contributions Policy would need to be amended.

## The Council's decision on growth assumptions, scope, and charges

- 11.36 The Council was provided with the Beca and EPS report to consider before the Council's October 2006 meeting. The Council attended a workshop on the day of the meeting, where the Chief Executive and project team gave a presentation. The Council minutes included an outline of the presentation, which shows that the Council was taken through:
- the revised estimated capital costs of the scheme;
  - a breakdown of three different growth scenarios and the corresponding effect on rates and charges; and
  - four different rates and development contributions proposals using projected section numbers of 3300, 4000, 4500, and 5000.
- 11.37 There is no reference in the Council minutes to any discussion about the risks to the funding of the scheme if the growth projections did not eventuate or how those risks could be mitigated.
- 11.38 At the workshop, the Council decided to increase the growth projection to 4500 sections. By doing so, they would be able to divide the now-higher project costs between more ratepayers and so keep the uniform targeted rates at a level similar to that set out in the out in the June 2006 Statement of Proposal. The recommended rates and development contributions (GST inclusive) differed slightly from those in the Beca and EPS report and were as set out in Figure 9.

**Figure 9**  
**Changes in rates and development contributions between June and October 2006**

Charges	Previous GST inc rates & charges (publicly advertised)	Proposed GST inc rates & charges
Uniform annual charge	\$630.00	\$697.50
Uniform targeted rate (with SWSS subsidy)	\$2,000.00	\$4,290.40
Uniform targeted rate	\$6,862.50	\$9,090.40
Development Contribution	\$11,060.00	\$12,937.50

Sources: 2006 Statement of Proposal, Option 3.2, page 24, Council workshop minutes, figures from Beca representatives' presentation.

- 11.39 The Council also resolved to:
- adopt the Beca and EPS report; and
  - endorse an amendment to the Project Deed and authorise the Chief Executive and Mayor to execute the amendment, which included extending the commencement date to 26 March 2007. (The deed amendment referred to in the minutes was not in KDC's files, so we could not establish exactly what change in the scope of the works had been agreed.)
- 11.40 One of the effects of these resolutions was that sections that were not previously affected by the wastewater scheme would now be required to connect.
- 11.41 A Beca staff member who reviewed the population numbers for the development contributions model commented in an email in November 2006 to Beca and EPS staff that she had some reservations about the 4500 figure that had been adopted. She stated:
- While we accept that there has been recent rapid subdivision in Mangawhai we also note that at least some of this is likely to have been instigated as a response to the proposed Wastewater project (people subdividing before the contribution requirements apply) and secondly, it corresponds with a period of rapid economic growth, which appears (at least in the medium term) to be easing. In this respect, we consider the range of 3,410 and 4,400 provide an upper and lower projection with perhaps a midpoint scenario the more probable.*
- 11.42 Beca told us that the development contributions model was designed to be updated over time with actual data, to forecast funding requirements. It told us that it was decided not to carry out remodelling at this point but to wait until actual data was available.
- 11.43 We discussed the issue of the growth projections with KDC staff. One KDC officer told us that there had been an increase in applications for subdivision consent while the development contributions policy had been suspended, with developers seeking to avoid being levied before the policy was reintroduced in July 2006.
- 11.44 Beca and EPS' report noted that the LTCCP and the Development and Financial Contributions Policy would need to be amended to account for the changes to the rates and development contributions. It also noted that:
- These amendments would publicly notify the community of the Council's intention to see further development in the Mangawhai area (which would then be subject to RMA process).*

- 11.45 The Council adopted the report. However, it set out in the “Reason for the decision” that:

*The proposal met the Council and communities requirements for a community wastewater scheme for Mangawhai and is not significantly different to the proposal publicly notified with Kaipara’s Future – Working Together (Council’s Long Term Council Community Plan).*

- 11.46 The Council did not consult on the increased scope and the increased capital costs of the project, and it is not clear when the residents first knew about the cost of the expanded scheme. We discussed with the Chief Executive and with several of the councillors who were present at that meeting why the Council decided not to consult. KDC’s former Chief Executive told us that the Council considered that consultation was not required because it thought the cost to the ratepayer, as set out in the 2006 Statement of Proposal, was not going to increase. One of the councillors confirmed this. Councillors also told us that this was the advice the Chief Executive gave them.
- 11.47 Several media articles subsequently reported the increased scope and cost, but the Council did not convey any of this information to its community directly.

### **Our comments on the decision to change the assumptions and increase the scope**

- 11.48 Our overall impression of this stage of the work on the project is that there was considerable confusion. The estimates of figures for current sections, projected growth, capital costs, operating costs, capacity of the scheme, and funding are not stable or consistent. Different numbers appear in different documents written by different people (see our comment in Part 8 on the lack of any overall system within KDC for overseeing the project’s management, costs, and funding). By this stage, there should have been consistent and agreed methods for calculating all of these figures, so that changes could be monitored and reported.
- 11.49 KDC’s former Chief Executive told us that growth projections were always based on the applications for consent KDC received. As we set out above, we were unable to reconcile the figures in the different reports. There was no information in KDC’s files to suggest that KDC officers reviewed the figures and assessed them against KDC’s files.
- 11.50 EPS told us that numerous growth scenarios were modelled with the Council, including both high and low growth. “Council understood that through this process that a range of assumptions were being made to support each scenario.”

- 11.51 What is clear is that the cost of the project was increasing and that additional funding needed to be found. This was achieved by revising the growth projections so that the cost would be spread over a larger number of future ratepayers and expanding the scope of the scheme so that more properties would be serviced. These changes meant that, although the project was costing more, the immediate cost to individual ratepayers could remain roughly the same.
- 11.52 We identified several flaws in this work:
- The revised population estimates that formed the starting point for the funding model do not appear to be particularly robust, and the Council did not test them against its own data.
  - Council minutes do not show that there was any consideration of the risk that growth would be slower than projected and therefore no plans for how to manage that risk if it eventuated.
  - The cost estimates for the various components of the scheme were only indicative at that stage (for example, the cost of house connections ended up being significantly more than estimated at this stage).
  - Not enough work was done to ensure that the main funding mechanisms – development contributions and rates – were reliable and enforceable.
  - The changes to the project’s scope and approach were not being closely monitored and managed from an affordability perspective.
- 11.53 Affordability of the project had always been a critical issue for the Council and the community. In our view, this meant that the Council should have carefully considered all changes to ensure that they were necessary and affordable. The quality of the work on estimated capital costs and funding in 2006 shows that this was not the case.
- 11.54 In particular, we do not consider it satisfactory for the Council to have put one set of costs to the community for comment in February 2006 and then immediately started work on how the costs were changing. The costs had already increased significantly by the time the Council adopted the final Statement of Proposal only four months later.
- 11.55 We attribute this to the lack of any coherent project overview or control of the “big picture”. By this stage, it seems that the Council was managing the project day by day and issue by issue.
- 11.56 The Council’s focus on the costs to the ratepayer meant that it failed to consider the overall increase in the capital costs of the project. Had the Council thought of it in terms of an increase of \$22 million in capital costs, it might have thought through the decision to increase the scope more fully.



## Part 12

# Other changes to the wastewater project

- 12.1 In Parts 7-11, we have described some of the major changes and challenges that the Council had to deal with between 2003 and 2007. There were many other changes during this period. In this Part, we provide our overall comments after briefly outlining the more significant of those other changes:
- the extensions to the project management contract with the Beca consortium;
  - changes to the process for KDC to take ownership of the scheme;
  - changes to the project documents;
  - changes to the financing arrangements; and
  - changes to what was to be built.
- 12.2 In summary, we conclude that:
- It was sensible for the Council to extend the Beca consortium's contract for project management, but it was done in a piecemeal way. The Council did not appear to have estimated or budgeted for the costs of the project management services.
  - The financing and contractual arrangements were complex, and it appears that the Council and its advisers did not understand them well. The delays to getting started cost the Council an estimated \$450,000 in financing costs.
  - The Chief Executive and EPS decided to use swaps to hedge KDC's interest rate risks. However, they did so in breach of KDC's Treasury Management Policy, and it is not clear that the Council approved the decision to use swaps.
  - The Council did not get independent legal advice about the new contractual documents or independent financial advice about the financing arrangement.
  - It appears that, by this end of this period, the Council was no longer in control of the project or its costs.
  - KDC's record-keeping was poor.

## Extensions to the Beca consortium's project management contract

### The Council agrees that the Beca consortium should continue as project managers through the construction phase

- 12.3 The original contract with Beca, in 2000, had been for the consortium to provide project management services until the signing of a contract for a BOOT type of PPP. The fee for those services set out in the contract was \$617,000.

- 12.4 At a meeting on 23 July 2003, the Council considered a report from the Chief Executive recommending that Beca be retained until construction was complete (that is, until commercial acceptance). The report set out that, because of several changes that had occurred, the project management fees to date were then \$799,525 and that the cost for the project management services until commercial acceptance would be a further \$194,050. This made a total of \$993,575, as well as a time and materials charge. The cost did not include legal advice Bell Gully was to provide through EPS or Beca. The report advised that this level of fees was appropriate in the context of a total project budget of \$13 to \$15 million.
- 12.5 The Council agreed to accept the proposal from the project managers to manage the project until commercial acceptance.

#### **How to pay for the project management**

- 12.6 It appears that, until that point, the Council had not considered how it would fund the consortium's project management costs. In a memorandum to the Chief Executive in December 2003, KDC's Finance Leader noted that Beca's fees of \$641,000 had been funded from working capital and that a further \$350,000 had also been committed. He noted that \$1 million represented a "highly significant portion of our working capital".
- 12.7 By June 2005, KDC was having cash flow issues. In an email to the Chief Executive, KDC's Finance Manager noted that KDC's working capital was \$768,000, which would not even meet monthly expenditure requirements. He advised that the same arrangement that had been reached between Simon Engineering, ABN Amro, and KDC needed to apply for EarthTech. This appears to be that ABN Amro would lend KDC money to pay for the project management costs and so restore KDC's level of working capital.

#### **Project managers' contract is continued through the implementation phase**

- 12.8 In January 2006, Beca submitted an offer to the Council for the consortium to provide services during the implementation phase of the wastewater project. These services included:
- administering the contract;
  - providing periodic technical auditing services;
  - seconding a person to act as a community liaison; and
  - providing statutory planning advice for the subsidy application and for development contributions.



- 12.9 The community liaison representative was to be based full time in Mangawhai. The role would include:
- *Liaison with residents and other affected parties, and the contractor's local representative;*
  - *Being a referral point for all enquiries passed to Council;*
  - *Provision of feedback and reporting to Council staff in Dargaville;*
  - *Provision of current information to the Project Director administering the contract; and*
  - *Meeting with residents as required to explain the construction of the scheme.*
- 12.10 These services would cost \$474,750. This did not include planning support services, which would be billed on a time and disbursement basis.
- 12.11 At its meeting in May 2006, the Council resolved to accept the proposal from Beca to manage the implementation phase of the wastewater project.

### Our comments

- 12.12 The project still needed a substantial amount of management and monitoring. It was sensible to extend the contract with the Beca consortium and keep it in this role. In particular, the community liaison work that Beca carried out in the later stages of the project proved to be very important.
- 12.13 However, we consider that the way the contract extension was done is another indication of the lack of proper overall governance of the project. It was foreseeable from quite early on that project managers would be needed for the life of the project. However, the project managers' role was extended in a piecemeal way. As we set out earlier, in the initial stages of the project, the Council failed to identify what it needed to do to manage the project and the limitations of the project management services to be provided by the consortium. Without any other project management, it is clear that the Council was very dependent on the project managers to keep the project progressing.
- 12.14 We are also concerned that the Council did not appear to have clearly estimated and budgeted for the costs of the project management services.

### Changes to how Kaipara District Council would take ownership of the scheme

- 12.15 The 2005 financing documents and Project Deed included a single date for commercial acceptance. Commercial acceptance was the point at which EPS was to sign-off for KDC that EarthTech had finished construction and demonstrated that the wastewater scheme functioned. After commercial acceptance, KDC was

to draw down its loan and pay MDHL for the wastewater scheme. MDHL would then transfer ownership of the wastewater scheme to KDC.

- 12.16 In March 2007, Beca and EPS put a paper to the Council recommending that the Council change to a two-stage commercial acceptance process to lower the financing costs. KDC's term loan facility with ABN Amro had a lower interest rate than the financing ABN Amro was providing for the progress payments that MDHL was making to EarthTech while the scheme was being built. The purchase price KDC would pay MDHL after commercial acceptance included these construction financing costs. So KDC would save money if it could move some of that financing over to its lower-interest loan earlier.
- 12.17 Effectively, what Beca and EPS were proposing was that KDC would buy the wastewater scheme in two stages at two different dates and would draw down twice on its term loan facility to pay for the purchase. That is, by the date for Commercial Acceptance 1, part of the wastewater scheme would be completed. Provided that EPS signed off the work, KDC would draw down on its loan and pay MDHL for the part of the wastewater scheme that was completed and take ownership of it. When the remaining works were completed by the date set for Commercial Acceptance 2, KDC would draw down on the loan again, pay the remaining amount to MDHL, and take ownership of the rest of the scheme.
- 12.18 The consultants estimated that changing to a two-stage commercial acceptance process would save KDC about \$322,000. In the paper to the Council prepared by Beca and EPS, there was nothing about the financial risks if the commercial acceptance dates were not achieved or how those risks could be mitigated. The Council agreed to adopt a two-stage commercial acceptance "provided that EarthTech or ABN Amro does not attempt to use this as a lever to re-negotiate the Project Deed or the financing documents".

### Our comments

- 12.19 Changing the commercial acceptance dates could have saved KDC some money, but there were risks. If the project failed to meet the dates specified in the financing arrangements in the Project Deed and Tripartite Deed, the Council would incur additional costs. If the Council adopted this proposal, it also needed to manage the contract tightly to ensure that the timetable was met. These risks do not appear to have been fully explained or understood. As we explain in Section C, the project did not run to time and the decision to change the commercial acceptance dates ended up costing KDC more than it hoped to save.
- 12.20 KDC's former Chief Executive told us that the two-stage commercial acceptance was fully explained to the Council in a workshop. There were no records of

this workshop or copies of any papers or presentations provided in KDC's files. Therefore, we were unable to confirm that the risks of the two-stage commercial acceptance process were fully explained to the Council.

### The Council agrees to sign amended project documents

- 12.21 As explained in Part 11, in October 2006, the Council approved several amendments to the Project Deed and gave the Mayor and Chief Executive authority to execute the relevant modification to the Deed. However, the Project Deed was still not operative and so its modification process could not be used yet. The conditions in the Project Deed were met in August 2007, when the resource consents were granted, at which point the Deed became operative.
- 12.22 In September 2007, the Council was given a presentation about the modifications now being negotiated. These modifications:
- included changes to the treatment plant site that had been needed to resolve an appeal in the resource consent process;
  - included the transfer pipeline to the farm;
  - included the winter storage dam;
  - removed the irrigation system at Mangawhai Park;
  - provided for two months to refine the guaranteed maximum price; and
  - provided for two commercial acceptance dates.
- 12.23 In November 2007, the Council received a further presentation at a workshop and formal meeting. The presentation set out the history of the project and the proposed changes. It noted that the risk allocation had changed because of the Local Government Act 2002, KDC's purchase of the farm, and the contract negotiations. Several risks had been taken back by KDC or were now shared by KDC and EarthTech.
- 12.24 The presentation set out that the total loan to be provided by ABN Amro was now \$53 million. The guaranteed maximum price for construction had increased to \$37.8 million. There was no detailed information in the material provided to the Council on the financing arrangements or details of the contracts that the Council was about to sign.
- 12.25 The Chief Executive's paper noted that the contract provided for only 1216 sections to be connected. However, further modifications would be negotiated while construction proceeded, and a further 500 to 1000 properties should be connected. He noted that the wastewater treatment plant was capable of servicing more than 2000 properties.

- 12.26 The Council minutes for the meeting on 28 November 2007 record that the Chief Executive's report stated that "The project remained within the parameters adopted by the Council and was recommended for signature." The Council authorised the Mayor and Chief Executive to execute the project documents.
- 12.27 Not all of the works that the Council had agreed to in October 2006 were included in the November 2007 Project Deed. We were unable to determine why the Council did not raise this issue when it agreed to execute the Project Deed. In addition, some changes to the scope of the works were anticipated before the Project Deed was signed, such as relocating the wastewater treatment plant because of one of the Environment Court appeals. These changes were not included in the Project Deed. The effect of these issues was that the Council still did not have clear understanding of what the full costs of the project would be when it agreed to sign the Project Deed.
- 12.28 On 7 December 2007, the amended project documents were signed. The amended documents reflected the change in the scope of the works, the increased costs, and the new two-stage commercial acceptance process. If construction went to plan, the total purchase price would be \$42,891,500, made up of \$37,840,182 in construction costs, the \$800,000 advance to the Council for its project management costs, bank fees of \$1,840,697, and interest costs of \$2,165,000.

### **What professional advice was obtained?**

- 12.29 Bell Gully assisted EPS with negotiating and completing the core part of the Project Deed, excluding the schedules, as well as the other project documents. Bell Gully provided a letter to KDC's Chief Executive setting out its involvement and confirming that the documents reflected EPS' instructions to it and its advice to EPS. Bell Gully confirmed that, on that basis, the documents were appropriate for KDC to execute and rely on. Bell Gully noted that this confirmation assumed that KDC was satisfied with "the structure of the Mangawhai EcoCare Project, the matters in respect of which KDC will need to satisfy itself, the commercial terms of each of the Project Documents, and the risks and obligations assumed by KDC under the Project Documents". The letter to KDC was two pages long and did not include any detailed information about the documents the Council was proposing to sign. The Council did not seek its own legal advice about the agreements before signing them.
- 12.30 The financing arrangements were complex. There were very few documents in KDC's files about the financing arrangements. We understand that EPS negotiated the financing arrangements on KDC's behalf. Beca told us that the financial arrangements EPS negotiated were provided to the Chief Executive for

approval. The Chief Executive told us that EPS used PwC (Australia) to provide advice about the financing arrangements. We found no evidence in KDC's files that KDC staff or EPS used PwC (Australia) or sought independent financial advice about the financing arrangements that the Council would enter into. In particular, there was no evidence that an assessment was made of whether the financing arrangements offered by ABN Amro were competitive or provided value for money. In the presentation and report given to the Council at the meeting in November 2007, no information was provided about the details of the financing arrangements that were to be entered into.

### Our comments

- 12.31 The delays in starting the project cost KDC a significant amount of money (about \$450,000). The Project Deed was amended in October 2006 because it took more time to satisfy the conditions that had to be met before the Deed could become operative (resource consents and consultation processes under the Local Government Act 2002). The Deed was amended several more times during 2007 for the same reason. As we set out earlier in the report, we consider that KDC was unlikely to be able to meet the time frame given for satisfying the conditions and that the time frame was simply too short. This meant that it was likely that KDC would incur additional commitment fees and other bank fees from delaying the start of construction.
- 12.32 When the Deed was amended in October 2006, the commitment fees increased from \$8,333 each month to \$12,634 each month. The value of the works carried out by EarthTech in this period also bore interest at a rate of 9.75%, which was capitalised monthly. Further ABN Amro fees were also incurred. In total, close to \$450,000 in financing costs were incurred before the amended project documents were finally signed in December 2007. These financing costs were made up of \$218,643 in commitment fees and \$228,175 in EarthTech's financing costs.
- 12.33 We are concerned that, when the Council signed the financing documents in October 2005, it did not understand that additional financing costs would be incurred if it failed to obtain the resource consents or complete its consultation within the time limit. As already noted, the original time allowed for these conditions was probably unworkable.

## The changes that were made to the financing arrangements

### A new Land Acquisition Facility Agreement

- 12.34 As discussed in Part 10, the Term Loan Facility Agreement had been amended twice previously to provide funds to purchase the farm. In December 2007, the arrangements for financing the farm purchase changed again. ABN Amro agreed to provide another term loan facility to KDC – this was called a Land Acquisition Facility Agreement.
- 12.35 The loan to be provided under the Land Acquisition Facility Agreement (the additional loan) was to be drawn down on 7 December 2007. KDC would use the additional loan to repay the entire principal and interest owing under the existing loan (called the term loan facility) as well as pay any associated costs, such as bank fees. The additional loan was to be repaid at Commercial Acceptance 1, or on 28 February 2009, when money was drawn down on the existing loan (the term loan facility) to pay for the first part of the wastewater scheme that had been completed. KDC was to use the money from the existing loan to repay the additional loan.
- 12.36 There were very few documents in KDC's files about the financing documents that were signed in December 2007. No information in the files explained why KDC entered into the Land Acquisition Facility Agreement or whether there were any financial advantages to this.
- 12.37 As with the other 2007 project documents, there is no evidence in KDC's records that the Council sought independent legal or financial advice before signing the new financing documents. There is also no evidence in KDC's records that the Council determined whether the terms offered by ABN Amro were competitive with what was available in the local government sector at that time. KDC's former Chief Executive told us that PwC (Australia) were used to provide advice about these issues. However, there is no record of any such advice in KDC's files. We did not confirm with PwC (Australia) what advice it gave.

### Swaps

- 12.38 The documents to be signed by the Council in December 2007 included an International Swap Dealers Association agreement with ABN Amro. A swap is a contractual arrangement used to hedge risks. In this case, it was used to hedge interest rate risk.
- 12.39 In late 2007, EPS and KDC's Chief Executive agreed that it would be appropriate to use swaps to hedge KDC's interest rate risk under the loan agreements it was

about to enter into. There was no information in KDC's files about why it wanted to use swaps or any advice about the associated legal and financial issues. Nor was there any evidence to suggest that KDC's Treasury Management Policy had been considered. That policy states:

*2.1 Liability Management Policy*

*2.1.1 Interest Rate Exposure on Borrowings*

...

*(c) A passive approach will be taken to borrowing.*

*Attempts to identify advantageous interest rate trends and committing the borrowing programme to forecasted rates will be avoided. Trading and or speculative operations will be avoided, reliance being placed on risk management within available market strategies.*

*(d) When it is appropriate to do so, borrowing exposures may be hedged.*

*Before resolving to hedge an exposure, or to delegate the authority to hedge a transaction or a specific series of linked transactions, Council must:*

- obtain specific advice from expert advisers independent from those who are recommending the transaction*
- be satisfied that the risk to the Council of not proceeding with the hedge is greater than the existing transaction without the hedge*
- be satisfied that the reduction in risk is sufficient to justify the cost of the hedging instrument.*

- 12.40 There was nothing in KDC's files to indicate that the Council was advised that staff were about to start using swaps. The Council was told that the interest rate was to be fixed, but it was not explained that this would be done by using swaps. From the information we have seen, it is likely that this action was inconsistent with KDC's policies and therefore unauthorised. We discuss KDC's use of swaps later in Part 17.

### **Increase in subsidy amount from Sanitary Works Subsidy Scheme sought**

- 12.41 In December 2007, KDC's Chief Executive sent a letter to the Northland Medical Officer of Health seeking additional SWSS funding from the Ministry of Health. He advised that there had been several changes since the original application had been made. These changes had increased the estimated capital costs of the project to \$53 million. The Chief Executive requested a further subsidy amount of \$9.8 million in addition to the \$6.63 million that had already been approved. He requested an initial payment of \$880,000.

### Our comments

- 12.42 In our view, these financing arrangements were overly complex for the nature of the project and KDC. To assess what was being proposed, the Council would have needed to be able to get independent advice from its own expert legal and financial advisers. In general, sophisticated financial arrangements such as swaps are more appropriate for organisations that are large enough to maintain their own internal treasury function or otherwise have arrangements for access to specialist treasury skills.
- 12.43 As with other aspects of the project, we consider that the amount of documentation supporting these financing decisions and the level of scrutiny of them was inadequate.

### The changes that were made to what was to be built

- 12.44 Both the 2005 and 2007 Project Deeds set out the parameters of the wastewater treatment plant's capacity. However, it is difficult to compare them because the two deeds use different parameters. The key design parameter for a wastewater treatment plant is the maximum daily inflow peak in wet weather. This was set out in the 2007 Deed but not in the 2005 Deed.
- 12.45 The 2007 Deed changed the wastewater treatment plant that was to be built. The 2005 Deed provided that an IDEA (intermittently decanted extended aeration) plant would be built, and the 2007 Deed provided that a CASS (cyclic activated sludge system) plant would be built. Both are different forms of sequence batch reactors – that is, processing tanks that treat wastewater in batches. Components of the wastewater plant were also made significantly smaller.
- 12.46 In effect, in 2007, the treatment plant was made smaller while the population it would cater for increased. It appears that the design capacity for the wastewater treatment plant in 2005 had been too large.
- 12.47 Both Beca and EarthTech told us that in around 2005 Beca and EarthTech staff had several meetings to review the design. Beca told us that:
- Our wastewater engineer noted the reviews were “high-level” in nature assessing the appropriateness of the works being proposed by [EarthTech], and bearing in mind that contractually [EarthTech] was responsible for the design and we had to avoid “instructing” [EarthTech] and thereby relieving them of that design responsibility (and transferring it to KDC).*
- 12.48 We have not been able to establish whether the reduced size of the plant affected the construction price that had been negotiated in 2007. We could also find no



evidence that any consideration was given to whether this reduced size would require the resource consents to be amended.

- 12.49 There was also no evidence that the Council was told in December 2007 about the proposed changes to the design of the wastewater treatment plant.

### Our comments

- 12.50 We acknowledge that, in a BOOT type of PPP, the public entity does not need to have a full and detailed understanding of what is being built or how the infrastructure will work. However, it is usual for the public entity, as the ultimate owner of the asset, to specify in broad terms what was being built and have some oversight of it. The further away from the BOOT model, the weaker the long-term financial incentives on the contractor become. As a result, the purchaser is likely to need to become progressively more interested in the detail again.
- 12.51 The 2005 Project Deed included some specification of what was to be built. The extent of the changes to what was being built after that contract was signed suggest that there might not have been enough consideration of what was appropriate for KDC's needs when that contract was prepared. Again, the benefits of a PPP approach of "buying the whole package" are undermined if the preparatory work has not been thorough enough and changes are needed once the contract is under way. We consider that these changes show that the contract had not been adequately reviewed before it was signed.
- 12.52 As we set out in Section C, this attitude was also evident during construction, when it appears that, in some cases, what was built did not match what was in the contract.
- 12.53 We are unable to determine whether the reductions in what was to be built in the 2007 Project Deed translated into cost savings for KDC.

### Our overall comments

- 12.54 In our view, the growing picture is that the Council was not really in control of the project or its costs. The various changes to the project described in this Part are characterised by poor data, not enough information being provided to the Council on what it was being asked to agree and sign, a lack of independent legal or financial advice about the transactions, little work to assess value for money, and inadequate scrutiny of the detail of the project documents. The financial risks of adopting a two-stage commercial acceptance process were not explained to the Council.

- 12.55 The Council signed the project documents when the scope of the works to be carried out was not resolved and when the contract documents did not include all known issues. This created uncertainty about the capital costs of the scheme and caused delays that meant KDC incurred additional costs.

## Part 13

### How was the community kept informed?

- 13.1 While the events summarised in Parts 7 to 12 were taking place, KDC and its contractors were also communicating regularly with Mangawhai and Kaipara ratepayers about what was happening. In this Part, we discuss:
- the formal consultation KDC carried out between 2003 and 2007;
  - communication on the important decisions discussed in this Part; and
  - our comments.
- 13.2 In summary, we conclude that:
- Until mid-2006, KDC kept the community informed on the project and put a lot of effort into this.
  - After then, its communication was much poorer, and it failed to communicate important decisions that affected the overall cost of the project, such as the purchase of the farm and the increase in the scope of the works.
- 13.3 We have not commented on whether KDC's consultation with the community complies with the Local Government Act 2002, as this matter is before the High Court.

#### **Formal consultation carried out by Kaipara District Council**

- 13.4 Between 2003 and 2007, KDC carried out several formal consultation processes under the Local Government Act 2002. As well as its regular consultation about the draft annual plan each year and the draft LTCCP every three years, it also consulted formally on several Statements of Proposal relating specifically to the wastewater project. These were:
- Mangawhai EcoCare Project, in 2003;
  - Development Contributions Policy, in 2005;
  - Development and Financial Contributions Policy, in 2006, as part of the consultation on the 2006 LTCCP; and
  - Mangawhai EcoCare, in 2006, as part of the consultation on the 2006 LTCCP.
- 13.5 The Northland Regional Council (NRC) publicly notified the application for resource consents and notice of requirement for the designation, and the community was able to make submissions on them.

### **The July 2003 Statement of Proposal on the Mangawhai EcoCare Project**

- 13.6 The draft Statement of Proposal was provided to the Council at its meeting on 23 July 2003, where it was adopted for public consultation. We have already discussed what was in the Statement of Proposal in Part 8.
- 13.7 The Council held an open day in Mangawhai on 9 August 2003. This provided an opportunity for the community to ask questions. The consultation period concluded on 1 September 2003. The Council received 127 submissions, and 29 submitters requested an oral hearing. These were heard by the Hearings Committee on 9 and 10 September.
- 13.8 After the oral hearings, the Hearings Committee appointed a working group to analyse the submissions and report back to the committee. The working group, consisting of councillors, an EPS representative, and a KDC officer, reported back to the Hearings Committee at a public workshop held in Mangawhai on 8 October 2003. KDC files included an update about the wastewater project that was to be provided to the community shortly after that meeting explaining the Hearing Committee's recommendations, which would be put to the Council at its next meeting.
- 13.9 The Hearings Committee then presented its recommendations to the Council on 22 October 2003. It recommended that the project proceed subject to several amendments. An article in an *EcoCare Newsletter* distributed by KDC in November 2003 provided information about the changes to the scheme the Council had adopted because of the consultation process.

### **2005 Statement of Proposal on a Development Contributions Policy**

- 13.10 As discussed in Part 8, KDC's Development Contributions Policy had come into effect from 1 July 2004. Soon afterwards, several problems in the way the policy was interpreted came to light. At a meeting on 23 March 2005, KDC officers recommended changes to the policy. The Council agreed with the recommendation and approved a draft Statement of Proposal for public consultation.
- 13.11 The consultation process was publicly notified in the *Northern Advocate* on 24 March and the *Mangawhai Memo* on 31 March 2005. The Statement of Proposal was sent to all potentially affected ratepayers with a covering letter.
- 13.12 Submissions opened on 30 March 2005 and closed on 2 May 2005. Hearings took place on 11 May 2005. As we set out in Part 8, some submitters identified other problems with the policy. At its August 2005 meeting, the Council resolved to suspend the application of the policy pending the adoption of a revised policy.

### **2006 Statement of Proposal on a Development and Financial Contributions Policy**

- 13.13 A new Development and Financial Contributions Policy was drafted. The law firm Brookfields reviewed this policy before the Council reviewed it in April 2006. At that meeting, the Council adopted the policy for inclusion in the 2006-16 draft LTCCP for consultation. The Council adopted the policy in June 2006.

### **February 2006 Statement of Proposal on the Mangawhai EcoCare Project**

- 13.14 As we discussed in Part 11, the Council issued a second Statement of Proposal on the scheme for consultation as part of its 2006 LTCCP process.
- 13.15 Before the draft Statement of Proposal was adopted for consultation, two public forums were held to seek public input. These were held in Dargaville and Mangawhai on 4 and 14 October 2005.
- 13.16 The draft LTCCP, which included the Statement of Proposal, was advertised on 8, 9, and 15 March, and a letter was sent to every ratepayer on 21 March 2006. Public meetings were held on 27, 29, and 31 March and 3 April 2006. Consultation closed on 21 April 2006. The Council received 271 submissions on the draft LTCCP and heard from 101 submitters. Hearings were conducted on 8, 9, and 10 May.
- 13.17 The Council held a special meeting on 22 May 2006 to consider the submissions and resolved that staff should amend the LTCCP in keeping with the decisions resulting from the deliberations. KDC staff would present a revised copy of the draft to a special Council meeting to be held on 7 June 2006. At the meeting on 7 June, the Council adopted its LTCCP with some amendments.
- 13.18 KDC held an open day in Mangawhai on 28 July 2006. Aerial photographic plans were on display. EarthTech was in attendance, as well as councillors, KDC officers, and the Community Liaison Officer. Copies of the adopted Statement of Proposal were available, as well as copies of the information booklet *Information for Landowners & Residents*.

### **Notice of requirement and application for resource consents**

- 13.19 Beca prepared a Consents Management Plan to guide prospective tenderers through the consenting requirements. That plan set out that resource consents would be required for the wastewater scheme. It also stated that one of the strategies to minimise consenting risk was keeping the community informed and involved in selecting the site and disposal options.

- 13.20 In September 2006, KDC and EarthTech filed an application for 13 resource consents with the NRC. KDC also required a designation for the scheme. Under the designation process in the Resource Management Act 1991, KDC would normally be the decision-maker on the notice of requirement. The Council delegated its decision-making powers on the notice of requirement to the NRC's Hearings Committee, which would also decide the resource consent applications. This was done to manage KDC's conflict of interest, which arose because it was both the applicant and decision-maker on the notice of requirement.
- 13.21 The consents applied for, and the proposed designation, were fully notified in accordance with section 93(2) of the Resource Management Act 1991. This included:
- newspaper advertisements;
  - individual letters to owners of properties in the area potentially affected by the proposal, including those within the scheme's sewerage district, properties along the pipeline routes, properties adjacent to the irrigation area, and properties adjacent to the Hakaru River; and
  - letters to iwi or their representatives, oyster farmers in the upper Kaipara Harbour, the Department of Conservation, Forest and Bird, Fonterra, Telecom, and Transit New Zealand.
- 13.22 The Council also advertised the submission process in the *Mangawhai Memo* and encouraged community members to submit.
- 13.23 The Hearings Committee heard submissions on the applications and notice of requirement. A total of 61 submissions were received, with 36 submitters also providing oral submissions. Hearings took place in Mangawhai on 8 February 2007. The NRC's Hearings Committee granted the resource consents and confirmed the notice of requirement in March 2007. Three appeals were filed with the Environment Court. However, they were resolved through mediation. The Project Deed then became operative from 28 August 2007.

## Communication on important decisions

### Change from a BOOT to DBFO scheme

- 13.24 As set out in Part 7, the Local Government Act 2002 meant that KDC could not continue with a BOOT scheme. The PSC met to discuss the implications of this in January 2003 and then reported to the Council with its recommendations. The Council implicitly resolved to proceed with the project as a DBFO scheme and agreed that further consultation on the proposed funding arrangements should be carried out.

- 13.25 KDC files contained an update about the wastewater project that was to be provided to the community in February 2003, advising the community of the changes in legislation and the Council's decision to continue with the project, subject to some changes in approach. The Mayor also distributed an open letter to the Mangawhai community on 21 February 2003 providing information about the changes.
- 13.26 The Community Liaison Group received an update from an EPS staff member and KDC's Chief Executive on the Council's decision. Group members confirmed that the community wished to be kept up to date in simple and meaningful terms. It was agreed that an article for the *Mangawhai Memo* and an *EcoCare Newsletter* would be prepared for the community's consideration. These were finalised and distributed to the community before the next Community Liaison Group meeting.

### Decision to rescind preferred proponent status

- 13.27 The community was advised through a press release in January 2005 that HWE, the parent company for Simon Engineering, had been undergoing a refinancing programme and that a potential new investor was carrying out a due diligence process. KDC advised that this would result in delays in signing the Project Deed, but it remained confident that the process would be successfully completed.
- 13.28 However, HWE was placed into voluntary administration on 31 January 2005. The Council called an extraordinary meeting on 9 February 2005. In a session from which the public was excluded, the Council resolved to rescind Simon Engineering's preferred proponent status.
- 13.29 KDC's files included an article that was drafted to be included in an issue of *Mangawhai Memo* that was distributed to the community in February 2005 advising of the Council's decision to withdraw preferred proponent status. The newsletter confirmed that EarthTech and NorthPower had been invited to be preferred proponents to ensure a competitive process to complete negotiations.

### Decision to award preferred proponent status to EarthTech

- 13.30 KDC's files included an article that was drafted to be included in an issue of *Mangawhai Memo* in June 2005. The article advised the community that negotiations were under way with EarthTech and that costs to the users would be maintained at the same levels as previously advised, subject to inflationary increases. It noted that full consultation with the community would be required if there were any significant changes to any part of the project.
- 13.31 The Council resolved to accept the draft offer from EarthTech on 24 August 2005 in a meeting from which the public was excluded.

- 13.32 Various articles in the local newspapers in August 2005 advised that KDC was in final negotiations with EarthTech.

### **Decisions to purchase the Lincoln Downs farm**

- 13.33 The draft Statement of Proposal on the wastewater scheme was issued for consultation in February 2006. It stated that the final disposal site had not yet been determined. As outlined in Part 10, negotiations to purchase the Lincoln Downs farm began in March 2006. The Council agreed in principle to purchase the farm in May 2006, subject to a full report being provided to the Council on the technical acceptability of the site, the use of the rest of the property, and the financing of the purchase.
- 13.34 Although the final Statement of Proposal adopted in June 2006 was amended to reflect several changes resulting from consultation, it did not include any additional information about the likely cost of the disposal site or any other costs associated with the selected disposal site, such as costs for a transfer pipeline.
- 13.35 As we set out in Part 10, in August 2006, the Council was advised that the owners of the farm were seeking an increase in the purchase price. The Council agreed to this.
- 13.36 An *EcoCare Newsletter* was distributed in July 2006 that provided an update on the status of the project and also advised of a Community Open Day to be held on 28 July 2006. In that newsletter, KDC provided information about its proposed use of the treated wastewater. It advised that it had a range of irrigation options available, including a specific site that it was currently purchasing. This site was also to be used to store the treated wastewater. There was no further information about the farm purchase or its indicative costs in that newsletter.
- 13.37 The Council agreed to sign the final sale and purchase agreement for the Lincoln Downs property in November 2006, and the purchase was finalised in April 2007. We could not find any newsletters or press releases around this time that advised the community of the purchase.

### **Decision to increase scope**

- 13.38 As we set out in Part 11, in October 2006, the Council agreed to increase the scope of the works to be carried out by EarthTech. These changes would also significantly increase the costs of the scheme.
- 13.39 The Council received a report from Beca on the increased capital costs and how they were to be funded. The report noted that, because the proposed rates and development contributions would need to change, the LTCCP and the



Development and Financial Contributions Policy would need to be amended. The report did not state whether the change in the scope of works to be carried out also required consultation.

- 13.40 Some councillors told us that they considered that further consultation was unnecessary because the cost to individual ratepayers was not increasing. KDC's former Chief Executive told us that the Council did not believe that it needed to consult. No amendment to the LTCCP was ever proposed or consulted on.
- 13.41 According to Beca's Consultation Summary dated 7 February 2007, information about the project was contained in three updates about the wastewater project that were distributed between September 2006 and January 2007. However, we were only able to locate a copy of one of these, dated 9 November 2006. It contained no information about the decision to increase the scope of the scheme. It was limited to information about the resource consent application that had just been lodged.
- 13.42 We found no evidence of KDC directly advising the community of its decision to increase the scope of the scheme.

### Our comments

- 13.43 In Section A, we commented that KDC's work to consult with the community and keep people informed was good up to 2002. Between 2003 and 2007, the quality of that communication deteriorated. KDC still put a significant amount of effort into communication, but the substance of the information became less meaningful. As the problems with the project mounted – for example, with the farm purchase and changes to the costs and scope of the project – KDC's communication became less frequent and less detailed.
- 13.44 We do not comment on specific legal questions, such as whether the consultation requirements of the Local Government Act 2002 were met, because these issues are currently before the High Court.



## Part 14

# Our overall comments on how the Council dealt with problems

- 14.1 Between 2003 and 2007, the weaknesses in the way the project had been set up started to show. In this Section, we have detailed how the Council dealt with the many problems it faced during these years. We consider that the Council would have been able to deal with these events better if it had had a stronger system for maintaining overall control of the project. Instead, what we have detailed is a series of disjointed decisions on issues when they arose, with no particular regard for the overall aim and affordability of the project.
- 14.2 In our view, the Council had become committed to the project in its current form and was not able to stand back and reassess it appropriately when problems arose. We saw no evidence of a willingness or ability to contemplate writing off what had been done to date or backtracking a step or two. Instead, there was a determination to press on and find solutions to whatever problems presented themselves. Several problems that were encountered should have caused the Council to stand back and reconsider whether its approach remained appropriate.
- 14.3 We are concerned that the Council lost control of the size and cost of the project during these years. It is not satisfactory that we could not find clear and consistent figures for the project's costs and funding during its life.
- 14.4 More generally, our concern about the quality of KDC's record-keeping and its informal approach to decision-making increases as the years progress. We have commented in several places on the poor quality of KDC's decision-making processes. For example, in Part 10, when discussing the work to find a disposal site, we commented that:
- The records are partial at best. For example, the written records do not show whether the Council was given information about the limited capacity of the site.
  - Decisions seem to have been taken informally (for example, we do not know what formal authority the Chief Executive had to make the initial offer to purchase).
  - KDC did not obtain a valuation for the farm until the bank required it to.
  - We did not see evidence of appropriate work to consider financing and borrowing options, and the value for money of the proposed financing arrangements.
- 14.5 In summary, we consider that, by the time construction was ready to begin in late 2007, the Council had already lost control of the project – what was being built, what it would cost, how many properties it would service, how it would be funded, and what the legal responsibilities of each of the parties were.

- 14.6 As we set out earlier in the report, the Council initially failed to understand what it needed to do to manage the project and the limits of the project management services the Beca consortium would provide. The Council appears to have mistakenly assumed that the project managers would provide it with assurance that what was to be constructed would be cost-effective and appropriate for its purposes and that the financing arrangements would be appropriate and competitive. In fact, the limited project management services provided none of these things, and the Council needed to manage these issues itself. The Council did not have enough information to make the decisions it was being asked to make, so it relied heavily on the project managers' advice.
- 14.7 The Council's focus on the affordability to ratepayers rather than the overall project costs meant that it failed to appreciate the significance of the increase in capital costs and to assess whether that was appropriate.

## Part 15

### How construction was to be managed

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- 15.1 In Section B, we discussed what happened between 2003 and 2007, when the Council dealt with several difficulties in getting the wastewater project under way. In this Section, we look at the construction and implementation phase of the project. Later Parts in this Section discuss:
- events during the construction process;
  - funding and financing changes;
  - the process of KDC taking ownership of the scheme;
  - how the scheme is operating now; and
  - our overall comments on events during the construction phase.
- 15.2 In this Part, we cover how the construction process was to be managed. We discuss:
- the basic commitments in the 2007 project documents;
  - the arrangements for overseeing the construction work; and
  - our overall comments
- 15.3 In summary, we found no evidence that KDC monitored how the tools in the contract to manage its risks were being used while the project proceeded. KDC does not appear to have:
- received the information it needed to assure itself that the design was appropriate for its needs before construction began (so it could not be certain that what was to be built and paid for was suitable); or
  - received the monthly monitoring reports from the Project Director in EPS (so it had no way of monitoring the progress of construction or of understanding whether modifications would lead to additional financing costs).
- 15.4 As we set out in the next Part, the contract documents did not cover all the works to be carried out. This had financial consequences for KDC.

#### **The basic commitments in the 2007 project documents**

- 15.5 The 2007 Project Deed and Tripartite Deed included a construction timetable. They provided for EarthTech to carry out the works and for MDHL to make progress payments for the works. MDHL then took ownership of the works as they were constructed. Interest accrued on the payments made by MDHL. The accrued interest, the various fees ABN Amro charged, and the actual construction costs all formed part of the purchase price that KDC was to pay to MDHL once construction was complete.

- 15.6 If KDC made changes that meant that works were not completed to the construction timetable – for example, by modifying the works to be carried out or by changing the dates for commercial acceptance – and MDHL incurred any costs as a result, these costs would be added to the purchase price, as well as additional interest costs. There were therefore potential cost consequences if KDC agreed to change the scope of the works in any significant way.

### **How the guaranteed maximum price worked**

- 15.7 The contract included a guaranteed maximum price for the works set out in the Project Deed and a provision for sharing the benefits of any savings. That is, the works set out in the Project Deed were to be carried out for a fixed cost. If the costs came in below that price, KDC had to pay EarthTech half the value of the difference between the guaranteed maximum price and the actual costs paid. If the actual costs exceeded the guaranteed maximum price, EarthTech was responsible for the additional amount.
- 15.8 To make up the guaranteed maximum price, the cost for each part of the work was set using either a fixed or a variable amount. For example, the cost for the geotechnical investigation of the storage site was a fixed amount. The cost for the reticulation pumps was a variable amount. This was to be made up of EarthTech's fee, the base cost of the pumps, and a contingency amount. EarthTech had to tender the variable components. EarthTech told us that it always obtained a minimum of three quotations from local or national subcontractors for the full range of works. Incorporated into the amount paid to EarthTech was a design fee, management fee, and margin. EarthTech also assumed a range of risks for the scheme's performance.
- 15.9 During construction, EarthTech was required to regularly compile a document setting out the actual costs it had incurred. We did not find a copy of any such document in KDC's files. However, monthly reports that EarthTech provided to the Project Director included this information.
- 15.10 The Project Deed also required the guaranteed maximum price to be revised and updated to record any adjustments resulting from modifications. Again, we did not find any copy of such a document in KDC's files. However, the monthly reports that EarthTech provided to the Project Director included this information.

### The works that were not included in the Project Deed

- 15.11 Although the Council agreed to change the scope of the works to be carried out in October 2006, those decisions were not fully reflected in the amended Project Deed that was signed in 2007. For example:
- The Council agreed to include the costs of connecting properties to the sewer network, but these works were not included in the 2007 Project Deed.
  - Because of the resource consent process, it had been agreed to move the wastewater treatment plant and to seal Thelma Road. The Council knew this before it signed the Project Deed in December 2007. However, the Project Deed did not include any provision for these works.
- 15.12 This meant that the costs agreed to in the Project Deed and covered by the guaranteed maximum price did not cover all the works that were to be carried out. It also meant that the timetable for construction, including the dates for commercial acceptance, would need to change. As a result, KDC was likely to incur additional financing costs. We did not find any evidence that this was explained to the Council.

### Our comments

- 15.13 In our view, the amended contract documents should have covered all the works that KDC intended to carry out as part of the project. This would mean that KDC could be certain about the cost of the project. It would also mean that KDC would be unlikely to incur additional financing costs because the dates for completing works needed to change. In the documents we reviewed, we could find no explanation of why the contract documents were signed even though they did not include the full scope of the works to be carried out.
- 15.14 The Council's approach of dealing with changes in the project's scope while the works progressed carried risks. In our view, if the Council wished to take this approach, it needed to closely monitor the additional costs to ensure that the project remained affordable. As we discuss later, there is no evidence that this occurred, and the modifications KDC made had a significant effect on the cost of the project. Ongoing changes to the requirements also undermine the benefits of a PPP approach, as already discussed.
- 15.15 There was no information in KDC's files to show how the final figure for the guaranteed maximum price was arrived at. It appears that the contract overheads and profit margin were agreed before the works were priced, because the guaranteed maximum price includes figures for EarthTech's fee. However, there is no other supporting information.

- 15.16 Ensuring that the guaranteed maximum price is not set too high is usually done either by determining the amount it would cost KDC to design and construct the scheme or by getting an independent audit of the estimated actual costs before finalising the price. A probity auditor is often also used. Beca told us that KDC did not estimate the cost of designing and building the scheme, nor did it engage an independent auditor. Beca told us that:

*EarthTech did however procure a significant value of works through competitive subcontract tendering. This process was transparent and provided an assurance that Council was getting competitive pricing. Competitive subcontract tendering is a cornerstone of pricing a contract that is not to exceed a Maximum Price.*

### Arrangements for oversight of the construction work

- 15.17 As we set out earlier in the report, the protections against construction risk that had been in the BOOT approach were reduced somewhat under the DBFO approach. The key mechanisms in the Project Deed to protect against construction risk during construction were:
- endorsement of the design reports;
  - endorsement of various other plans (as set out above);
  - monitoring of monthly progress reporting from EarthTech;
  - technical audits; and
  - the technical acceptance and commercial acceptance process.
- 15.18 In addition to these tools, which could be used during construction, other mechanisms in the contract would provide incentives for EarthTech to build a scheme that would operate appropriately. These included:
- warranties and indemnities provided by EarthTech;
  - the ability to reduce the monthly operating payments if the performance standards set in the Project Deed were not met; and
  - the requirement for asset condition reports and maintenance to bring the scheme up to standard.
- 15.19 The combination of the tools in the Project Deed to manage construction risk should have caused EarthTech to build a scheme that operated appropriately. The tools we have set out in paragraph 15.23 could be used only after construction had been completed, while the tools set out in paragraph 15.22 could be used only during construction. To protect itself, KDC needed to make sure that it took advantage of the tools that were available to manage the construction process. This would mean that it would not need to use the tools that were available during the operating period and afterwards.



- 15.20 We reviewed how KDC used the tools that were available to it to manage construction risk during the construction phase. We note that, unlike a traditional design/construct contract, KDC had no direct oversight of construction.

### **Final design report**

- 15.21 The Project Deed required EarthTech to submit a final design report to the Project Director (at EPS) for endorsement, two months before construction started. The Project Director and EarthTech had to agree on the drawings and specifications included in the final design report.
- 15.22 Our ability to assess this stage of the work on the project was hampered by our not being able to review EPS' files. However, we have assessed how well KDC managed its role during this stage of the work by reviewing the information in its files, the information in Beca's files, and the information EarthTech provided to us about what it submitted to EPS.
- 15.23 EarthTech told us that it prepared the design report and provided it to the Project Director. As an example, EarthTech provided us with a copy of the specification of the reticulation system and transfer main.
- 15.24 EPS told us that the Project Director provided copies of the endorsed designs to KDC. However, as we have set out above, there were no copies of these in KDC's files.
- 15.25 KDC was unable to produce any information from its files to show that it knew whether the Project Director had endorsed the final design report nor any copies of the final design report.
- 15.26 As we set out earlier in the report, Beca and EarthTech staff reviewed the design in 2005. However, by 2007, the design had changed. KDC had no information to assure itself that people with appropriate specialist expertise, such as a wastewater engineer, had reviewed the later design report before it was finalised. Nor did it have any information that would show that it had been satisfied that the Project Director had used appropriate processes to check that the specified design standards and requirements of the resource consents were met.
- 15.27 Beca told us that it carried out a design review and provided a report on this to the Project Director. We found in KDC's files a copy of a design review report carried out by a Beca Director in July 2009. We discuss this further in Part 18. There was no evidence in KDC's files that a design review was carried out before construction started.

- 15.28 EarthTech also told us that final design reports for the treatment plant and the strategic design for the reticulation were prepared and provided to the Project Director during the design and construction activities. As examples, they provided us with copies of three design features reports for the reticulation system.

### **Works programmes and other plans**

- 15.29 The Project Deed also required EarthTech to submit a works programme to the Project Director showing the order that works were to be carried out in. This was to ensure that the commercial acceptance dates would be met, which carried financial consequences for KDC. EarthTech was also required to update this works programme regularly. EarthTech told us that it updated the works programme regularly and provided this to EPS monthly. EPS told us that the Project Director provided copies of these to KDC. However, we found no copies of these in KDC's files. We found no information in KDC's files to suggest that it reviewed the information in these documents to monitor its financial risks.
- 15.30 EarthTech was also required to submit various other documents to the Project Director for endorsement, including an Operation and Maintenance Manual, a Quality Assurance Program, an Environmental Management Plan, and a Health and Safety Plan. Although we found copies of some draft documents in KDC's files, there was no information in KDC's files about whether the Project Director finalised or endorsed these documents. However, EPS told us that the Project Director provided all documents required under the contract to KDC.
- 15.31 EarthTech told us that it prepared these documents and provided them to the Project Director. It gave us copies of examples of these types of documents, including a Project Management Plan, an Occupational Health and Safety Management Plan, a Project Communication Plan, a Waste Disposal Management Plan, and an Environmental Management Plan. It also told us that the Project Director prepared and approved the Operation and Maintenance Manual before the scheme achieved commercial acceptance.
- 15.32 The Project Deed also required EarthTech to provide an environmental report on the land where the wastewater treatment plant was to be built by 7 January 2008, before works on the site began. EarthTech told us that an environmental report was prepared for the wastewater treatment plant site. It was part of the material submitted to the NRC as part of the resource consent application process. EarthTech was also required to provide an environmental report before works began on any other land KDC owned that was to be used for the scheme. There was no copy of any such report in KDC's files.

- 15.33 EarthTech was also required to give the Project Director monthly development reports. These were to set out several matters, including progress against the works programme. There were no copies of any of these reports in KDC's files. EarthTech told us that it prepared a project report each month during construction. This included a section on the programme (timetable), discussion about the programme, a cost report, and requirements of the integrated management system and project management plan. It provided us with a copy of a monthly report as an example.

### Our comments

- 15.34 One of the main tools to manage construction risk that KDC had was the requirement that the Project Director endorse the design reports before construction started. From what EarthTech told us, we are satisfied that the design reports were created and sent to the Project Director. Because we had no access to EPS' files, we were unable to determine what the Project Director did with these documents. There is no record of whether KDC saw those documents or checked that they had been completed.
- 15.35 In our view, the endorsement of the design was one of the main tools that KDC had to enable it to gain assurance that what was to be built was appropriate for its needs. Because KDC took ownership of the scheme immediately after construction, and because the operating period was relatively short compared to the life of the scheme, KDC needed to be certain that what was to be built was fit for its purposes and that appropriate quality checks were being completed. In our view, KDC should have assured itself that these critical documents were being submitted and approved as part of its monitoring of the overall project.
- 15.36 KDC also needed to keep copies of the documentation on the scheme's design in its files. It needs this information to be able to monitor the operating contract. As the owner of the assets, it will also need them when it becomes responsible for operating the scheme at the end of the current contract.
- 15.37 From what EarthTech has told us and the documents it provided, we are satisfied that it prepared monthly works programme reports and provided them to the Project Director. EPS also told us that it provided copies of these documents to KDC. In our view, KDC also needed to ensure that it received and kept copies of these documents. The Council needed to understand whether the project was running to time and whether additional financing or other costs would be incurred, so that it could monitor its own risks and assess the performance of its project managers.
- 15.38 With a works programme, KDC could determine whether EarthTech's performance caused delays. If so, it could appropriately pass on any additional costs incurred

because of those delays to EarthTech. Without a works programmes, and with the numerous modifications KDC made, it would have been almost impossible for KDC to tell whether EarthTech caused delays.

- 15.39 We were surprised that these documents were not in KDC's files, because the broad purpose of documents such as the design reports and other plans specified in the contract, as well as the sign-off requirements, is to assure KDC that the project is being managed appropriately. We do not know how KDC could be confident that the project was being managed appropriately if it was not provided with copies of the documents.

### Our overall comments

- 15.40 In our view, there were numerous problems with the contract documents that KDC signed. The documents should have covered all the works KDC intended to carry out as part of the project. There were risks with using the modifications process to deal with any changes to the scope of works, and some of these risks came to fruition. The fact that the documents did not cover all the works KDC had agreed to suggests that the Council had a very poor understanding of what it was agreeing to.
- 15.41 The contract provided KDC with some tools to enable it to manage construction risk, some of which were available during construction. In our view, KDC needed to ensure that it received information from its project managers about how it was using the tools to assure itself that the design of the scheme was fit for purpose and that construction was being appropriately managed.
- 15.42 From what we have been able to determine, it does not appear that a wastewater engineer reviewed the final design report before construction began. The Council does not appear to have been told that the final design report had been endorsed by the Project Director or the basis on which the endorsement had been made. Therefore, the Council could not be certain before construction began that the scheme it was paying for would be suitable for its needs.
- 15.43 Although EarthTech provided monthly reporting to the Project Director, and the Project Director told us that he provided this information to KDC, KDC does not appear to have used the information. There is no information in KDC's files to suggest that it used the information to monitor the progress of construction or to understand whether modifications would lead to additional financing costs.
- 15.44 In our view, at this stage of the project, KDC needed to be more closely involved with the project and ensure that it used the tools it had under the contract fully and appropriately.

## Part 16

### Events during construction

- 16.1 Construction of the wastewater scheme officially began with a ground-breaking ceremony and open day on 14 January 2008. The construction phase ended with the official opening of the system on 16 January 2010.
- 16.2 There were very few documents in KDC's files about the construction of the scheme. The construction of the scheme was under the control of the Project Director, in EPS. We did not have access to EPS' files in Australia, so were unable to assess how that role was carried out during the construction period. Our findings about how well KDC managed its responsibilities are based on the information in KDC's files, the files that we were able to review at Beca, and the information provided to us by EarthTech.
- 16.3 In this Part, we cover:
- how well KDC controlled what was being built;
  - whether EarthTech built what it was contracted to build;
  - modifications that were made during construction;
  - how the connections to residences were managed;
  - community liaison; and
  - our overall comments.
- 16.4 In summary, we conclude that:
- KDC had very weak control over the construction and what was built. It appears that what has been built is not the same as what is in the Project Plan in the contract.
  - Modifications to the scope of the works were agreed to by EarthTech and the Project Director, but it is not clear that the Council knew about, or agreed to, these modifications.
  - KDC tried hard to communicate with residents about the scheme, but the communication was not particularly effective.

#### Control over what was being built

- 16.5 As we explained in Part 15, the Project Deed required EarthTech to produce a design report for the Project Director at EPS to endorse. If EarthTech wanted to change the design or the Project Plan, it had to provide technical information supporting the change and seek the Project Director's consent. Some changes were made to the Project Plan. We found no documents in KDC's files about these changes, so we could not establish what changes were made, the process used

to make the changes, or what information EarthTech provided to support those changes.

16.6 EPS told us that the Project Director endorsed any changes to the design proposed by EarthTech. It told us that the design changes were documented as required and that KDC was advised of any changes in monthly reports.

16.7 Depending on its nature, any design changes might have also required a change to the resource consents. We were unable to determine whether the Project Director or KDC considered these issues.

16.8 In the early stages of construction, both the Project Director and ABN Amro had concerns about EarthTech's project management. In an email to EarthTech in September 2008, EPS noted that EarthTech had been "... requested to consider making an offer to KDC to offset costs expended to date associated with poor site Project Management/non control of [wastewater treatment plant] design works".

16.9 EPS provided this email to the Council's Chief Executive with the following comment:

*In summary, we went through the present [wastewater treatment plant] design and agreed on substantive reductions without impacting process performance. We also agreed to reduce some areas which may prove to be required after commissioning, but which we all think are more likely not to be required. If we delete them and "park" some money instead of sharing savings initially, we can add them later if they are required, or alternatively share the savings after we are sure. The total savings are hard to estimate until we see the agreed revisions and [name] gets pricing from suppliers etc. but it's probably in the region of at least \$500K. The design undertaken by [name] with [name] oversight had many "over the top" items. Beautiful Rolls Royce stuff but way too excessive for what needs to be a simple, robust plant. (eg: mono rail systems for pump removal that may only be required once in 10 years??. Pumps in dry well arrangements instead of submersible within tanks, standardisation of tank sizing etc. You will see the general detail in the email below).*

*I have also told [EarthTech] that you expect a price reduction to offset the wasted design and Project Management costs caused by poor control of [name] and [name]....*

*In practice, the issue is not that significant as the design undertaken has ensured that the process and pipework design etc is robust and what we had in front of us provided an excellent basis to assess what was an excellent design for a high cost solution, but one we could use to make pragmatic savings.*

### Our comments

- 16.10 In our view, this email shows that there were several problems with the way the project was run. First, there was no financial pressure on EarthTech to create a cost-effective design. Once NorthPower withdrew, there was no commercial tension in the tendering process and, therefore, little incentive for EarthTech to put in a cost-effective design. The benchmark was never updated, so KDC could not tell whether EarthTech's bid provided value for money.
- 16.11 This email also shows the risk of using a contract that includes a guaranteed maximum price and a provision for sharing savings when there is no independent assessment of the costs that make up that guaranteed maximum price. If the costs that make up the guaranteed maximum price are not independently assessed, a tenderer can set the guaranteed maximum price as high as it likes, knowing that it will make savings in the process and that way increase the amount it takes away in shared savings. It also means that there is no way of assessing whether the guaranteed maximum price is reasonable for the works to be carried out.
- 16.12 Another issue that this email identifies is that the original tenders were for a BOOT scheme with a 25-year operation. A 25-year concession period was likely to encourage tenderers towards including a well-built wastewater treatment plant with low operational and maintenance risk. When the project was changed to a DBFO arrangement with a 10-year concession period (with a five-year right of renewal), it was likely that proposals from tenderers would include a more cost-effective wastewater treatment plant. However, in this case, there was no re-tendering, and NorthPower withdrew its bid. Therefore, there was no competitive pressure on EarthTech to revise its wastewater treatment plant.
- 16.13 The lack of a robust tendering process meant that KDC lost an important mechanism for managing this risk. It is unclear what stage the construction of the wastewater treatment plant was at and whether EPS had endorsed the designs by September 2008. It is not clear why the issues with the design had not been identified when the Project Deed was signed or when the design reports were provided to the Project Director for endorsement before construction started. The fact that EPS could only ask EarthTech to consider making an offer to compensate for the additional costs was a direct result of failing to adequately review the design reports before construction.

## Did EarthTech build what it was contracted to build?

- 16.14 The Project Deed provides that EarthTech was required to develop and operate the wastewater scheme in accordance with the Project Plan included in Schedule A of the Project Deed. There was no information in KDC's files about the final design of the wastewater treatment plant, transfer pipeline, or dam. Although Schedule A of the Project Plan in the 2007 Project Deed set out what EarthTech was contracted to build, the Project Plan could be changed or modified, provided the Council consented. We know that there were some changes that meant that what has been built is not the same as in the Project Plan.
- 16.15 We identified several aspects of the wastewater treatment plant that were not the same as in the Project Plan. For example, the 2007 Project Deed provided for six tertiary filters to further clean the effluent, but only four were installed. The Project Deed also specified a "3mm aperture step or inline screen" to provide initial screening of the wastewater. What has been built has a 6mm screen. The purpose of the screen is to remove fibrous stringy material from the wastewater, which can foul machines and damage bearings. The larger the screen size, the more fibrous stringy material can get into the treatment plant, leading to higher maintenance costs.
- 16.16 The Project Deed required the construction to be carried out in accordance with the relevant New Zealand standards, among other things. However, it appears that at least one aspect of the scheme has not been constructed in accordance with the New Zealand standards. New Zealand Standard 4404:2010 *Land Development and Subdivision Infrastructure* outlines the standard design for gravity sewers. It has specific detail on where manholes and inspection chambers are to be located along a gravity sewer. The purpose of these provisions is to enable maintenance to be carried out easily. However, Schedule A of the Project Deed specifically leaves the choice of using manholes or inspection chambers up to EarthTech. There are no records to show that the manholes or inspection chambers used by EarthTech comply with the New Zealand standard.
- 16.17 EPS told us that the New Zealand standards were guidelines only. They also told us that the modern "Modified Conventional Sewer Reticulation Design" used by EarthTech provided significant cost savings to KDC and is a very common practice in Australia and New Zealand.
- 16.18 According to the 2007 Project Deed, two reactor tanks of about 960m<sup>3</sup> in volume were to be built. We were unable to determine whether the tanks were built with the volume specified in the Deed.



- 16.19 KDC has not been able to provide us with information about why the wastewater treatment plant was not constructed to meet the contractual requirements, nor what process the Project Director used to agree changes to the plant. We could not establish whether the Project Director considered whether any of these changes affected the resource consents held for the scheme. Importantly, we were unable to determine whether EarthTech passed on to KDC the savings it made by constructing less than was required under the initial contract documents.
- 16.20 We looked at the 2005 Project Deed and the 2007 Project Deed to assess what was required to be built. Our engineers also visited the site see how the wastewater scheme operated. They identified that the 2007 Project Deed significantly reduced parts of the Project Plan included in the 2005 Project Deed. For example, the 2005 Project Deed provided for three 1075m<sup>3</sup> reactor tanks to be built, giving a total volume of 3225m<sup>3</sup>. The 2007 Project Deed reduced the total capacity to 1920m<sup>3</sup>. This reduced the capacity by 40% from the 2005 Project Deed. We do not know whether there was a corresponding reduction in price.
- 16.21 It appears that the design for the wastewater treatment plant included in the 2005 Project Deed was oversized. Although we understand that Beca and EarthTech staff reviewed the design in 2005, there was no information in KDC's files about that review work and whether the design was appropriate. We were unable to determine why the Council signed off the 2005 Project Deed without assuring itself that the wastewater treatment plant design was appropriate. It does not appear from the Council's minutes that the Council was told, before it agreed to the 2007 Project Deed, that elements of the design were being significantly reduced or the reasons for that. We were unable to determine whether the savings resulting from the reduction were passed on to KDC.

### Our comments

- 16.22 The contract specifically required compliance with New Zealand standards. This is a matter that should have been considered during the endorsement of the final design report and when the Project Deed project plan was finalised. However, the effect of the changes agreed to by the Project Director was that the sewers did not comply with New Zealand standards, as required by the contract. We are unclear what authority the Project Director had to make changes that had the effect of meaning that the works did not comply with the contract.
- 16.23 In our view, these issues all identify that the Council had little real control over what was to be built and how it was to be built. The Council failed to assure itself before signing the Project Deeds that the design was appropriate for Mangawhai's needs.

## Modifications made during construction

### KDC oversight of the modifications process

- 16.24 The Project Deed signed in December 2007 set out a process for modifications, or changes to the agreed scope of the works. Both EarthTech and KDC could request changes to the scope of works. Both KDC and EarthTech requested modifications to the scope of works.
- 16.25 The Project Deed provided that, if KDC requested a modification, EarthTech had to supply the Project Director with information about the time and cost consequences of the modification. This included information about how the additional work would affect dates, such as those set for commercial acceptance. EarthTech also had to provide information about the effects of the proposed modification on the wastewater scheme (such as on durability and operation). KDC could then accept or refuse the modification.
- 16.26 We asked for information about the modifications from Beca and EPS. They advised us that, although they could provide us with some material, finding the remaining material would require significant work. From the information we were provided with, we were unable to determine which modification requests KDC made were actually carried out. In some cases, requests for modifications were made, but the Project Director decided not to proceed with them. We also did not have the information about the proposed modifications that EarthTech should have provided to the Project Director. Therefore, we were unable to determine what information the Project Director relied on to accept the modifications or whether the process used complied with that set out in the Project Deed.
- 16.27 EarthTech told us that changes to scope were dealt with using the modifications process under the Project Deed and were properly documented. It provided us with copies of documents for one of the modifications.
- 16.28 When we reviewed KDC's files, we found only one instance where modifications were referred to the Council for decision. This was in January 2010, when the Council approved EarthTech carrying out work to repair sewerage infrastructure that subdivision developers had installed in the past. One of the Chief Executive's monthly reports to the Council records that the addition of further areas to be reticulated was discussed with the Council at a workshop. His report noted that recommendations about further areas to be reticulated would be provided to the Council progressively. It does not appear that there was regular reporting on the modifications to the Council, and the information about modifications that was provided in the Chief Executive's reports was limited.

- 16.29 KDC's files do not appear to have a full record of all the modification requests from KDC, EarthTech's notices, or the Project Director's acceptances. We were unable to determine whether the Chief Executive was advised of the proposed modifications, nor whether he agreed to them being carried out.
- 16.30 EPS told us that the Project Director provided all documentation as required under the contract, including modification requests. EPS also told us that information about all modifications was provided to the Council and explained in monthly reports and other documents. EPS also told us that KDC approved all modifications and that, in most cases, KDC requested the modifications.
- 16.31 It is unclear from the Project Deed whether any quality assurance process would apply to works carried out as modifications after commercial acceptance. It also appears that the Project Director's powers to inspect and audit work did not extend to works carried out as modifications. KDC does not appear to have discussed these issues.

### **How much was spent on modifications?**

- 16.32 A paper prepared by Beca in November 2007 (which we discussed in Part 12) stated that KDC had loan financing from ABN Amro of up to \$53 million. Of that, \$49.5 million was committed to pay other costs of the scheme and \$3.5 million was available for modifications. If cost savings could be made through the guaranteed maximum price process, then other funds could potentially be available. At that point, KDC also had \$5.9 million in revenue from the SWSS subsidy, which it could use to fund the scheme.
- 16.33 The paper is not entirely clear, but it appears that the amended (2007) Project Deed did not include some works that were required for the scheme. These works were to be carried out as modifications. These included the work to connect houses to the scheme and additional works to connect some new subdivisions. The paper estimated that the cost of connecting the new subdivisions would be about \$1.0 million to \$1.5 million. There was no estimate of the cost of the work to connect houses.
- 16.34 As we set out in Part 12, modifications agreed by KDC could affect whether the dates set for commercial acceptance were met, which would in turn affect KDC's financing costs. Nothing in the papers that went to the Council in November 2007 discussed this issue, nor was it recorded as being discussed by the Council in the minutes.
- 16.35 It is also unclear why the Council signed off the amended project documents when it was clear that the scope of the works and, therefore, the possible costs were unknown. In November 2007, the total project costs were estimated to be

\$53 million, of which \$3.5 million was available for modifications. By January 2011, the total project costs were estimated to be \$63.3 million. Of this, \$8.6 million had been spent on modifications, an increase of \$5.1 million. The project management and financing costs had also increased by \$5.2 million.

- 16.36 It appears that, by March 2008, the \$3.5 million budget for additional work had already been exceeded. In a paper to the Council on rates and charges in March 2008, the Chief Executive set out that the project costs were \$57.7 million, including \$5.5 million for future modifications. The minutes of the Council meeting on 26 March 2008 do not record that there was any discussion of the increased capital costs or the amount to be spent on modifications.
- 16.37 KDC's former Chief Executive told us that the:
- Council understood at the signing of the Project Deed there were significant additional connections to be made and that growth was occurring at a rapid rate. The Council required that all properties be connected. This was to be funded by the funding arrangements in place. The Council was measuring costs by looking at the fees to be charged to ratepayers to operate the system and fees to be paid by developers.*
- 16.38 A February 2011 presentation to the Council set out that the modifications totalled an additional \$8.6 million. The modifications listed were as set out in Figure 10.

**Figure 10**  
**Modifications to Project Deed**

Storage dam and irrigation system	\$0.8 million
House drain connections	\$5.4 million
Additional areas	\$1.1 million
Resource consents	\$0.5 million
Repairs to sewers vested in the Council by developers	\$0.8 million

Source: "EcoCare Project Review", PowerPoint presentation to the Council from Project Management Team on 9 February 2011.

### What were the modifications?

- 16.39 Because of the lack of records in KDC's files, we were unable to determine what the scope of the works covered by the modifications was. We asked KDC for information about the modifications and the costs of each. However, it was unable to provide this information. We were also unable to determine what work

the project managers did to determine that the work that was completed after commercial acceptance was carried out to the appropriate standard.

- 16.40 From the information we have, we found that there were several problems with the modifications agreed to. We have summarised these below.
- 16.41 The modification changing the location for the wastewater treatment plant was because of agreements made to settle the appeals to the Environment Court on the resource consents for the wastewater scheme. This change was known before the amended Project Deed was signed in December 2007. However, it was not included in the Deed. The modification papers showed that the Project Director requested this modification from EarthTech in December 2007, but it was not finally agreed until May 2009. By this time, the work had been completed (in keeping with the modified requirements). The purpose of the modifications process in the contract is to ensure that the cost, design, and construction implications for the rest of the scheme are understood before the decision to change is made. That purpose was defeated in this case.
- 16.42 One of the modifications the Project Director requested related to Baylys Beach (an area on the west coast of the district). The Project Director asked EarthTech to provide a cost for assessing the site for connecting Baylys Beach to the Dargaville wastewater treatment plant and for preparing concept designs, construction designs, and construction costs. It is unclear how this modification could be authorised under the Project Deed.
- 16.43 EarthTech told us that it created a preliminary design for a wastewater scheme for Baylys Beach and provided this to EPS and KDC. KDC told us that work carried out by the project managers on the investigations of Baylys Beach and other wastewater schemes were included in the Mangawhai wastewater project costs. It identified invoices from Beca for this work that were about \$280,000. It also told us that the value of these works was removed from the valuation of the Mangawhai scheme because of the scheme asset valuations completed in 2012.

### Our comments

- 16.44 It is clear that, before KDC signed the amended project documents in December 2007, it was aware that additional work to that set out in those documents would need to be carried out. In our view, there were risks to KDC signing the amended project documents and leaving these issues to be managed through the modifications process. It does not appear that KDC ever assessed what these risks were or how they could be mitigated before it signed the amended project documents.

- 16.45 From the information we have seen, KDC did not have a clear process for managing the modifications, including determining when Council approval was required. The Council files did not include any evidence of regular reporting to the Council on what modifications had been agreed and the costs of those modifications, although EPS told us that there was regular reporting. If the only reporting was that shown in the files, the Council would have had limited information to enable it to understand the costs of the modifications and, in turn, how that might affect its financing.
- 16.46 Because KDC had limited funds available for modifications, it needed to maintain strong oversight of the modifications process. It is not clear that it did this. What is clear is that costs increased and works not authorised by the Project Deed and unrelated to the wastewater project were carried out.

### **How the connections to residences were managed**

- 16.47 As we set out earlier in the report, in 2006, the Council agreed to connect residents to the scheme as part of the scope of works to be carried out. In October 2006, the Council was told that the work to connect houses was likely to cost \$2.35 million. This work was not included in the 2007 Project Deed. Rather, it was done as a modification. In some cases, works on private land were also required to connect a group of residents to the wastewater scheme. For example, a single drain running through one resident's property might connect five other properties to the scheme.
- 16.48 There are requirements in the Local Government Act 2002 and the Local Government Act 1974 that control how a council can carry out works on private land. These Acts also set out what landowners' obligations are for a wastewater scheme, including the parts that are on their land.
- 16.49 Before construction started, KDC provided residents with an information booklet that included information about connections. Residents were later provided with information about when properties would be connected. We understand that discussions were held with residents on-site before connection works started, where this was possible.

### **Use of the Sanitary Works Subsidy Scheme subsidy**

- 16.50 The Council decided to use part of the SWSS subsidy to pay for the cost of connecting ratepayers who had sections created before 23 March 2002. The subsidy was also to be used to reduce the uniform targeted rate that those ratepayers would pay. The Council intended that other ratepayers would have to pay for the costs of connecting to the scheme. It appears that EarthTech carried

out connections for 1172 ratepayers who were eligible for the subsidy. The remaining 778 had to pay for the connection work.

- 16.51 A report to the Council in 2012 stated that the cost of connections was \$7.948 million. This did not include the cost of installing the grinder pumps. This meant that 1172 properties were connected at an average cost of \$6,781 for each property. The \$7.9 million was more than the total amount provided by the SWSS subsidy. However, the subsidy was also to be used to reduce the targeted rate for those eligible. It is not possible for the SWSS subsidy to have covered all of these costs. Some will have had to be funded by other revenue, such as rates.
- 16.52 The connections work was carried out as a modification to the Project Deed. We understand that the work was done on a cost reimbursement basis, which included EarthTech's fee. We were unable to determine what information was provided to the Project Director about the likely costs of the connections. There is no record of such information being provided to the Council.

### Who got connected

- 16.53 KDC was able to legally require people within the drainage district to connect their properties to the wastewater scheme. However, not all of the properties in the drainage district were connected. It appears that decisions were made not to connect some properties because they were very costly to connect. A draft policy paper EPS prepared in 2006 stated that, in deciding to include properties in the scheme, the following matters may be considered:

*Some allotments in Mangawhai are in locations such that connecting them to the scheme would cost significantly more than the average cost per property. Some examples of these properties can be found on the harbour front where steep, heavily vegetated slopes would need to be negotiated by a pressure sewer. If the exclusion of such allotments is unlikely to have any practical impact on the overall objective of the scheme (ie improving ground water and harbour water quality) it may be considered economically beneficial and environmentally acceptable to exclude them from the scheme....*

*Large allotments which have adequate area for on-site disposal may be excluded from the scheme as there is no perceived environmental benefit from connecting them to the EcoCare scheme.*

- 16.54 We were unable to establish whether this policy was finalised or what basis was used to decide who would be connected. It is not clear that the Council discussed this issue. The policy on who would be connected within the drainage district was unclear and created confusion for residents.

- 16.55 In particular, when we met with residents, many people expressed concern that the local councillor's house had not been connected even though her property was located quite close to Mangawhai Village. We established that she and her husband had wanted to connect to the scheme as part of their plans to upgrade the property. However, it was eventually established that their property, like the school over the road, would fall outside the drainage district, although areas close to them were connected. She told us that the reasons KDC gave them for declining to connect the property included that the cost to KDC of making the connection was greater than the connection costs they would pay to KDC and that the property was large enough to support its own wastewater treatment system without risk of contamination to the Harbour.
- 16.56 This particular councillor had no involvement in the decisions about who would be connected and was unhappy to have been excluded from the scheme. However, she has been the subject of considerable personal criticism because people could not understand the basis on which decisions were being made. In our view, KDC could have communicated its criteria for connection more effectively and explained why various properties did not meet the criteria.
- 16.57 It does not appear that KDC has taken any steps to ensure that those properties within the drainage district but not connected – in particular, properties close to the estuary – have correctly functioning septic tank systems to minimise effects on the environment.
- 16.58 Some properties that could be connected were not connected because their owners needed to carry out works to upgrade the drains on their properties before they could be connected.

### **Shared grinder pumps**

- 16.59 Residents were advised in November 2007 that each property that was to be serviced using the low-pressure system would have a grinder pump that then connected to KDC's sewer lines. They would pay for the power costs of the grinder pump. They would also be responsible for additional maintenance costs arising from misuse of the system and for replacing the grinder pumps in the future.
- 16.60 By 2008, that position had changed. Multiple properties were to be serviced by a single grinder pump to save costs. A paper EPS prepared noted that shared grinder pumps were not common in New Zealand or Australia but would save KDC money. The paper also set out that KDC would pay the power costs for the shared grinder pumps.
- 16.61 It is unclear why this change occurred. We could find no record of the Council discussing this. Sharing grinder pumps can create problems for residents, such



as liability for maintenance and access for repair and maintenance. Eventual replacement can also be problematic, particularly where some residents sharing the grinder pumps have different occupancies in their houses – for example, permanent residents compared to those who own holiday houses that might be occupied only intermittently. We were unable to determine why KDC decided to pay for the power costs for some grinder pumps and not others. Again, we saw no evidence that the Council discussed this issue.

16.62 It appears that the way that the connections work on private land was done has the legal effect that KDC does not own the grinder pumps. They are owned by the ratepayers, who are then responsible for operating and maintaining them. We understand that, at present, EarthTech repairs the grinder pumps, although KDC does not regard the grinder pumps as part of the wastewater asset that it owns.

16.63 There are clear benefits to KDC owning the grinder pumps, maintaining them, and replacing them. These benefits include ensuring that replacement pumps maintain the integrity of the wastewater scheme and that maintenance work is carried out to a uniform standard. In our view, KDC needs to reconsider the issue of who owns the grinder pumps, who pays for the power for them, and who is responsible for their maintenance and replacement. KDC told us that it is currently reviewing its policy on the ownership and maintenance of both existing grinder pumps and any that may be required for future extensions.

### **Common drains and public drains on private property**

16.64 We understand that the reticulation system also includes drains that run across private land and service several properties. If such drains (called common drains) are not declared to be public drains, they remain private drains. All of the ratepayers whose properties are serviced by that drain are responsible for maintaining and repairing those common drains. As a paper drafted by EPS in 2006 sets out:

*With any common drainage system there is a potential for disagreements to occur between interconnected owners. The issues are generally associated with damage or asset failures and the resultant responsibilities and costs.*

16.65 It is usually regarded as preferable to declare that drains connecting more than one property are public drains. Easements should also be put in place to give KDC the right to go on to the property and maintain the drains as required. KDC's former Chief Executive told us that, historically, KDC required private drains, including those used jointly, to be maintained by those using them to reduce the costs to ratepayers.

- 16.66 The mechanism used to carry out the work on private land (section 459 of the Local Government Act 1974) did not provide for any ongoing right for KDC to access these common drains. However, it is possible for a council to lodge a certificate on the title of properties setting out the rights and responsibilities of each party for a common drain. We found no evidence that KDC lodged such certificates on the titles of affected properties, nor that it communicated the rights and responsibilities of the landowners to them when the common drains were installed.
- 16.67 In some cases, EarthTech has installed public sewers across private property. KDC owns these public sewers and is required to maintain them. We understand that it is best practice to locate sewers within the legal road, because it makes long-term maintenance and eventual renewal of the sewer easier for the council. For example, the council does not have to negotiate access, and reinstatement of the site is likely to be less costly. It also means that landowners are not restricted in how they can use their property – for example, they could be restricted from building over a public sewer on their property. Although these decisions might have meant that the reticulation network was cheaper, ultimately, it is likely to have increased future costs for both residents and KDC.
- 16.68 EPS told us that it is common practice in Australia and New Zealand to locate sewers on “brownfields” sites in both private and public land because this “provides the cheapest ‘whole of life’ cost”. EPS also told us that KDC was aware of this and obtained legal advice that this was appropriate.
- 16.69 Although there was a copy of legal advice on KDC’s files about access to private property to install sewer lines, there was nothing in that advice about whether it was appropriate for public sewer lines to be placed on private land.
- 16.70 EPS disagreed with our view that the location of public sewer lines on private property was likely to have increased costs for both residents and KDC. It told us that “Modern pipeline in situ maintenance and repair techniques mean that the likelihood of having to enter private property to undertake maintenance (should any be required) is very low.”
- 16.71 We did not see any information in KDC’s files to indicate that the Council discussed the location of public sewer lines on private property or the potential costs or benefits of such an approach.

### Our comments

- 16.72 In our view, there were significant problems with the process for deciding that KDC would carry out the work to connect houses to the system and the way in which that work was done.
- 16.73 The decision to reverse the earlier decisions and take responsibility for this work was made without a full understanding of the cost and difficulty that would be involved. The full cost of the work ended up being \$7.9 million rather than the maximum \$2.5 million estimated when the decision was made in 2006. KDC received \$6.63 million (including GST) through the SWSS subsidy. These funds were meant to cover the costs of the house connections and to reduce the uniform targeted rate for those qualifying for the subsidy.
- 16.74 In terms of difficulty, the decision meant that KDC's contractors would dig and lay pipes on people's sections. They would need to interact with property owners about the detail of exactly what work was to be done and how people's gardens and paved areas would be reinstated afterwards. If the work was not done well, there was an obvious risk that property owners would become upset. Taking on this work created significant new risks that were not well managed.
- 16.75 In our view, the information that KDC provided about who would be connected and who would not created confusion and significant ill will in the community. This was compounded by people paying different amounts and having different work done for them depending on when their property had been established, whether they were part of a new subdivision, and so on. When we met with residents in Mangawhai, the overriding message was that people did not understand why different properties were treated differently. Although we have confirmed that there were reasons for those differences, we agree that the information was very confusing.
- 16.76 We are also concerned at the number of decisions made during the connections process that involved short-term savings on construction costs but created longer-term problems for KDC as the eventual owner of the scheme. Obvious examples are the decision to install grinder pumps shared between sections rather than one for each property and the use of common drains. KDC has taken none of the usual legal steps, such as lodging easements on titles, to ensure appropriate access to maintain the infrastructure.
- 16.77 All of these concerns again lead us to conclude that KDC was not in proper control of the project. Decisions were based on poor information and made without a full understanding of the costs and consequences. It is not clear how many of these decisions were made by, or communicated to, the Council.

## Community liaison

- 16.78 The ground-breaking ceremony for the wastewater scheme took place on 14 January 2008, and all residents were invited. An open forum was held after the ceremony. Drawings of sewer pipeline routes and an initial construction programme were available for viewing. EarthTech staff members were also present to answer queries. The invitation advised that construction was expected to take two years and that there would be disruption to roads and public and private property during this period.
- 16.79 In the six months before the ground-breaking ceremony, KDC distributed updates on the wastewater scheme monthly and sometimes fortnightly. These provided information about what residents should expect, who to contact with queries, and what residents needed to do if they planned any building works.
- 16.80 In October 2007, residents were advised that they would shortly receive an information booklet providing details of how the scheme was to be constructed and how it would affect them. The booklets were to be mailed to all residents. Additional copies would be available from the EcoCare Project Office and KDC offices. The booklet was distributed in November 2007.
- 16.81 Residents were advised that the EcoCare Project Office was to be established in Mangawhai Village in early November. The Community Liaison Officer would share this office with EarthTech staff to provide a “one stop shop” for queries and concerns. Residents were invited to join an email database to receive regular updates sent out by the Community Liaison Officer.
- 16.82 In December 2007, ratepayers were sent a *Notice of Intention to construct works on private land*. Recipients were advised where to view a description of the proposed works and reminded that the project information booklet outlined their rights and obligations if they wished to object.
- 16.83 From the ground-breaking ceremony in January 2008 until November 2009, updates on the wastewater scheme were distributed fortnightly. These regularly included contact details for the Community Liaison Group, the Community Liaison Officer, and the Project Office; construction progress reports; answers to common queries; reinstatement processes; explanations of the proposed rates and charges; and information about grinder pumps.
- 16.84 In addition, we are aware that the Community Liaison Officer dealt with many email queries and concerns during the construction period. We received many positive comments about the value of her work.

- 16.85 In November 2009, when the construction team withdrew and the Community Liaison Officer position was disestablished, the community was advised that KDC's Customer Services Team would handle any queries about the project.
- 16.86 An official open day took place on 16 January 2010.

### **Communication about connections and laying of pipelines**

- 16.87 As part of the 2006 Statement of Proposal, KDC proposed to connect each property within the drainage district to the scheme. This was a change from the earlier 2003 Statement of Proposal, which said that connections were to be the responsibility of each homeowner.
- 16.88 The Council decided to use the SWSS subsidy to meet the cost of connections for properties that existed before 23 March 2002.
- 16.89 In November 2007, the project information booklet was distributed. It provided information about who would be connected. It also clarified that some properties within the drainage district would not be connected because sparse development meant that the properties would have a minimal effect on the Harbour or because distance or access difficulties meant that the properties would be too expensive to connect.
- 16.90 The booklet also provided answers to several frequently asked questions about the connection process, the type of drain to be used, whether gravity sewers or grinder pumps were to be installed, and matters of reinstatement.
- 16.91 EarthTech held "street corner meetings" shortly before it began construction work in each area, and local residents were invited to attend.
- 16.92 In our discussions with residents, many told us that they felt that the quality of communication about connections was very poor. Many reported that they had not been advised when they were going to be connected and received no confirmation once connected. Some commented that street corner meetings simply did not take place or, if they did, contractors took no notice of agreements reached about the location of pipes.
- 16.93 One of the subcontractors that carried out the main reticulation works (but not the actual house connections work) told us that, in its view, the consultation with homeowners and residents before construction began was inadequate. It meant that the subcontractor had to carry out more direct liaison with homeowners and residents than it had expected to. Under its contract, it was originally required to contact property owners by a notice only. However, it ended up having to notify and negotiate the location of pipes with the property owners. It thought that KDC

or EarthTech should have carried out this negotiation and notification of works. It created additional cost and difficulty for subcontractors.

### **Communication about property reinstatement**

- 16.94 The project information booklet distributed in November 2007 explained that properties would be restored to their original condition after construction work was completed. The booklet confirmed that photographs of the property would be taken before work began to ensure that the property was reinstated to its original condition. These photographs were to be kept on each property file in the Project Office. Homeowners would be asked to sign off the restoration work once it was completed to their satisfaction. If they were not happy with the reinstatement works, they were able to lodge a complaint with the wastewater project team, who would be responsible for assessing each case and applying appropriate remedial action.
- 16.95 During the construction work, residents were frequently provided with information about the reinstatement process through updates on the wastewater scheme provided by KDC. These updates also included information about where construction would take place next.
- 16.96 A question and answer document posted on KDC's website in March or April 2008 included information about reinstatement.
- 16.97 One of the main subcontractors that carried out most of the reticulation work (but not the house connections work) told us that EarthTech would not approve payments to it until the property owners had signed off the reinstatement work. The subcontractor resolved most of the reinstatement issues. However, a small number were left to EarthTech and KDC to finalise. The subcontractor told us that this was only done after a lengthy period during which it had to put considerable effort into resolving the issues.
- 16.98 The subcontractor also told us that, in one case, it sought to avoid a potentially difficult reinstatement issue by proposing to realign a pipeline, rather than place it across a driveway. EarthTech disagreed and instructed the subcontractor to leave the pipeline in its proposed alignment. The reinstatement proved very difficult, and the landowner was unhappy with the reinstatement work on the driveway. As a result, EarthTech required the subcontractor to replace the whole driveway.

## Our comments

- 16.99 We received mixed views on the quality of communications with the community during the construction period. KDC was trying to communicate with the community, but in some cases this communication was not effective.
- 16.100 Many residents commented that communication was good, and most reported that, once connected, they experienced no issues and believed that the scheme was working as it should.
- 16.101 It would appear that, although communication before connection was extensive, EarthTech's actual communication during construction was inconsistent and, at times, either inadequate or non-existent.

## Construction issues raised by residents

- 16.102 When we met with members of the community, they raised with us several concerns about how the construction was carried out. We selected 10 of those concerns and asked one of our engineers to look into those matters further. He sought more information from KDC about the particular issues and visited the sites where the issues occurred.
- 16.103 His answers to the issues we raised with him are set out in Figure 11.

**Figure 11**

### Questions and answers on connections to the wastewater scheme

Questions	Answers
1. Property A is not connected.	This is because it is further than 60 metres from the reticulation and therefore not required to be connected.
2. Property B appears to have 4+ dwellings but only one is connected with a grinder pump.	All these buildings are on one title. There is one connection, and each of the houses is connected through that one connection.
3. Property C has a grinder pump, but none of the adjacent dwellings around the end of the cul de sac have a grinder pump. They have gravity connections with no grinder pumps.	There is insufficient head for this property to allow a gravity connection to function.
4. Properties D, E, F, and G appear to have no service connections.	This was a small subdivision served by a Reflections plant. They have subsequently installed gravity connections to the system.
5. Property H has a connection that appears to be located causing unnecessary duplication of on-site reticulation. Is there a reason for this?	The connection was installed based on the septic tank location. The septic tank was bypassed requiring the line to be located on the other side of property.

Questions	Answers
6. Property I appears to have been connected, but the owner indicates that it is not connected.	The property has defective drains. The owner needs to apply for a building consent to connect.
7. There is a pipeline installed across the front of Property J that has a connection to that property but has no connections beyond that. Is this a section of pipeline that is redundant?	Yes, the pipeline was installed assuming this property would connect further along its frontage. Its connection is further down the street, so this last section of sewer and manhole are redundant until another connection is made.
8. It appears that Properties K, L, M, and N are not connected. Why is this?	These properties could not gravity to the main in their street. These properties were not included in the original scope of the wastewater scheme. It was intended that these properties connect to another system over the other side of the hill. Property L is now connected with a grinder pump. Property M could also connect if needed.
9. Street O appears to have a service connection that is not connected	Council records indicate “defective drains do not connect”. Owner needs to remedy then apply for building consent to connect.
10. It appears that Properties P to Y are not connected to the wastewater scheme. Is there any reason for this when properties over the road are all connected?	These properties were not in the original scope of works for the wastewater scheme.

### Our comments

- 16.104 When we met with residents in Mangawhai, people showed us photos and other information to illustrate the damage done to their properties or raised questions with us about what seemed to be poor quality work or arbitrary decisions.
- 16.105 Our work to check on the various issues raised shows that there were usually good reasons for the decisions. Communication was the main problem. In some cases, it was true that the reinstatement process was protracted and not particularly satisfactory.

### Our overall comments

- 16.106 In our view, the events described in this Part show that the Council received little reporting about how the construction was carried out. There was a surprising lack of information about the construction period in KDC’s files. There were also many issues that we were simply unable to come to conclusions on. Often, we could not tell what the decisions were, who made the decisions, or what the basis for the decisions was.



- 16.107 The Council should have ensured that it received regular, more detailed reporting from its Chief Executive and project managers during the construction period. Some decisions cost KDC significant amounts of money, but these decisions do not appear to have been referred to the Council to discuss or decide on. Some decisions will have future cost consequences for KDC, but yet again the Council was not informed about them.
- 16.108 The Project Deed provided KDC with some tools that it could use to control what was built and how it was built. As we set out above, it is not clear that it used the tools it had. It appears that EarthTech did not build what was specified in the Project Plan in the Project Deed. The Project Deed required the scheme to be developed and operated in accordance with the Project Plan. Changes could be made to the Project Plan with the consent of the Council. However, we cannot establish the process for making those modifications and whether they were formally or informally authorised. KDC had little, if any, control over the modifications and their cost consequences.
- 16.109 In our view, the connections process was also badly managed. The Council's decision to take on responsibility for connecting houses to the scheme was based on inadequate information about cost, the reasons for decisions were opaque, and the risks of miscommunication with property owners were poorly managed. Too many people were left confused and angry by this work. Attempts were made to communicate with people and to reinstate properties after the work had finished, but these efforts were not always effective. We are also concerned that the proper legal arrangements were not put in place to enable long-term maintenance of the infrastructure. In our view, short-term cost savings took precedence over long-term cost-effectiveness.
- 16.110 All of these points give further weight to our overall view that the Council was not in control of the project. The lack of any effective high-level management or governance of the project was becoming apparent.



## Part 17

# Funding and financing changes during construction

17.1 In this Part, we discuss:

- the changes that the Council agreed to make to how the project would be funded;
- how KDC started to use interest rate swaps;
- the changes to the timing of the project that meant the swaps needed to change;
- what the Council was told about these financial issues; and
- our comments.

17.2 In summary, we conclude that the Council managed the financing of the project very poorly. The Council took no steps to get any independent advice about whether the debt financing was appropriate and competitive with what was available in the market. The Council's understanding of the financing arrangements was so poor that it failed to appreciate that changes to the scope of works would have financial consequences. The Council should have had much stronger oversight of the financing for the project, including the debt financing.

17.3 We have not discussed the issues that KDC had with the rates that it levied in this period. Clearly, there were problems with the rates levied for the wastewater scheme, and the rates were defective. We have not discussed these issues in this report because they are discussed in detail in the Validation Bill being considered by Parliament and are also the subject of judicial review proceedings in the High Court.

### Changes in the way the scheme would be funded

17.4 The Council considered the rates and development contributions to fund the wastewater scheme at its meeting in November 2007. The Council next considered this issue in March 2008. The Chief Executive provided a report to the Council recommending the rates and charges set out in the last column of Figure 12, which we have compared to the figures set out in the 2006 Statement of Proposal.

**Figure 12**  
**Changes to rates and charges from June 2006 to March 2008**

Rates and charges	2006 Statement of Proposal (GST included)	March 2008 (GST included)
Uniform annual charge	\$630.00	\$692.90
Uniform targeted rate (pre-2002 ratepayers)	\$2,000.00	\$2,654.10
Uniform targeted rate (post-2002 ratepayers)	\$6,862.50	\$7,516.60
Development contribution	\$11,060.00	\$12,183.80

Source: 2006 Statement of Proposal, Option 3.2, page 24 and Council minutes, 26 March 2008, page 16.

- 17.5 The Chief Executive's report advised that the rates and charges had been calculated using the funding model PwC (Australia) developed. The model assumed that 4500 sections would be connected after 25 years. The rates and charges also included an escalation to account for the increases in the CPI.
- 17.6 The report also noted that capital expenditure on the project had increased from \$53 million in November 2007 to \$57.7 million in March 2008.
- 17.7 The Council adopted the Chief Executive's recommended rates and charges.
- 17.8 Rates were first levied for the scheme in 2008/09 and were the same as the rates agreed at the Council's March 2008 meeting. Concerns about the rates first began to be raised in 2009.

## Kaipara District Council's use of interest rate swaps on its loans

- 17.9 Interest rate swaps are a financing instrument that involves a contractual relationship between a financier and a party who wishes to manage their interest rate risk. The normal use of interest rate swaps by local authorities is to change the interest rate from floating to fixed. This gives the local authority certainty about its exposure to rising interest rates.
- 17.10 As we set out in Part 12, KDC signed an International Swap Dealers Association agreement with ABN Amro in December 2007. Under the contract documents:
- When the Land Acquisition Facility Agreement was signed in December 2007, it was decided to use a floating interest rate.
  - The Term Loan Facility Agreement also had a floating interest rate.
  - At Commercial Acceptance 1, KDC would draw down funds under the term loan to repay what it owed under the Land Acquisition Facility Agreement and to pay MDHL the purchase price of the completed facilities.

- At Commercial Acceptance 2, KDC would draw down more funds to pay MDHL the purchase price for the remaining facilities.
- 17.11 In April 2008, ABN Amro provided EPS with advice about whether to use an interest rate swap for these two agreements. The paper set out that the current floating interest rate was 8.80% a year. ABN Amro advised that interest rates were unlikely to ease in 2008, and it recommended that KDC fix the interest rate on the debt KDC expected to incur between May 2008 and August 2009 (comprising the loan to purchase the farm and the drawdown at Commercial Acceptance 1), by using an interest rate swap to fix the rate at 8.36% for that period. This provided certainty for KDC.
- 17.12 ABN Amro advised that, if the floating rate increased, KDC would save money in interest payments. The reverse also applied – that is, if the floating rate reduced, KDC would be unable to take advantage of the lower rate – but this was not explained to the Council.
- 17.13 The ABN Amro paper noted that, if the Commercial Acceptance 1 date and drawdown (which was to be on 1 January 2009) was delayed, “the value in the existing swap can be retained and embedded in a new swap with a new modified debt tranche”. However, the paper did not explain that doing this would incur costs or what those costs would be. We note that the 1 January 2009 date was a mistake: the date for Commercial Acceptance 1 was 7 February 2009.
- 17.14 The KDC’s Finance Manager reviewed the advice. In an email to EPS, which was also copied to the Chief Executive, the Finance Manager noted that:
- Local government is not in the business of second-guessing interest rate movements. It’s too much like speculation. Were you not talking earlier this year of seeking some independent advice of your own to double-check on the ABN advice?*
- 17.15 EPS replied to the Chief Executive that:
- We could get some further independent advice but I think that ABN’s advice, whilst not being totally at arms length, does not benefit them in any way that I can see. As part of the partnership for Mangawhai, I suggest we should accept their advice. We can review the position again at CA1.*
- 17.16 We could not find any response from the Chief Executive in KDC’s files. However, it appears that the Chief Executive agreed to enter into the swap.
- 17.17 In a paper to the Council in March 2008, the Chief Executive recommended fixing the interest rates for the Land Acquisition Facility and for the construction period

between Commercial Acceptance 1 and 2. His paper set out that the rates were currently not fixed and that:

*... in the current environment this has the potential to increase costs by approximately \$90,000 if the ABN Amro and other market predictions prove correct.*

*... advice had been received from ABN Amro that it is possible to hedge against future interest rate rises during the construction phase.*

- 17.18 The paper did not set out that the mechanism to fix the interest rates was a swap or that there were costs and risks in using such instruments, particularly where the timing of the underlying borrowing being hedged is uncertain. Importantly, the paper did not draw attention to the fact that what was being proposed was not consistent with KDC's Treasury Management Policy and that the steps required by that policy to manage risk had not been followed.
- 17.19 KDC's former Chief Executive told us that KDC's Finance Manager would have drafted the report to go to the Council. He told us that he does not recall being told that there was a breach of KDC's policy. If it had been raised, he would have advised the Council of this. He told us that he believed that "there was significant financial benefit to Council. The bank was consistently asking Council to change these arrangements. They were disadvantaging the bank." We were unable to verify from KDC's files whether KDC's Finance Manager prepared the report.
- 17.20 The Council agreed to fix the interest rates on the Land Acquisition Facility, and for the construction period between Commercial Acceptance 1 and Commercial Acceptance 2, up to August 2009.

### Changing project dates meant the swap had to change

- 17.21 ABN Amro set up the swap to start from 1 May 2008, which effectively fixed the interest rate that KDC was paying until 6 August 2009. However, as set out in paragraph 17.13, the swap was based on the drawdown for Commercial Acceptance 1 occurring in January 2009. The contractual documents and loan set out that two drawdowns would be made on the loan to pay for the scheme at Commercial Acceptance 1 and Commercial Acceptance 2. It appears that the swap did not match with the expected cash flows under the contracts and loan. We do not know why neither ABN Amro nor EPS identified this mistake.
- 17.22 In late December 2008, it had become clear that the date for Commercial Acceptance 1 was going to need to change because of the modifications. ABN Amro advised EPS that, if the date were to change, the swap would need to be broken and that there were costs to doing this. In an email in December 2008,

EPS noted that the floating rate had dropped. EPS discussed the costs of breaking the swap with ABN Amro and set out that the date for Commercial Acceptance 1 had always been February 2009. EPS also stated that the dates for commercial acceptance were always subject to change, that ABN Amro had been told this, and that any break costs were for ABN Amro to deal with.

- 17.23 ABN Amro acknowledged that the date for Commercial Acceptance 1 was supposed to be February 2009. However, it did not agree with EPS' view that the break costs were ABN Amro's problem. It advised that the swap agreement was based on the cash flow model that anticipated the drawdown for Commercial Acceptance 1 in February 2009. As Commercial Acceptance 1 was not going to happen until somewhere between June and August 2009, the swap either needed to be closed out or restructured. Because interest rates had fallen since the swap was entered into, there was a cost to close out or restructure the swap.
- 17.24 ABN Amro noted that the Land Acquisition Facility would need to be extended beyond its expiry date of February 2009 because of project delays. The amount of the facility also needed to be increased to cover the increase in capitalised interest payments that would need to be made. As the banks' cost of financing had increased because of the change in global financial markets, ABN Amro advised that there would be increased costs to changing the Land Acquisition Facility.
- 17.25 ABN Amro provided EPS with advice about how the break costs were calculated. It also set out what the projected interest costs would be, based on several floating interest rate options.
- 17.26 EPS advised ABN Amro that KDC had agreed to close out the swap. In an email to EPS in February 2009, ABN Amro proposed to fund the swap break costs of around \$825,000 through a drawdown under the Land Acquisition Facility. It agreed to increase the amount of the loan under the Land Acquisition Facility Agreement to \$7.5 million and to extend the expiry date from 28 February 2009 to 31 December 2009. ABN Amro charged an upfront fee of \$7,500 to do this and increased the margin on the Land Acquisition Facility from 0.55% to 1.5% each year. EPS advised ABN Amro that KDC agreed to this. ABN Amro advised that the swap was closed out and that the cost to KDC was \$840,000.
- 17.27 It appears that the Land Acquisition Facility Agreement was amended in February 2009. The amendment is largely in the terms set out above. It sets out that the swap termination costs were \$840,000.

## What the Council was told

- 17.28 EPS prepared a report about the cancellation of the swap agreement in February 2009. Several drafts were prepared. The report set out that interest rates had fallen because of the global financial crisis and that the margins banks were charging for loans had increased. The report stated that:
- ABN Amro and Beca/EPS International have been in negotiations since late 2008 to restructure or cancel the swap arrangement to enable Council to take advantage of the lower interest rates now available. The fixed interest rate swap has now been closed out and it has been agreed to convert the Construction Funding Agreement to a floating rate.*
- 17.29 The report set out that swap break costs were \$840,000 and that the margin on the Land Acquisition Facility for March to August 2009 had increased from 0.55% each year to 1.5% each year. However, the report did not explain that the swap needed to be broken and that the increased margin needed to be paid on the Land Acquisition Facility because modifications meant the date for Commercial Acceptance 1 could not be met.
- 17.30 The report noted that there would be “significant savings to be gained through the period from March 2009 to August 2009 which off-set the above costs based on current projections”. One draft of the paper put these savings at \$75,000 to \$175,000 after deducting break costs. A later version of the draft put the range at \$750,000 to \$875,000.
- 17.31 This later version of the draft appears to suggest that, at the same time as breaking the swap agreement, the interest rate payable on the Construction Funding Agreement between EarthTech and ABN Amro would be converted to a floating rate. Assuming the floating rate remained at 4% each year until August 2009, EPS estimated that about \$700,000 could be saved. It is unclear how this would be achieved, because KDC was not a party to the Construction Funding Agreement and would have no control on the interest paid. KDC did not have a copy of the Construction Funding Agreement in its files, so we were unable to determine what the interest rate was or how it was to be set.
- 17.32 The report noted that:
- The only real alternative was to continue to pay the fixed interest at 8.36% p.a. for the period up to August 2009 that would have increased the cost to Council with no offsetting savings.*
- 17.33 In our view, this report was misleading. The reason the swap had to be broken was that the dates for commercial acceptance had changed. It is unlikely that



KDC would have elected to use a swap to refix at the higher interest rate when its underlying loans were based on floating rates.

- 17.34 The report stated that ABN Amro had recommended taking the approach set out in the paper and “that PwC had also reviewed this position and confirmed that the general approach was sound”. There were no copies of any advice about this issue from PwC (Australia) in KDC’s files. The report went on to state:

*In addition to ensure the integrity of the process it is recommended that [name] (ex ABN Amro) be engaged to conduct an independent review of the financing arrangements with ABN Amro to confirm ABN calculation and to recommend any potential other areas for savings.*

- 17.35 This person had been the banker at ABN Amro and had been involved with the financing for KDC since at least 2005. He had provided the advice about entering into the swap agreement to KDC. He reviewed the final draft of the paper.
- 17.36 We tried to assess the estimated cost savings provided in the various EPS papers. We were unable to establish what the figures were based on or whether there were significant savings from breaking the swap. However, we would be surprised if there were any net savings from breaking the swap once the break costs of \$840,000 were taken into account.
- 17.37 There was no record that this report was provided to the Council. We were not able to determine from KDC’s files that the Council was ever advised that these costs had been incurred in March 2009. A paper reviewing the project prepared by the project managers appears to have been provided to the Council at a meeting in June 2010. This paper set out that a break fee was paid “to change the fixed loan to a floating line during the final stages of the construction period”. However, the paper makes no reference to the use of swaps or why it was necessary to incur these costs.

### Our comments

- 17.38 KDC managed the financing of the project very poorly. This was because, in the initial stages of the project, the Council failed to understand what it would need to do to manage the project and the limits of the services to be provided by the project managers. In particular, it needed to have independent financial advice about the debt financing arrangements it entered into. Because it failed to get this advice, KDC relied heavily on EPS for advice about debt financing issues and did not appear to have the advice regularly reviewed internally. As has become evident, KDC also did not understand the requirements of the rating legislation and how to set lawful rates.

- 17.39 KDC's use of interest rate swaps resulted in KDC incurring significant break costs when it became clear that the cash flows assumed in the swaps did not match the underlying cash flows being hedged, because of delays in the date of commercial acceptance. In our view, KDC did not adequately understand the nature of swaps when it entered into those transactions. KDC's Treasury Management Policy also required expert advice to be obtained, yet this was not done.
- 17.40 As we have discussed in other Parts, the debt financing arrangements for this project were complex and KDC needed to have independent expert advice about these arrangements. PwC (Australia) carried out work on the financing. However, we could not assess the scope of this work because it was commissioned by EPS and held in EPS' files. KDC did not have direct access to this information.
- 17.41 In any event, the advice provided by PwC (Australia) through EPS was what needed to be tested with independent advice. Even when KDC officers identified the need for some independent advice, it was not sought.
- 17.42 From what we have been able to determine from KDC's files, the Council was provided with very limited information about the debt financing arrangements. If the only information was that in the files, then, in our view, there would not have been enough information for it to make informed decisions about the debt financing issues it was asked to decide. In some cases, the information was so inadequate that the Council could not have understood what it was being asked to agree to.
- 17.43 In particular, we were surprised that the Chief Executive's reports to the Council for February or March 2009 did not mention that the date for Commercial Acceptance 1 would not be met. Nor was there any reference to the swap needing to be broken as a consequence. In essence, it appears that:
- The transaction may have been entered into without proper authority and in breach of KDC's policies.
  - It cost KDC \$840,000 to break the swap because of the delay to the date for commercial acceptance.
  - The Council was not properly informed about what had happened.
- 17.44 In our view, the Council needed to have maintained much stronger oversight of financing issues and should have required the Chief Executive and its advisers to provide considerably more information than they did. The Chief Executive should have ensured that the Council's policies and processes were properly applied and that the Council was properly informed about such matters.

## Part 18

# The Council takes possession of the assets

- 18.1 In this Part, we discuss:
- the commercial acceptance process in the Project Deed;
  - changes to the dates for commercial acceptance;
  - whether the process for completing commercial acceptance in the Project Deed was met; and
  - our comments.
- 18.2 In summary, we conclude that:
- Commercial acceptance was given even though significant elements of the wastewater scheme were not complete and the scheme had not been proven to work. There was no evidence that KDC was told this before it paid the purchase price.
  - The changes to the dates for commercial acceptance did not save KDC money. Rather, they ended up costing KDC significantly more than it would have saved. Modifications appear to have been agreed without regard for the effect that they would have on the dates for commercial acceptance.
- 18.3 In July 2008, there were changes in the ownership of EarthTech. Tyco, EarthTech's parent, sold part of that company to AECOM Technology. Tyco retained the part of the former EarthTech company responsible for constructing and operating the wastewater scheme, which became Water Infrastructure Group (WIG). Throughout this report, we refer to this company as "EarthTech".

### The commercial acceptance process in the Project Deed

- 18.4 As we discussed in Part 12, the Council agreed to a two-stage commercial acceptance process. This meant that the first part of the scheme was to be completed, and then paid for by KDC, while work continued on the remaining part of the scheme. The Project Deed provides that "Facility 1" was to be completed first. This was made up of the wastewater treatment plant and the reticulation network to service 540 properties. "Facility 2" was to be completed last. This was made up of the reticulation network to service the remaining 676 properties, the transfer pipeline, the dam, and the reuse/disposal system.
- 18.5 The Project Deed required each facility to go through a process to establish that it met technical completion and commercial acceptance.
- 18.6 Technical completion was essentially a check that the facility was constructed in accordance with the Project Deed (except for minor defects or omissions) and was capable of being operated for its purpose and in accordance with all consents. For

technical completion to be met, all the restoration works at the sites had to be completed, and the Operation and Maintenance Manual for that facility had to be completed.

- 18.7 The Project Deed also provided that EarthTech had to carry out pre-commissioning and commissioning tests. Once EarthTech was satisfied that the facility met the requirements for technical completion, it was required to notify the Project Director. KDC was then required to instruct its “Technical Adviser” to carry out a technical audit of the facility. The Technical Adviser was required to be appointed by KDC. After the technical audit, the Technical Adviser was required to issue KDC and EarthTech one of three things:
- *A certificate stating that, in its view, Technical Completion has been achieved in respect of the Facility and then issue a Certificate of Technical Completion; or*
  - *A notice that in its view Technical Completion has not been achieved and such notice shall include the matters and things required to be done before the Facility shall achieve Technical Completion; or*
  - *A notice that the Facility is so far from Technical Completion that it is not practicable to issue the notice specified above, and require the Promoter to continue with the execution of the Works.*
- 18.8 The Project Deed provided for a similar process for commercial acceptance. Figure 13 sets out the timing and dates set by the Project Deed.

**Figure 13**  
**Timing and dates of Technical Acceptance and Commercial Acceptance**

	Facility 1	Facility 2
Commencement Date (CD)	7 December 2007	7 December 2007
Technical Acceptance	13.75 months after CD: late January 2009	19.75 months after CD: late July 2009
Commercial Acceptance	14 months after CD: 7 February 2009	20 months after CD: 7 August 2009

Source: Schedule A, Project Deed, section 11.

## Changes in the dates for commercial acceptance

- 18.9 The various modifications and other problems meant that the date for Commercial Acceptance 1 could not be met. As we discussed in Part 12, our work suggests that the Council did not consider the potential cost consequences of signing the amended project documents in December 2007, when the scope of the works was not final.

- 18.10 The project documents set out the dates for Commercial Acceptance 1 and Commercial Acceptance 2, and the Council agreed to this two-stage process after receiving advice that it would save KDC money. It appears that the Project Director and EarthTech agreed in March 2009 to extend the date for Commercial Acceptance 1 by 21 weeks. They then agreed in July 2009 to change the date again so that Commercial Acceptance 1 would occur on the same date as Commercial Acceptance 2. This eliminated the cost savings that they had been trying to achieve.
- 18.11 The Project Director and EarthTech appear to have agreed these changes using the modifications process in the Project Deed. KDC's files do not hold any of the modifications papers on this issue. Nor could we obtain all the relevant papers on this issue from Beca. We were unable to determine what matters the Project Director considered in agreeing to the modifications.
- 18.12 A paper that EPS prepared in February 2009 referred to the need to change the dates for commercial acceptance. We discussed this in Part 17 in relation to the swap agreement KDC used to hedge its interest rate risk. We were unable to determine whether this paper was provided to the Council or whether the need to change the dates for commercial acceptance was discussed with the Council.
- 18.13 It is not clear to us that the Project Director had the authority to modify the dates for commercial acceptance in this way, without any formal reference back to KDC.

### **Was the Project Deed process for commercial acceptance followed?**

- 18.14 As we set out earlier in this Part, the Project Deed sets out a process for determining whether commercial acceptance had been met.
- 18.15 Although Beca provided technical advisory services, we could find no evidence in KDC's files that KDC formally appointed a person to carry out the role of Technical Adviser as required under the Project Deed. KDC's former Chief Executive told us that Beca was appointed to carry out this role. The Technical Adviser was required to carry out a technical audit of parts of the scheme to determine whether they met "technical completion". The Project Deed enabled technical completion to be met if minor omissions or defects existed, provided that they did not prevent the scheme being used. The Technical Adviser was also required to carry out a technical audit of parts of the scheme to determine whether commercial acceptance had been met and to issue a certificate if this was the case.

- 18.16 It is not clear to us that the process for technical completion and commercial acceptance set out in the Project Deed was followed. We set out below what was done.
- 18.17 Beca's contract for project management set out that Beca would provide technical auditing services. The contract stated that:
- The nature of delivery mechanism for this project requires [EarthTech] to establish its own quality management systems and inspection/monitoring procedures to ensure the project is completed in accordance with agreed Project Plan including any agreed modifications to this plan.*
- The technical auditing service is targeted at providing Council with confidence that [EarthTech] is following its own quality management system and is generally constructing the project to comply with contracted quality standards.*
- 18.18 The contract set out that Beca would provide, at a minimum, quarterly technical audit visits to the project to assess whether EarthTech was implementing agreed quality management systems. The contract also provided that "Sampling inspections will also be made of critical 'as constructed' elements of the project."
- 18.19 EarthTech told us that, in addition to the Beca technical audits, ABN Amro visited the site each month and carried out its own technical audit of the works before making any payment to EarthTech.
- 18.20 Beca staff carried out several technical audits starting in December 2008, although work started on the scheme at the beginning of 2008. The early technical audits provided that the purpose:
- ... was to establish that [EarthTech] is following its own quality management system and is generally constructing the project to comply with contracted quality standards. Focus was on the [wastewater treatment plant] rather than reticulation. Focus was put on items with design life significantly longer than 15 years being the period after which the works will be handed back to KDC.*
- 18.21 Later technical audits looked at the reticulation system.
- 18.22 EarthTech advised EPS in June 2009 that it expected to achieve Commercial Acceptance 1 by 4 July 2009.
- 18.23 In early July 2009, a Beca Technical Director carried out a high-level review of the design reports prepared by, or on behalf of, EarthTech. Beca's Technical Director reviewed the reports on the wastewater treatment plant and the transfer pipeline. He concluded that both reports "demonstrate a robust approach to defining design inputs and assumptions as a basis for the detailed design of these

assets". However, he noted that he had not reviewed the process design for the wastewater treatment plant in detail.

- 18.24 Beca staff carried out the fifth technical audit on 16 July 2009. This was finalised on 24 August 2009 (after commercial acceptance had been given on 28 July). The technical audit report states that the purpose of the technical audit was "to establish whether or not the works are technically complete". The report noted that a large number of works were outstanding at that date, including:
- completion and commissioning of the effluent disinfection systems (UV and chlorination);
  - completion of CCTV testing of the reticulation system;
  - completion of the testing of the storage dam liner; and
  - completion of the Operation and Maintenance Manual and the as-built documentation.
- 18.25 The report recommended following up several issues to ensure that outstanding works were completed, including ensuring that the required dam inspections were carried out.
- 18.26 In Promoter's Notice Number 4, dated 17 July 2009, EarthTech requested that the Project Deed be amended so that references to the Technical Adviser were replaced with references to the Project Director. It proposed that commercial acceptance be given even though the works had not been completed. EarthTech proposed that it provide a \$2 million bank guarantee that could be called on if the agreed outstanding work or works were not completed by 30 June 2010. The Project Director accepted the modification request on 17 July 2009.
- 18.27 We could find no evidence in KDC's files that EarthTech arranged for a bank guarantee or that evidence of such a guarantee was provided to EPS before it issued the commercial acceptance certificate. Again, it is not clear whether the Project Director could make such a significant change to the Project Deed without referring it back to KDC.
- 18.28 There were risks in giving commercial acceptance for the scheme when there was work outstanding and the scheme as a whole had not been proven to operate. KDC took ownership of the scheme after commercial acceptance, so it needed to understand those risks and take steps to mitigate them. We were unable to determine from KDC's papers why EPS decided to give commercial acceptance when the scheme was clearly not completed.

- 18.29 On 28 July 2009, EPS sent EarthTech a Certificate of Technical Completion signed by Beca. The Certificate of Technical Completion noted that:
- As per Modification Acceptance Number 4, requirements for completion have been modified and include a provision covering Outstanding Work. Outstanding Work means the work set out in Appendix 1 of this Technical Completion Certificate.*
- 18.30 On the same day, EPS issued the Certificate of Commercial Acceptance. In doing so, EPS noted that the settlement date was 31 July 2009 but that the agreed date for EarthTech to begin operational service was 21 July 2009. This was based on the technical completion date of 20 July. EPS advised that payment for operations would begin from that date.
- 18.31 On 31 July 2009, MDHL invoiced KDC for the sale of the treatment plant and reticulation assets as due and payable under the Tripartite Deed. The amount specified in the invoice was wrong. KDC did not identify the mistake and paid the incorrect amount. When the mistake was discovered, the invoice was reissued and the overpayment was refunded. The correct purchase price in the second invoice was \$51,476,960.76, including GST. KDC's former Chief Executive told us that the correct process was for the Project Director to approve the invoice before payment and that, in this case, KDC staff did not follow the correct process. We could find no record of this in KDC's files so were unable to verify that this was the case.
- 18.32 There was nothing in KDC's files to indicate that the Council was told that it was taking ownership of the wastewater scheme when there was work outstanding and the scheme had not been proven to work. There is also no evidence that it was advised that EarthTech would provide a \$2 million bank guarantee to deal with this issue.
- 18.33 After commercial acceptance, Beca carried out another two technical audits in August 2009 to determine if the works were technically complete or operating as intended. The last technical audit identified that several works were still outstanding.
- 18.34 There was nothing in KDC's files about what the project managers or KDC did to ensure that the remaining works were completed or how works carried out as modifications after commercial acceptance were monitored or signed off.



## Our comments

- 18.35 As we set out earlier in the report, there were a range of mechanisms in the contract that, if used, could help KDC manage its greater exposure to construction risk, including tools that were available during and after construction. The tools needed to be used in combination. If only the tools that were available after construction were used, KDC would be left in a weaker position to recover any losses. It also needed to fully use the tools that were available during construction to make sure that what was built was fit for purpose before it took ownership.
- 18.36 As discussed in Part 15, the main tools KDC had available during construction were reviewing design documents and monitoring construction, as well as the technical audits and commercial acceptance process discussed in this Part. The purpose of carrying out the technical audits before commercial acceptance was to ensure that the scheme was fit for purpose when ownership finally transferred to KDC. The contract clearly set out that commercial acceptance was to be given only if the scheme had been constructed in accordance with the Project Deed and was capable of being operated.
- 18.37 We have explained that the technical audits were carried out and identified issues that needed to be fixed. However, the parties proceeded to commercial acceptance without fixing these issues. By doing so, KDC effectively waived one of its main protections and weakened its position. It does not appear that the Council was ever told that it was purchasing a scheme that had not met the requirements of commercial acceptance set out in the contract.
- 18.38 It appears that, because of delays caused by the modifications, the construction works could not be completed by the date set for commercial acceptance. However, rather than delaying commercial acceptance to enable the works to be completed, the Project Director issued the commercial acceptance certificate. EarthTech proposed to secure the performance of the outstanding works with a bank guarantee. However, we have no evidence that such a guarantee was arranged.
- 18.39 In our view, it is questionable whether the Project Director could modify the Project Deed in such a fundamental way without referring it back to KDC as the principal party to the contract. The scope of the Project Director's delegated authority from the Council is not clear.
- 18.40 In any event, we do not consider that the risks in making such changes were properly identified, reported, and managed. There was no evidence in KDC's files that these issues were discussed with the Council. In our view, given the significance of the effect of the changes – that KDC was buying a wastewater

scheme that was incomplete and had not been proven to work – these matters should have been discussed with the Council before the decisions were made.

- 18.41 We were unable to determine from KDC's files whether the work that was outstanding at commercial acceptance was completed and whether Beca or EPS carried out any further work to determine whether the works were complete and the scheme operated as intended.
- 18.42 In our view, KDC should have had closer oversight of the commercial acceptance process. Its lack of involvement is highlighted by no-one in KDC identifying that MDHL issued an incorrect invoice for the purchase price. We did not find any document in KDC's files breaking down the purchase price into different components. KDC staff had no way of checking whether the invoiced purchase price was correct or not.

## Part 19

# How the wastewater scheme is operating now

19.1 In this Part, we discuss:

- what the Project Deed says about how the scheme is to be operated;
- how KDC is managing the contract;
- monitoring by the NRC;
- the suitability of the disposal site; and
- our comments

19.2 In summary, we conclude that the wastewater scheme is now operating effectively. However:

- KDC did not actively manage the contract until very recently.
- Part of the disinfection process in the wastewater treatment plant has failed to work. This has resulted in changes to the operation of the plant and has required EarthTech and KDC to get the resource consents amended.
- The farm does not have enough land to dispose of all future flows of treated wastewater. KDC needs to assess how it will dispose of the treated wastewater in the future.

### The operating requirements in the Project Deed

19.3 The Project Deed sets out the services that EarthTech must provide during the period it operates and maintains the wastewater scheme. EarthTech has a 10-year contract to operate the scheme, starting from July 2009. Under the Project Deed, KDC has an option to renew the operating contract for a further five-year period at the end of the 10 years.

19.4 Under the Project Deed, EarthTech is required to meet specified service standards. If it does not meet them, KDC is able to reduce the monthly operating payments it makes to EarthTech. The initial annual operating payment was \$930,166 plus GST. The operating payments increase annually. KDC told us that it is currently paying \$1,032,000 as an operating payment. This does not include power costs, which KDC pays separately. The Project Deed provides that KDC is to pay actual power costs plus 10% (net of GST) to EarthTech. We do not know the basis for the extra 10% or whether it is actually being paid. KDC told us that power costs in 2011/12 were \$64,000.

19.5 EarthTech is required to maintain and repair the scheme while it is operating it. However, the Project Deed limits the works EarthTech is required to carry out for the operating payment. Some work is extra and is charged separately, such as maintaining sewer lines installed by property developers.

- 19.6 If EarthTech fails to provide the services it is required to under the Project Deed, KDC can use the default process under the Deed. If EarthTech does not remedy the failure, KDC has several remedies available to it, including terminating the contract.

### How Kaipara District Council is managing the contract

- 19.7 The Project Deed is complex. EarthTech has several obligations on it to ensure that it is operating the scheme appropriately, and KDC has various powers to ensure that this is being done. KDC can reduce the amount it pays in monthly operating payments to EarthTech if EarthTech does not comply with the performance standards in the Deed. To do this, KDC needs to monitor EarthTech's performance under the contract. Therefore, KDC needs to have a clear plan for monitoring and managing the contract.
- 19.8 KDC took ownership of the scheme in July 2009, and EarthTech began operating the scheme from that date. In KDC's files, we found an incomplete draft contract management plan EPS prepared in March 2010. We were unable to find a completed version of the plan in KDC's files. Until recently, KDC has not been actively managing the contract or using the draft contract management plan. EPS told us that the draft contract management plan it provided to KDC was intended to be a working document to be used as the basis for managing the contract.
- 19.9 EarthTech is required to provide monthly reporting to KDC on whether it has met the performance standards specified in the Project Deed and various other flow and quality information. KDC's files do not contain a full set of these monthly reports. EarthTech told us that it has provided all monthly reports to KDC. The operations reports show that EarthTech had problems with grinder pumps, odours from the reticulation network, the UV disinfection system at the wastewater treatment plant, and stormwater infiltration into the reticulation network.
- 19.10 There were odour problems with pump stations and rising mains in the initial months of the scheme's operation. Beca told us that this became apparent during the commissioning of the plant and that KDC engaged it to provide technical advice. EarthTech installed odour control systems in these areas at its own cost. These appear to have resolved these issues.
- 19.11 There have been issues with the UV units used for disinfecting the effluent since they were installed, and they do not appear to have ever worked effectively. The UV units are used to kill coliforms and, in particular, *E coli* in the wastewater. EarthTech has managed to achieve the standards for *E coli* set in the resource consent by chlorinating the effluent. This occurs before the effluent is transferred

to the dam. EarthTech told us that the UV units have had problems because of the unusually turbid nature of the wastewater. EarthTech told us that “... with all wastewaters having different characteristics, the success of this approach [UV disinfection followed by top-up disinfection with chlorination] was always an ‘unknown’ until the wastewater was actually experienced at the plant and the level of transmissivity established”. EarthTech told us that, for this reason, it was always recognised that there could be issues with this. EarthTech told us that this work has been carried out at its expense.

- 19.12 Because the application for resource consent provided that the UV units would be used to treat the wastewater, EarthTech has had to apply to the NRC to amend the resource consents to allow the alternative treatment. The NRC has amended the resource consents.
- 19.13 Stormwater infiltration of wastewater schemes is a problem because it increases the amount of water going into the scheme. This can make the scheme’s operation more difficult. The monthly reports EarthTech prepared show that there have been problems with stormwater infiltration into the scheme in particular areas, such as Jack Boyd Drive. EarthTech has had to carry out work to limit the infiltration from these areas. EPS told us that stormwater has infiltrated in areas where developers of subdivisions installed sewers, rather than EarthTech.
- 19.14 Grinder pumps can be blocked by people putting the wrong items into the wastewater system. EarthTech has unblocked and fixed several grinder pumps for this reason. Some grinder pumps have failed because of manufacturing defects. These have either been replaced by the manufacturer under warranty or repaired by EarthTech where this has been possible.
- 19.15 The monthly report for December 2009 noted that there was a leak in the liner of the dam. EarthTech has placed a pump below the liner and pumps any escaped liquid back to the dam. It is unclear whether the liner has been repaired.

### **The Northland Regional Council’s monitoring**

- 19.16 The resource consents require EarthTech and the Council to send quarterly monitoring reports and an annual report to the NRC. We found a copy of only one quarterly monitoring report in KDC’s files. The NRC advised us that EarthTech has sent all of the quarterly and annual reports it is required to.
- 19.17 The NRC’s monitoring of the scheme once it became operational has shown that the plant has generally complied with its resource consents. The NRC has raised several compliance issues with EarthTech. These include the placement of irrigation sprinklers too close to a stream and stormwater infiltration. The

NRC advised EarthTech in August 2011 that, because the volume of effluent to be treated in the wastewater treatment plant had increased, the amount to be irrigated would increase, and therefore the area irrigated needed to be increased. The initial area irrigated was 25 hectares. In February 2012, this was increased by five hectares. KDC considers that this is likely to still not be enough, and EarthTech is to assess whether more land needs to be added.

- 19.18 Because the UV units at the wastewater treatment plant are not functioning, the NRC has also amended the resource consent to include the use of chlorine as the final treatment method.

### Suitability of the disposal site

- 19.19 Disposal of treated effluent to the disposal site is done using a “soil moisture deficit” system with a factor of safety. This means that irrigation is based on the ability of the upper soil layers to “hold” water and on the need of the associated plants for water uptake. This method is typically aimed at maximising the efficiency of an irrigation water resource and minimising the potential for deep drainage to underlying groundwater.
- 19.20 Our engineers advised us that this is considered to be quite a conservative approach. It is more usual for a dedicated effluent disposal irrigation system to be operated using a “precipitation index” or similar system. An irrigation system based on a precipitation index allows irrigation when the soil is above its water-holding capacity but there is little or no risk of overland flow. This method enables higher levels of irrigation compared to the “soil moisture deficit” system.
- 19.21 Our engineers advised us that irrigation using the precipitation index system would achieve the primary purpose of disposing of the treated effluent with minimal risk. They also told us that this system is used for other wastewater schemes in the North Island. The soil moisture deficit method is used for irrigation of treated wastewater where the treated wastewater is applied to areas such as golf course or sports fields. It is used where the disposal of the wastewater is a secondary purpose to ensuring appropriate irrigation for landscaping or turf requirements for amenity purposes. The major problem with the soil moisture deficit method is that, after heavy rainfall, the treated effluent cannot be applied and needs to be stored.
- 19.22 In simple terms, if the land is used only for disposing of the effluent, then it can be irrigated to the full capacity of the soil using the precipitation index system. If the land is used for some other purpose and effluent is being used to irrigate, then it can be irrigated only to the extent consistent with that other purpose. Surplus effluent has to be stored in a dam.

- 19.23 EPS told us that leading Australian specialists designed the irrigation system. It told us that:
- ... the critical issues for Council was long term sustainability and the establishment of a strategic base which would allow Council to develop further reuse in adjacent farm areas and on the Mangawhai Golf Course.*
- 19.24 EPS told us that the system incorporates a modern approach involving sustainable (long-term) land use where nutrient levels are maintained at appropriate levels. It told us that the views of our engineers were based on outdated systems that are not considered best practice and that pose unacceptable risks.
- 19.25 In our view, if the land is to be used specifically for effluent disposal, then it is in KDC's interest to maximise its use for that purpose. The precipitation index system is currently used successfully in other effluent irrigation systems in New Zealand that include strict annual nutrient loading rules (which Northland does not have). The soil deficit method is feasible, but it is conservative and therefore limits the amount of irrigation that can be applied. As the scheme grows, if this method is retained, KDC will run out of irrigable land on the farm and will need to either find other land or find neighbouring landowners who want to use the treated effluent.
- 19.26 Beca told us that, when the farm was purchased, it was an operating dairy farm and that KDC considered the proposal to irrigate on a "soil moisture deficit" basis and continue dairying. KDC also discussed irrigation on the basis of "precipitation index". KDC approved the proposal to continue to operate the dairy farm. However, Beca noted that, if the farm is now being used only for effluent disposal, it would be sensible to review the method of irrigation.
- 19.27 Our engineers visited the disposal area. They noted that some of the irrigation blocks or parts of the blocks are situated in wet, swampy areas of the farm. They told us that this was inappropriate and should be remedied.
- 19.28 The land area of the farm is not enough to take all the projected treated wastewater created by the scheme. EPS advised KDC in 2012 that:
- It was always envisaged that the farm was not sufficient in size to be able to manage the total flow that could be derived from Mangawhai in the future. Part of the strategy revolves around how much irrigation area the council needed to own to be able to adequately manage this aspect. The farm was purchased on this basis and it was always intended to develop relationships with adjacent farmers/landowners to take the reuse water to provide the additional area/s required to reuse the treated effluent. 200,000m<sup>3</sup> per year was calculated as the maximum that could be managed on the farm.*

- 19.29 EPS estimated that the irrigation area on the farm should be able to cope with 3000 connected properties and that, with an annual increase of about 6% in connected properties, the farm would reach capacity in 2018/19.
- 19.30 EarthTech told us that it was always known that the farm did not have enough irrigation area and that this led to the development of a reuse strategy. It told us that part of the reuse strategy is for KDC to develop arrangements with adjoining landowners to use the treated wastewater on their properties during the irrigation season: “As with many other reuse schemes, once the scheme has been proven and a comfort level is generated, farmers will be keen to enter into arrangements to take the recycled water.”
- 19.31 In January 2008, the Council considered the re-use strategy prepared by Beca and EPS. The Council agreed to Beca and EPS, and the Australian irrigation consultants, carrying out work to look at re-use options and potential users of the treated wastewater, and to carry out initial negotiations with those potential users.
- 19.32 We understand that EPS, on behalf of KDC, looked at options for landowners adjacent to the treatment plant, transfer pipeline, and farm to use the treated wastewater. However, none of these were taken up.
- 19.33 EPS also looked at how the farm could generate an income as well as providing an effluent disposal site. The farm had originally been used for dairying. It appears that the desire to generate income drove the need for the wastewater treatment plant and the irrigation system to be upgraded so that the treated effluent would meet Fonterra standards and could be used on a working dairy farm. However, the Lincoln Downs farm is not used for dairying or any purpose other than disposal. No other farmers have been willing to buy the treated wastewater for irrigation on other properties.
- 19.34 KDC’s former Chief Executive told us that it was always understood that the main purpose of the farm was as an effluent disposal site and that “the generation of revenue was a side benefit and was important but not the prime purpose”. However, there were costs to generating this revenue, such as the changes to the wastewater treatment plan and irrigation system.

### Our comments

- 19.35 KDC needs to have processes to ensure that it can actively monitor the contract. That way, if EarthTech is not carrying out its obligations under the contract, KDC can reduce its monthly operating payments.
- 19.36 It appears that the UV units have never worked properly and were not working when commercial acceptance was given. The original Project Plan and assessment



of environmental effects for the resource consents provided that chlorination was not intended to be the primary method of disinfecting the effluent, although this is what has happened in practice. The primary method was to be through UV disinfection. As we set out above, the units not working has meant that EarthTech and KDC have had to have the resource consents varied, because the environmental effects of discharging the treated effluent are now different.

- 19.37 If the commercial acceptance process in the Project Deed had been applied properly, it is possible that KDC could have delayed taking ownership of the scheme until this issue had been resolved. Alternatively, KDC could have reduced the purchase price to reflect that this component did not work.
- 19.38 There was a lack of clarity about the purpose of the farm. It appears that it was purchased with the intention that it would generate an income, as well as providing a disposal site for the treated effluent. These two purposes conflict. The aim of disposing of treated effluent is to dispose of as much as possible without causing adverse environmental effects. If the land is being used to generate income, then the purpose of irrigation is different. That is, it is to apply only so much irrigation as is needed for production. This may be much less than in the first scenario.
- 19.39 In deciding to purchase the farm, KDC needed to determine what the primary purpose of the farm was. If the primary purpose was for disposing of the effluent, this should then have determined issues such as how the land was to be used, the standards that the treated wastewater would need to meet, and therefore the design of the wastewater treatment plant and the irrigation system. In that case, the capacity of the land to cope with future treated effluent flows should have been one of the main considerations in determining whether to purchase the land.
- 19.40 It appears that what has happened is that effluent disposal has been treated as a secondary purpose, which has led to decisions being made that conflict with that purpose. For example, the selected irrigation method is more appropriate where the primary purpose of the land is to generate income rather than to dispose of wastewater. The effluent is also being treated to a higher standard than is necessary for simple disposal. It is then stored in an open dam for some months until the ground has the capacity to absorb it. While it is stored, the quality of the treated effluent degrades again – for example, because of faecal matter from waterfowl.
- 19.41 When the land was purchased, it was clear that the land did not have enough capacity to cope with future effluent flows and that reuse options with neighbouring landowners would need to be pursued. In our view, KDC needs to

determine what the primary purpose of the farm is, make any resulting changes to the existing disposal system to ensure that the system is as efficient as possible, and work out what else KDC will need to do to dispose of future flows of treated effluent.

- 19.42 As we set out in Part 10, when developing a wastewater scheme, it is usual to identify the disposal site first because this determines the design of the treatment plant and other aspects of the scheme. It also plays a significant role in determining the costs of the scheme. By leaving the identification of the disposal site to very late in the project, KDC limited its ability to find a suitable site. As a result, it ended up with a site that is not ideal and will not be adequate for significant growth of the scheme. It is clear that KDC always envisaged that others in the community would take some of the treated effluent as a way of reducing the need for it to irrigate it all to land it owned. The concept of reuse of treated effluent is relatively new in New Zealand, although it is used widely in Australia. If KDC wanted to rely on reuse as a way of dealing with future growth, we consider that it should have explored this with the community at the start of the project to determine if it was viable.

## Part 20

# Our overall comments on construction and implementation

- 20.1 In this Part, we set out our overall comments on how KDC managed the construction and implementation stage of the project.
- 20.2 It is important to start by acknowledging that the Mangawhai community now has a reticulated wastewater system that is operating effectively. After initial “teething problems”, any practical problems appear to be occasional and relatively minor. The treatment plant is big enough to cope with expected population growth.
- 20.3 The NRC has not been able to provide us with any data to show whether the water quality in the Harbour is improving yet. We note that it may take some time for water quality to improve. KDC should work with the NRC to ensure that this monitoring is done, so that the community gets information about whether the scheme has achieved its purpose.
- 20.4 However, it is clear from the events documented in this Section that KDC did not monitor and manage the construction process adequately. There is no need to repeat the detailed concerns we have already outlined in previous Parts. In this Part, we simply make a few overall points.
- 20.5 We were very concerned to see how loose the contract monitoring and management were and how little attention KDC paid to the steps built into the contract to protect the Council from the risk that the scheme would not be constructed properly or would fail to operate as intended. It is largely because of the quality of EarthTech’s work that the scheme operates well and has had few performance issues in the last four years of operation, rather than contractual processes designed to protect KDC.
- 20.6 We also have significant concerns about the way in which funding and financing matters were dealt with. In KDC’s files, we found no systematic monitoring and reporting of the overall costs of the project against a budget. We are also very concerned about the way in which KDC entered into swaps and transactions.
- 20.7 The relevant parties were clearly all working hard to construct the scheme but made little effort to be clear about exactly what was being built and at what cost. This type of approach is not acceptable for a major public sector project. The PPP context did not remove the need for the Council to be in control of the overall project and for it to be able to publicly account for what was being done.

- 20.8 Given the level of community concern about the project and its affordability, the need to be able to account to the community for exactly what the money was being spent on and why should have been a priority for the Council and its advisers. The poor records and informal decision-making show that this was not the case. We did not anticipate that we would effectively have to reconstruct many of the records of financial transactions and other decisions from scratch while we carried out this inquiry. Appendix 5 summarises the information that we have been able to compile. We regard that information as totally inadequate.

## Part 21

# The accountability system for local authorities

21.1 In this Part, we briefly summarise the main agencies that have some oversight or accountability role for local authorities. We then explain the different roles and business units of the Auditor-General in more detail, because they had the most involvement in matters involving the wastewater project. In the Parts that follow, we assess in detail the work that was carried out by:

- Audit New Zealand, as the appointed auditor for KDC until 2012; and
- the Office of the Auditor-General (OAG) and other agencies, who each received correspondence raising concerns about KDC and the wastewater project at various points.

### The main agencies and their roles

21.2 No single agency oversees all of the work of local authorities. Local authorities are independent statutory bodies governed by directly elected members. As such, they are primarily accountable to the electorate through the democratic process.

21.3 Several agencies have some role in scrutinising the work of local authorities and holding them to account. However, each of these agencies does so within the limits of their role and statutory mandate.

21.4 Most of the work of accountability agencies involves reviewing the work of local authorities and reporting an independent view of that work, which helps to inform the electorate when it votes. Most agencies have little, if any, capacity to directly intervene in what local authorities do. It is also fundamental that accountability agencies respect the right of the elected members to make decisions and set policy. Accountability agencies therefore focus on reasonableness and procedural fairness to ensure that they do not usurp the proper role of the governing body.

### The Auditor-General

21.5 The primary role of the Auditor-General is to report on how public money has been used and what has been achieved with it. The focus is on providing audit assurance on public accountability reports and selected areas of public entity performance. The Auditor-General has associated powers to inquire when serious concerns are raised about how resources have been used. The different parts of the Auditor-General's work are discussed in more detail in paragraphs 21.20-21.37.

## Ombudsman

- 21.6 An Ombudsman investigates the administrative decisions, recommendations, and acts or omissions of central and local government agencies as they affect individuals or bodies in their personal capacity. Investigations are conducted under the Ombudsmen Act 1975. Investigations can be conducted after an Ombudsman receives a complaint or on an Ombudsman's own initiative.
- 21.7 An Ombudsman generally cannot investigate complaints if the complainant has a right of appeal or review to a court or tribunal on the merits of their case. For local authorities, an Ombudsman can investigate decisions made by a committee of the Council or advice given by a Council employee to the Council. However, an Ombudsman cannot investigate decisions or actions of the Council itself. This restriction ensures that the focus is on "matters of administration" rather than the policy choices of the governing body.
- 21.8 An Ombudsman may refuse to investigate a complaint if there is another remedy or right of appeal that it would have been reasonable for the complainant to pursue or if, during an investigation, it appears that any further investigation is unnecessary.
- 21.9 An Ombudsman's initial consideration is whether it is the agency best placed to deal with the complaint or whether it should refer the complaint another agency. The first step in assessing whether the matter falls within its jurisdiction is to obtain information relevant to the complaint from the entity complained about, because the complainant might not have had access to all relevant information.
- 21.10 The Office of the Ombudsman is aware that the effectiveness of this approach depends on it obtaining full and accurate information from the agency concerned.
- 21.11 The Offices of the Ombudsman and the Auditor-General will sometimes consult each another on correspondence one has received. This is because the Ombudsman is often better placed to deal with a matter affecting an individual and the Auditor-General with systemic issues.

## Department of Internal Affairs and the Minister of Local Government

- 21.12 The primary function of the Department of Internal Affairs (the Department) for local government is to provide support to the Minister of Local Government (the Minister) and to administer the relevant legislation. The Minister:
- leads the relationship between central and local government;
  - is responsible for policy issues about the constitution, structure, accountability, and funding of local government; and

- has primary responsibility for legislation concerned with the system of local government and its overall efficiency.

- 21.13 However, the Minister is not answerable for local government decisions and cannot intervene in them. A local authority is not accountable to central government. Instead, it is accountable to its ratepayers and residents.
- 21.14 Under the Local Government Act 2002, the Minister can, in certain circumstances, appoint ministerial reviews and commissioners to act in place of elected members if they cannot perform their functions or if they are not properly performing their functions. Part of the Department's concern, therefore, is to assess whether there is evidence that would support the Minister's intervention.
- 21.15 At the time of the events with which this inquiry is concerned, the Minister's powers in this respect were blunt. Unless the local authority asked the Minister for assistance, the statutory threshold for intervention was high. Intervention was considered only if there was significant evidence that a local authority had a problem that it could not resolve on its own and that the problem involved serious organisational failure, mismanagement, or misgovernance.

### **New Zealand Police and the Serious Fraud Office**

- 21.16 The New Zealand Police have general responsibility for investigating possible criminal offences. The Serious Fraud Office is a separate organisation with specific responsibility for investigating and prosecuting serious or complex fraud.

### **Other agencies**

- 21.17 As well as the agencies described above, many other agencies are involved in overseeing specific aspects of the work of local authorities.
- 21.18 The courts provide a forum for deciding disputes and resolving questions of law involving public entities. In particular, judicial review is a form of legal action that has been specifically developed to enable the courts to rule on whether public sector entities are acting lawfully.
- 21.19 Within central government, the State Services Commission has the power to carry out inquiries into the performance and conduct of state sector organisations. There is no equivalent of the State Services Commission for local government.

### **The Auditor-General's overall role and structure**

- 21.20 The Auditor-General is an Officer of Parliament. The primary function of the Auditor-General is to audit the financial and other information that public entities are required to have audited. The Auditor-General also has discretion to carry out

related assurance work, performance audits, and inquiries into how entities are using their resources.

- 21.21 In carrying out these roles, the Auditor-General must act independently of central and local government and of public entities.
- 21.22 The Auditor-General's main power is to report her findings to Parliament and to the public generally. The Auditor-General has no direct powers to intervene in the actions public entities take or the decisions they make. The Public Audit Act 2001 specifically prohibits the Auditor-General from questioning the merits of a policy with which a public entity must comply. Nor is the Auditor-General able to make a determination of legality – legal issues can only be finally decided by a court.
- 21.23 The organisation supporting the Auditor-General is made up of three business units – the OAG, Audit New Zealand, and a Corporate Service Team that supports both units. The Auditor-General also contracts audit service providers and other expertise from the private sector.
- 21.24 Audit and assurance work is funded by charging fees to the entities being audited. Funding for performance audits and inquiries comes from Parliament. The appropriation for performance audits and inquiries for each of the three years from 2009/10 to 2011/12 was \$6.587 million.

## What the Office of the Auditor-General does

### Oversight of annual audits

- 21.25 The OAG oversees and co-ordinates all annual audit work, sets auditing standards, appoints auditors (either from Audit New Zealand or the private sector), provides technical support to auditors, carries out quality assurance reviews of audit work, and helps to manage the relationship between auditors and public entities and between the Auditor-General and Parliament.
- 21.26 The OAG analyses and reports the results of annual audit work to Parliament and the public. It also provides support to select committees when they review how public entities have performed.

### Performance audits

- 21.27 A performance audit is a systematic assessment of a specific aspect of a public entity's role or function. A performance audit may consider any of the following:
- whether an entity is carrying out its activities effectively and efficiently;
  - whether an entity is complying with its statutory obligations;



- any act or omission resulting in waste; and
- any act or omission appearing to show a lack of probity or financial prudence.

21.28 Performance audits are major projects requiring considerable planning. Topics are carefully selected and set out in an annual work programme, which is finalised after consultation with Parliament and other parties.

### Inquiries

- 21.29 As well as financial audits and performance audits, the Auditor-General has discretion to inquire into any public entity's "use of its resources". The inquiries function is ancillary to the Auditor-General's main work of carrying out annual audits.
- 21.30 The OAG receives between 200 and 400 requests for an inquiry each year. Managing this correspondence and carrying out formal inquiries into the small number of matters selected for in-depth work comprises 1% or 2% of the Auditor-General's overall work. No team of staff is dedicated to this work. It is regarded as part of the general work of various staff within the OAG. The number of substantial inquiries can vary significantly from year to year. During the last five years, OAG has completed between six and 21 substantial inquiries each year.
- 21.31 Although an individual's complaint may trigger an Auditor-General's inquiry, the purpose of that inquiry is not to resolve the individual's complaint against a public entity. The primary focus is the accountability of the public entity and lessons for others working in similar areas.
- 21.32 Given the overall role and expertise of the Auditor-General, the OAG's inquiries generally focus on one or more of the following areas:
- financial impropriety;
  - problems with an organisation's overall governance or management; and
  - other systemic or significant concerns that may be significant for the organisation, its sector, or the public.

### What Audit New Zealand does

- 21.33 For most public entities, the Auditor-General appoints a particular person to act as the auditor for that entity on her behalf. The appointed auditor is supported by a team of audit staff and the general professional support systems of that person's firm.

- 21.34 Audit New Zealand is the business unit of the Auditor-General that carries out annual audits and related assurance work for the public entities allocated to it. Audits of other public entities are allocated to private sector audit firms.
- 21.35 In formal terms, the auditor's role is to give an opinion on whether information produced by a public entity fairly reflects the entity's actual performance. Historically, the focus of audit work was on an entity's financial statements. Nowadays, many public entities are required to report not only financial information but also information explaining how well they have carried out their role and functions. In the public sector, the auditor's role therefore involves auditing both financial and other performance information.
- 21.36 The essence of the public sector auditor's role is to give an opinion on the reliability of the information the entity has produced. The auditor explains the entity's financial situation, what has been spent, and what has been achieved with that spending.
- 21.37 All auditors must comply with the auditing standards set by professional bodies when they carry out this work. In the public sector, the Auditor-General also sets some additional auditing standards to take account of the public sector context.

## Part 22

# Independent review of the work of Audit New Zealand

### How the review was carried out

- 22.1 When KDC asked the Auditor-General to begin this inquiry, it was clear that any examination of what happened at KDC and with the wastewater project also needed to examine the role played by KDC's auditors. Understanding this aspect was also vital from the Auditor-General's perspective, given that she is the responsible statutory officer who appoints providers to carry out audit work on her behalf.
- 22.2 All organisations review aspects of their own work from time to time to support ongoing improvement. The challenge for this part of the inquiry was to ensure that the review of audit work was carried out independently, so that it would be publicly credible.
- 22.3 To that end, the terms of reference for the inquiry set out that the Auditor-General would appoint an independent person to carry out the review of audit work. We commissioned Mr Neil Cherry for this work.<sup>1</sup> Mr Cherry worked for Audit New Zealand at an early stage in his career (as have most auditors with public sector audit experience). We therefore asked Mr Des Pearson, the former Auditor-General of Victoria, Australia, to act as a peer reviewer for Mr Cherry.
- 22.4 Appendix 6 includes the terms of reference for the review. The terms of reference required the review to take a comprehensive approach, by looking at 10 years of annual audits of KDC and three audits of KDC's LTPs.
- 22.5 Mr Cherry describes how he carried out the review in his report, which is published in full as Appendix 6. In summary, the review:
- gathered background information on KDC and the issues of concern to the inquiry;
  - for each audit being reviewed, obtained the relevant accounting and auditing standards, internal methodology documents, and other guidance that was applicable at the time;
  - reviewed all the audit files in detail and interviewed relevant staff;
  - prepared a draft report;
  - sought comment from Audit New Zealand and the relevant individual staff members;
  - revised the draft report in light of the comments received; and
  - circulated a final draft for further comment from Audit New Zealand, individual staff members, and Mr Pearson as peer reviewer.

<sup>1</sup> Mr Cherry is the current chairman of the New Zealand Auditing and Assurance Standards Board, a board member at the External Reporting Board, and a board member of the Australian Auditing and Assurance Standards Board. He carried out this review in his personal capacity.

- 22.6 Mr Cherry provided the penultimate draft report to the inquiry team on 1 November 2013, so that we could prepare to incorporate it into this final report. He provided us with his final report on 15 November 2013.

### What the review found

- 22.7 The full report is published as Appendix 6. It is a substantial and technical document, so we summarise it briefly here.

### The purpose of an audit

- 22.8 The review emphasises the need to understand the role of an auditor compared with the responsibilities of the entity being audited. The entity is responsible for complying with legislative and accountability requirements. It must maintain financial and other records so that it can accurately meet its reporting obligations. The auditor's role is to provide an independent opinion on whether the information reported by the entity is reasonably reliable.
- 22.9 Local authorities are required to have specific information in their annual reports and LTPs audited. The purpose of the audit is to enhance the degree of confidence that readers can have in the audited information.
- 22.10 In technical language, the auditor's objective is to obtain reasonable assurance that the audited information:
- is free from any material misstatement; and
  - is presented in a manner consistent with generally accepted accounting practice.
- 22.11 The auditor then provides an opinion on whether the information meets those standards.
- 22.12 "Reasonable assurance" does not mean that the auditor has tested every transaction or disclosure, or looked at every aspect of the local authority's operations and activities. Auditors assess whether particular activities, projects, or transactions have a direct material effect on the information being audited and plan their work accordingly.

### Audit systems and methodologies

- 22.13 Overall, the review concluded that the audit methodologies and approaches developed by Audit New Zealand and/or the OAG provided a reasonable and appropriate basis for an auditor to plan and perform audit engagements. At all times, the audit methodology aligned with the requirements of the applicable auditing and assurance standards.

- 22.14 The review also noted that there were three separate independent quality reviews of Audit New Zealand's systems and methodology during the 10 years under review. Two were carried out by the New Zealand Institute of Chartered Accountants, and one was carried out by the Australasian Council of Auditors General. These reviews were similar in scope to those carried out on other chartered accounting practices. None of those reviews identified any significant issues or deficiencies.

### **Audits carried out between 2003 and 2005**

- 22.15 Between 2003 and 2005, the auditor carried out an annual assessment of the management of the wastewater project, to help plan the audit work. Mr Cherry's review considered that this work was too narrow to be a complete assessment of the project. The review also considered that this work did not give enough attention to understanding the funding and financial implications and the Council's overall governance and risk management. However, the review accepted that this limitation did not affect how the audit was planned and performed, given that the project was still being developed during those years. The auditor was still in a position to properly express an opinion on the information in the annual report.
- 22.16 Mr Cherry's review criticises the sufficiency of documentation in the audit files for these years. Auditors are required to document the evidence and basis for any professional judgements they make during their audit work. The review found that, in many cases, there was not enough documentary evidence in the file to show the testing that had been done and to support the judgements that had been made.
- 22.17 In particular, the review noted that there was not enough documentation to explain how or why the auditor assessed the management control environment as good or effective during these years. The review concluded that the auditor's consideration of the financial management environment had been too narrow and relied too much on discussions with management during these years.
- 22.18 Overall, the review concluded that the audits carried out during these years satisfied the audit objective: the auditor had obtained reasonable assurance that the audited information met the required standards.

### **Audits carried out between 2006 and 2009**

- 22.19 Mr Cherry's review found that, between 2006 and 2009, problems continued with the adequacy of documentation in the audit files to support the work done and judgements reached. Problems also continued with the assessment of the management control environment within KDC.

- 22.20 Given what was happening with the wastewater project during these years, the project should have been a major focus for the auditor. However, the auditor relied on the assessment of the wastewater project that had been carried out in 2005. The review found no evidence that the auditor updated their understanding of the project. The files show that the auditor did not identify any significant audit risk associated with the wastewater project during these years. The auditor did not adequately assess the project's potential effect on KDC or the audit engagement. Nor did the auditor give any independent consideration to the accounting treatment for the project.
- 22.21 The review concluded that the auditor inappropriately relied on KDC's management as a primary source of audit evidence and did not independently corroborate the information management provided.
- 22.22 As a result, the planning and assessment of risk that was done did not provide a sound basis for planning and performing the audits during this period. There was also limited testing of, and limited consideration given to, the wastewater project during the actual audit work. Some test procedures were performed incompletely or inadequately.
- 22.23 The review concluded that, for the 2009 Annual Report, the result was that the financial statements materially misstated information and that an incorrect audit opinion was issued.
- 22.24 The review also found significant deficiencies in the auditor's work on rates during these years. The review concluded that the auditor should have detected many of the irregularities covered by the Validation Bill through normal test procedures. The review comments that the primary reasons for the deficiencies were:
- *A lack of understanding of the requirements of the [Local Government (Rating) Act 2002];*
  - *A lack of understanding of the objective or purposes of the audit test procedure; and*
  - *A failure to adequately identify the risks and significance of non-compliance.*
- These lapses meant that the auditor was not in a position to apply sufficient professional judgment when performing the audit test procedures, or identifying potential material non-compliance, or irregularities, should they be present. The deficiencies noted in the auditor's work were not identified or addressed through the engagement quality review processes.<sup>2</sup>*

<sup>2</sup> Paragraph 43.10 of Mr Cherry's report.

- 22.25 The review notes the highly subjective nature of the auditor's work on legislative compliance and that the individual auditors had felt that they had little guidance to help them determine when they had done enough work. It records that Audit New Zealand has guidance in its manual that complies with professional requirements, but accepts that this is an area that needs more attention.
- 22.26 Overall, the review concludes that the audits during these years were substandard in some respects and questions whether they satisfied the audit objective. This conclusion affects four annual audits and two audits of LTPs.

### **Audits carried out between 2010 and 2012**

- 22.27 Mr Cherry's review found that the quality of audit work improved between 2010 and 2012. The sufficiency and quality of documentation in the audit files increased, showing the additional effort that was going into the KDC audit as problems came to light. The review found only minor deficiencies in audit quality during these years. These deficiencies were unlikely to affect the auditor's conclusions.
- 22.28 During the 2010 audit, KDC accepted legal advice that there were problems with the relevant targeted rate that needed to be addressed. KDC disclosed this in its annual report, so the audit report did not comment on it further. The 2011 Annual Report included extensive disclosure on a wide range of issues, including the restatement of financial information to address the misstatement in the 2009 financial statements.
- 22.29 Overall, the review concluded that the audit work during these years satisfied the audit objective. The review notes that considerable resources were devoted to KDC's audit during these years, as problems came to light.

### **The Auditor-General's response**

- 22.30 Mr Cherry's independent review found that audit quality varied significantly during these 10 years and was inadequate in some cases. This is obviously not satisfactory. The Auditor-General has an overall responsibility to ensure that all audits carried out in her name reach an appropriate standard of quality. In this Section, we summarise the steps that the Auditor-General has taken or is taking to address these concerns about audit quality within Audit New Zealand.

### **Changes that have already been made**

- 22.31 As noted in Part 1, the Auditor-General removed Audit New Zealand from the KDC audit in late 2012 and appointed a new audit service provider. This change was made once the OAG's internal quality assurance report on the audit work had

been finalised and as soon as a transition to a new auditor was practicable. In practice, it was not practicable to change audit service providers until Audit New Zealand had completed the audits for the 2012 Annual Report and 2012–22 LTP.

- 22.32 The OAG maintains a quality assurance programme that periodically assesses samples of audit files for all appointed auditors. That programme of work has been advanced to ensure that all appointed auditors working in the local government sector will have had their work on local authority audits assessed by June 2014.
- 22.33 The OAG and Audit New Zealand have reviewed Audit New Zealand's methodology for considering rates during local authority audits. For annual reports prepared in 2013, the OAG required all appointed auditors of local authorities to complete a quality assurance questionnaire to enable the OAG to assess rating practice in the sector and to ensure that local authority auditors were applying a consistent standard to their work. The OAG is currently analysing the results of this work and will report on it separately.

### Other steps being taken

- 22.34 The Auditor-General is also taking some additional steps to ensure that Parliament, the public, and public entities can rely on the quality of audit work from Audit New Zealand. Given the questions raised by this independent review, she and Audit New Zealand have agreed that it needs to demonstrate that it is able to maintain a consistent and appropriate standard of audit quality.
- 22.35 The Auditor-General appreciates that Audit New Zealand, during the last five years in particular, has been working systematically to improve audit quality and achieve consistency throughout its portfolio. The Auditor-General endorses those steps, but considers that more needs to be done to demonstrate the necessary consistency.
- 22.36 Therefore, the Auditor-General has asked Audit New Zealand to provide her with assurance that it has reached the objective of consistent audit quality throughout its portfolio. Audit New Zealand will develop and implement an improvement programme, which will be overseen by two independent advisers to the Auditor-General.
- 22.37 Until this regime is able to satisfy the Auditor-General that Audit New Zealand's work is consistently maintaining an appropriate standard, she will not allocate any new audit engagements to Audit New Zealand, nor allocate any existing Audit New Zealand audits to other providers.



- 22.38 The Auditor-General emphasises that the concerns raised by this independent review do not suggest widespread or systemic problems that would justify removing audits from Audit New Zealand. Furthermore, she appreciates the professionalism and hard work of the Audit New Zealand leadership team and staff. However, the question mark over its work at present means that it is not appropriate to add to its portfolio until it has demonstrated that it can achieve consistency of audit quality.
- 22.39 To give some practical context to this decision, during the last five years, the number of new public entities created each year that require auditors to be appointed has ranged from 40 to 80.<sup>3</sup> Audit New Zealand would usually expect to be appointed to carry out a reasonable number of these new audits.

3 The overall portfolio of public entities requiring auditors usually sits at about 4000 entities. Many new entities are subsidiaries or other controlled entities of existing public entities. Others result from restructuring within the public sector.



## Part 23

# Review of work of the Office of the Auditor-General and other accountability agencies

- 23.1 In this Part,<sup>4</sup> we consider the response of the five agencies that were asked to investigate concerns about KDC's performance in relation to the wastewater scheme. The five agencies were:
- the OAG;
  - the Office of the Ombudsman;
  - the Department;
  - the New Zealand Police; and
  - the Serious Fraud Office.
- 23.2 This part of the inquiry was carried out by the Deputy Controller and Auditor-General, Phillippa Smith. Although she has been in the OAG since August 2005, she had no significant involvement in matters relating to KDC before this inquiry started in March 2012. She reviewed files of correspondence and other documents, and spoke to relevant officials, to understand how the agencies responded to concerns raised about the scheme since 2002. Her observations and comments are set out below.

### Complaints to the accountability agencies and how they were handled

- 23.3 I focus mainly on the OAG, the Office of the Ombudsman, and the Department because they received most of the requests for an inquiry or other intervention into the scheme. I refer to those requests as "complaints" and to the persons making them as "correspondents". I comment briefly on the involvement of the New Zealand Police and the Serious Fraud Office in paragraphs 23.162-23.165.

### October 2002

- 23.4 Between October 2002 and March 2005, the OAG received five complaints about the Council and the scheme. I am not aware that the Office of the Ombudsman or the Department received any relevant correspondence in this period.
- 23.5 The first complaint about the scheme, in October 2002, came from the Mangawhai Ratepayers and Residents Association (MRRA). The MRRA was concerned about the scheme's affordability and an alleged lack of proper consultation. It also asked whether the proposed funding mechanism complied with the Council's policy on borrowing. The OAG asked KDC and the appointed auditor for information to respond to the complaint.
- 23.6 However, the Local Government Act 2002 was enacted in December 2002, which meant that the scheme could not proceed as originally proposed (see Part 7).

4 This Part has been written by Phillippa Smith, Deputy Controller and Auditor-General.

KDC told the OAG that it was reconsidering its options and that it would consult ratepayers as required by the new Act. Therefore, the OAG decided not to take any further action with the complaint. It let the correspondent know and closed the complaint.

### June 2003

- 23.7 In June 2003, the OAG received a telephone call from another representative of the MRRA, concerned about whether KDC was properly considering other options for the scheme. He said that the scheme would impose a severe financial burden on the local residents and that members of the public were being excluded from Council discussions on the issue.
- 23.8 Later that month, the OAG received an email from one of the Kaipara District Councillors, arguing that, given the new requirements of the Local Government Act 2002, the Council should be required to start the whole process again. He asked the OAG to insist that the Council independently assess the whole project from a technical, legal, and financial perspective. He also said that ratepayers were actively considering a rates strike and/or asking for commissioners to be appointed.
- 23.9 The OAG asked KDC for information to enable it to assess the complaints. KDC responded that the consultation process had not yet begun. As explained in Parts 7 and 8, the Council had made decisions about its revised approach in January 2003 and was releasing a Statement of Proposal with which to consult the community in July 2003.
- 23.10 The OAG replied to the MRRA and the councillor in August 2003. It told them that, from its review of the information KDC had provided, it had no evidence that KDC was acting inappropriately or failing to meet its legal obligations. The reply said that the OAG's understanding was that, because of concerns raised by ratepayers, KDC had agreed to re-consult. Accordingly, the OAG did not intend to intervene.
- 23.11 Subsequently, an OAG staff member met the Chief Executive to talk about the scheme. The Chief Executive's advice to the OAG was that there was general agreement in the community that the scheme should go ahead, but there was concern about the cost.

### May 2004

- 23.12 In May 2004, the OAG received a letter from lawyers acting for one or more ratepayers concerned about the level of the proposed increase in water rates related to "the Mangawhai water supply". The letter asked whether the increase was legal. I was unable to find that letter in the OAG's files, so I cannot check the

precise concern. However, as explained in Part 8, in 2004, KDC was still discussing potential rates and charges in general terms. At the time of this complaint, the proposal was for a one-off “uniform general charge” and pan charges.

- 23.13 The OAG replied that it understood that KDC was considering the proposed increase as part of its 2004-14 LTCCP. The OAG advised the ratepayers concerned to seek further information from KDC and to participate in the consultation process. The OAG noted that a large increase in rates was not necessarily an indication of illegality.

### March 2005

- 23.14 In March 2005, the OAG received an email from a former councillor (who had also written in 2003 – see paragraph 23.8). He said that KDC had entered into a contract with an organisation that was bankrupt, that the organisation might have been bankrupt at the time of the contract, and that an estimated \$2 million had been wasted. He asked the Auditor-General to investigate. It appears that this was a reference to the financial difficulties faced by KDC’s preferred proponent for the scheme, Simon Engineering, and its parent company, HWE. As explained in paragraphs 9.20 to 9.25, in February 2005, the Council resolved to stop negotiating with Simon Engineering because its parent company had been placed in voluntary administration.
- 23.15 A note attached to this email suggests that the correspondent followed up his request by telephone in August 2005 or later. I found no evidence that the OAG replied. However, I note that, by this stage, the Council had resolved to contract with EarthTech.
- 23.16 The OAG has no record of further correspondence from Kaipara ratepayers for the next five years.

### March 2010: Complaint about the wastewater targeted rate

- 23.17 In March 2010, the OAG received a complaint from Correspondent A (a ratepayer). By this stage, the wastewater scheme had been built and was operating. The complaint was about the legality of a particular targeted rate (the wastewater targeted rate) that KDC had set for the scheme – specifically, the use of “unit of demand” as the basis for charging the rate. Correspondent A attached a copy of a submission he had made to KDC about the wastewater targeted rate. Correspondent A wrote again in May 2010 after identifying a different problem with the wastewater targeted rate – specifically, the factor used to assess liability.
- 23.18 The OAG acknowledged Correspondent A’s first request with a standard response, telling him it was carrying out “preliminary inquiries”, after which it would let him know how it proposed to deal with the information he had provided.

- 23.19 The OAG then contacted KDC to seek information about Correspondent A's complaint. KDC's Chief Executive said that KDC was already aware of Correspondent A's concerns and was seeking legal advice about the issues he raised. The Chief Executive undertook to keep the OAG informed.
- 23.20 In early May 2010, having not heard back from the Chief Executive, the OAG contacted him again. He said he was still waiting for legal advice but expected to receive it in time for the Council's May meeting. The Chief Executive received the legal advice, which concerned Correspondent A's first issue, later in May. The Council considered the advice at its meeting on 26 May 2010, but it made no decision on the issues at that meeting.
- 23.21 Correspondent A wrote to the OAG for a third time on 1 June 2010 after he had obtained a copy of the Chief Executive's report and disagreed with the legal advice it contained. He suggested that the Chief Executive had not actually received any legal advice and that the Chief Executive and other KDC staff had drafted the proposed rating resolution. He alleged that KDC was intentionally flouting the Local Government (Rating) Act 2002. He also alleged that what it was doing was potentially criminal and might need to involve the Serious Fraud Office. Correspondent A later addressed his arguments about the substance of the legal advice directly to the law firm concerned.
- 23.22 On 3 June and again on 25 June 2010, the OAG asked the Chief Executive for a copy of the legal advice and details of the decisions and actions that KDC was taking in response to the advice.
- 23.23 On 25 June, KDC's Chief Executive confirmed that KDC had received legal advice that recommended changes to the definition of "unit of demand", which the Council would consider at a workshop later that day. He undertook to let the OAG know after the workshop what actions the Council would take. The Chief Executive said that KDC's legal advisers had seen Correspondent A's correspondence and that Correspondent A's allegations were unfounded.

### **Responses by the Department of Internal Affairs, the Minister of Local Government, and the Office of the Ombudsman**

- 23.24 At this point, the OAG had not responded to Correspondent A other than acknowledging his first complaint in March. In his second communication to the OAG in May, Correspondent A said that, because he had not heard from the OAG since he wrote in March, he had escalated his concerns to the Office of the Ombudsman. He copied his letter to the Prime Minister, the Minister and the Associate Minister of Local Government, the Secretary for Local Government, and the member of Parliament for Northland.

- 23.25 An official from the Department contacted the OAG in response to Correspondent A's letter. The OAG told the Department that it was making "preliminary inquiries" to determine whether there was reason to establish a formal inquiry.
- 23.26 The Department then wrote to Correspondent A saying that the OAG was still investigating his complaint and that it was the Department's standard practice to remain apart from a case while it is under consideration by the Auditor-General or the Ombudsman. The Department encouraged him to continue to raise his concerns with KDC – in particular, in the lead-up to the forthcoming local body elections.
- 23.27 In a separate letter to Correspondent A, the Minister acknowledged the serious nature of Correspondent A's concerns. The Minister explained that local authorities were accountable to ratepayers and citizens for their specific actions and decisions, including rating decisions, rather than to the Minister. He suggested that, if Correspondent A had concerns about the Chief Executive, Correspondent A should talk to Council members and that he should continue to raise his concerns about the rates within the community in the lead-up to the local body elections.
- 23.28 An official from the Minister's office also contacted the Office of the Ombudsman in response to Correspondent A's concerns and told it that the OAG was investigating the rating issue.
- 23.29 The Assistant Ombudsman wrote to Correspondent A on 2 June 2010 asking him to clarify which matters he wanted the Ombudsmen to investigate and to provide evidence of the steps he had taken to resolve his concerns with KDC. With regard to Correspondent A's concern about the validity of the wastewater targeted rate, the Assistant Ombudsman said that the Office of the Ombudsman had been informed that Correspondent A had made the same submission to the OAG and that the OAG had agreed to look into the issues he had raised.
- 23.30 The Assistant Ombudsman told Correspondent A that it was not the practice of the Office of the Ombudsman to intervene when a complaint was being pursued by another agency. This was to avoid a situation where different agencies were conducting concurrent investigations into the same set of issues. The Office of the Ombudsman sought clarification from Correspondent A about a separate complaint also involving KDC and later made enquiries of the Council in an attempt to resolve the matter. Correspondent A acknowledged the need to have one authority investigate, but he was concerned about the time the OAG was taking.

- 23.31 The Office of the Ombudsman then contacted the OAG on 11 June 2010 to discuss Correspondent A's concerns and to tell the OAG that it was also dealing with two other complaints about the scheme.
- 23.32 The first of those other two complaints, received on 27 November 2009, was from Correspondent B on behalf of the MRRA, which had concerns about the application of the wastewater targeted rate to properties that were not connected to the scheme by the date from which the rate applied. The Office of the Ombudsman spent some time looking into this matter, including making enquiries at KDC. This prompted KDC to write to Correspondent B clarifying its approach to rates adjustments.
- 23.33 Correspondent B was not satisfied with the adjustments KDC proposed to make to the rates and contacted the Office of the Ombudsman again. The Chief Ombudsman advised Correspondent B to address any concerns about the adjustments to KDC in the first instance. Correspondent B could make a complaint to the Office of the Ombudsman if she was dissatisfied with KDC's response.
- 23.34 In response to further correspondence from Correspondent B concerning KDC's rating policy, as reflected in the wastewater funding impact statement, the Chief Ombudsman provided comments on these concerns and invited Correspondent B to respond.
- 23.35 The second of the other two complaints was from Correspondent C, who had written to the Office of the Ombudsman in November 2009. He was also concerned about the wastewater targeted rate and also raised wider concerns about the scheme and KDC's management of it. These wider concerns included:
- KDC's communication with the public – in particular, about the start-up date for the scheme;
  - whether decisions had been made with properly delegated authority;
  - whether the Chief Executive was keeping the Council properly informed;
  - additional work required on the scheme, how it was being funded, and whether KDC was properly recovering costs from the contractors involved; and
  - the financial model that KDC was using to support the project.
- 23.36 In February 2010, the Office of the Ombudsman had declined to investigate several of Correspondent C's wider concerns about the scheme. It did so because Correspondent C did not appear to have raised those matters with KDC or because there was insufficient information to establish grounds for an investigation. However, the Office of the Ombudsman was still looking at the rates issues.



- 23.37 After the Office of the Ombudsman had discussed the cases with the OAG, the Chief Ombudsman replied to Correspondents B and C on 14 June 2010 telling them that she had become aware that the Auditor-General was making enquiries of KDC about the rates issues before deciding whether to conduct a formal inquiry. Therefore, in accordance with her Office's long-established practice of not investigating a matter while another agency was looking into it, she did not propose to proceed with a separate investigation of their complaints.
- 23.38 The Chief Ombudsman invited both parties to send their correspondence to the OAG, so that the OAG had a record of their concerns. The correspondents were also invited to make a submission to the Office of the Ombudsman if they had concerns about this approach. On 9 July 2010, the Office of the Ombudsman forwarded Correspondent B's papers to the OAG, at her request. Correspondent C wrote to both the OAG and the Office of the Ombudsman expressing concerns, as detailed in the following paragraphs.

#### **June and July 2010: Correspondents' concerns about the management of their complaints**

- 23.39 In an email to the OAG on 21 June 2010, Correspondent C acknowledged that there were similarities between his concerns and those raised by Correspondents A and B. However, he said that he wanted assurance that the OAG had the authority to investigate the full range of issues he had raised. He also asked whether there was a conflict of interest for the Auditor-General in investigating matters that potentially overlapped with the audit of the Council. The OAG acknowledged receipt of the letter and said that it would let him know its position once it had had the opportunity to consider the information he had provided.
- 23.40 On 2 July 2010, Correspondent C wrote again to the Office of the Ombudsman and to the OAG about KDC's performance and noted the limited progress the OAG had made.
- 23.41 Correspondent C said that ongoing actions by KDC reinforced his previous allegations of misleading and inaccurate information being put to councillors. He also referred to attempts to "retrospectively re-write the framework of the funding and operation of the EcoCare project". He said that there was increasing evidence that the costs of the scheme had risen to such an extent that further development in Mangawhai was threatened and that the cost of remaining there would become prohibitive for retirees and other people on low incomes.
- 23.42 In his email to the Office of the Ombudsman, Correspondent C asked the Chief Ombudsman to reconsider her decision not to investigate while the OAG was considering the matter.

- 23.43 The OAG also received a further email on 29 June 2010 from Correspondent A, who was concerned that the OAG had not yet completed its preliminary enquiries. He said that the matter was urgent. He repeated his concerns about the Council's use of the concept of "unit of demand" to assess rates and with the suggestion that amending the definition of "unit of demand" would fix the problems he had identified. He said that this was "a total farce and flies in the face of all the statutory provisions". He described it as "a deliberate ploy by council to obtain money by deception because they know that they are breaching the provisions of the Rating Act and [Local Government Act 2002]".
- 23.44 Correspondent A telephoned three days later on 2 July 2010 and spoke to an OAG staff member about his concerns. According to his file note of this conversation, the staff member told Correspondent A that KDC had the information Correspondent A had provided and was taking legal advice on it. It was for KDC to decide how to respond to that advice, and the solution was therefore in KDC's hands. The file note records that Correspondent A was not prepared to accept this view of the matter. The file note also records that the OAG decided not to respond to him further at that stage.
- 23.45 However, the OAG did reply to Correspondent C on 6 July 2010. It copied its response to Correspondent A and the Office of the Ombudsman. The OAG said that it was not the Auditor-General's role to determine the legality of the Council's actions about rates. The OAG understood that Correspondent C was pursuing his concerns directly with KDC and encouraged him to do that, given that responsibility for rating matters rested primarily with the Council. The OAG said that it was still considering whether to conduct an inquiry.
- 23.46 The OAG's letter to Correspondent C prompted responses from both Correspondents C and A. Correspondent C asked in an email whose responsibility it was to determine the legality of the rates. Correspondent C said, "Unfortunately the perception I am getting is that there is in fact no watchdog/complaints mechanisms over the actions of Council ... Everyone seems to refer me to someone else, and it goes around in circles ...". It appears that the OAG did not reply to this email.
- 23.47 However, the Assistant Ombudsman advised Correspondent C that the Chief Ombudsman's decision not to investigate while the OAG was looking into the matter did not preclude Correspondent C from approaching the Office of the Ombudsman again after the OAG had concluded its enquiries. At that point, the Office of the Ombudsman would be prepared to consider any ongoing issues, provided they were outside the scope of the OAG's enquiries. Correspondent C was also informed that, although the OAG might not yet be in a position to finalise

its decision about whether to conduct an inquiry because it was waiting for information from KDC, this did not provide grounds for the Chief Ombudsman to intervene and embark on a separate investigation.

23.48 Correspondent A asked why the OAG had not told him from the outset that it could not examine the validity of a Council's rates. He also attached a copy of the resolution that the Council was going to be asked to consider about the definition of "unit of demand" (the subject of his first complaint) at the forthcoming Council meeting. He said that the councillors were totally dominated by the Chief Executive and had been relying on the Auditor-General "to save them from all this nonsense".

23.49 The OAG replied to Correspondent A on 22 July 2010, noting that it had explained to him its approach to inquiries when he had contacted the OAG by telephone, that any question of legality was for a court to determine, and that the Council had obtained legal advice and was entitled to rely on it.

23.50 The OAG's reply said that it had asked KDC to provide information about its process, including its legal advice. The reply also said that, once the OAG had received the information, it would consider the matter further. It said:

*For the sake of clarity, this review will not be to second guess either the policy decisions behind the rates or give a legal ruling. The OAG will be reviewing the process for administrative reasonableness, to assure ourselves that the Council has taken sensible steps in relation to the concerns that have been raised.*

23.51 The OAG sent a copy of this letter to KDC's Chief Executive with a note saying, "We look forward to hearing from you as discussed."

23.52 On 26 July 2010, KDC's Chief Executive sent the OAG the relevant business papers from the July Council meeting, including a copy of the legal advice that the Council had received in May and copies of business papers from the Council's July meeting.

23.53 At its July meeting, the Council resolved to amend the definition of "unit of demand", as recommended by its legal advisers. It also resolved to make corresponding changes to its funding impact statement during the next review of its LTP.

### **August 2010: Correspondent A complains to the Auditor-General**

23.54 Correspondent A then wrote to the Auditor-General on 23 August 2010 to complain about the way the OAG had dealt with his concerns.

- 23.55 He acknowledged that the Auditor-General could not make a ruling on legal matters but pointed out that she did have the power to hold an inquiry and to issue an opinion as a result of that inquiry. He queried the OAG's practice of not acting until it got a response from the Chief Executive and of accepting legal advice at face value. He again questioned the legal advice given to KDC, whether the legal advisers had been asked to consider all of the matters he had raised, and KDC's proposed method for remedying defects in the wastewater targeted rate.
- 23.56 He went on to say:
- The KDC is close to being insolvent. There have been huge cost overruns on the Mangawhai scheme and it seems that the unit of demand fiasco is a last-ditch attempt to raise more money to keep the Council afloat and pay the huge sums it is paying out to advisers and consultants. No one is aware of what is really going on. The Chief Executive keeps everything from the councillors and they are not even aware of legal proceedings taken against the council and large pay-outs that are made.*
- 23.57 The Auditor-General asked for a briefing on the matter. This briefing was provided by an OAG staff member who had not previously been involved in dealing with the complaints. He reviewed the file, which included the correspondence with all three correspondents, and concluded that:
- The complaints were fairly complex and not always well articulated.
  - It had taken the OAG some time to work through them, and KDC had been slow to respond.
  - The correspondents had become frustrated with the OAG and did not have a good understanding of the Auditor-General's role and powers.
  - Correspondent A's concerns about aspects of the wastewater targeted rate had some substance. However, only a court could make a finding on whether any failures on the Council's part affected the validity of the rate. A court might overlook any failures because the Council's intention was clear and its approach reasonable despite the shortcomings in the process.
  - Correspondents B's and C's concerns about the Council not giving refunds for part of the year when the wastewater service was not available had less substance. The concerns seemed to be largely the result of poor communication from KDC.
  - Correspondent C had several other concerns that the Office of the Ombudsman had told him to raise with KDC.
- 23.58 The OAG then decided to write to all three correspondents to tell them that it did not intend to conduct an inquiry. Instead, it would recommend that KDC initiate

an independent “first principles legal review” of its rating policies, practices, and documents (the first principles review) to get assurance about statutory compliance and to address inconsistent and confusing terminology.

- 23.59 On 27 August 2010, the OAG consulted KDC’s Chief Executive about the proposal that KDC commission an independent first principles review of its approach to the wastewater rate for 2010/11 against the requirements of the Local Government (Rating) Act 2002 and the Local Government Act 2002. This would enable any irregularity in setting the rate to be corrected during the current rating year. It would also enable any improvements that were required to be incorporated in the funding impact statement in the 2011/12 Annual Plan and rates resolution to be made.
- 23.60 The Chief Executive said that he had already asked KDC’s legal advisers for a “further legal review” of the rating for the scheme in response to Correspondent A’s letter to the legal advisers raising concerns about their legal advice. The Chief Executive said that the legal review was likely to be complex and might take two to three months to finalise. He said that he would keep the OAG informed of the results of the review. It appears that the Chief Executive regarded the “legal review” as meeting the OAG’s proposal for a first principles review of the rate, while the OAG expected there to be a separate review.
- 23.61 The OAG’s letters declining a request for an inquiry went to the three correspondents on 27 August (Correspondent A) and 6 September 2010 (Correspondents B and C), six months after the OAG had received Correspondent A’s first complaint. A copy of the letter sent to Correspondent C was sent to the Office of the Ombudsman, but not to the Minister or the Department.
- 23.62 The OAG said that it agreed that there were issues with the terminology that had been used for the wastewater targeted rate. It also said that there was confusion about KDC’s approach to charging for connection to the scheme. However, the OAG said that the overall intention was clear, KDC’s approach was not unreasonable, and an appeals mechanism was in place for disputes about the meaning of “unit of demand”.
- 23.63 Correspondent A wrote again to the Auditor-General on 30 August 2010 expressing frustration at the OAG’s decision. In particular, he challenged the OAG’s statement that KDC had acted reasonably, asking whether it was enough for KDC to have acted reasonably if it had not acted lawfully. The Assistant Auditor-General, Legal responded by explaining in more detail the OAG’s inquiries function and the OAG’s interest, as auditor, in legal matters.

- 23.64 From this time until late in 2011, the OAG considered that it had dealt with the requests for an inquiry and that KDC was addressing the rates issues.

### **September to December 2010**

- 23.65 After receiving the OAG's advice that it would not carry out an inquiry, all three Correspondents wrote again to the Chief Ombudsman asking her to re-open the investigation into their concerns. In some cases, the correspondents also wrote to the Minister, the Department, the OAG, the Prime Minister, and their local members of Parliament about their concerns. A summary of the three agencies' activities during the rest of 2010 follows.

#### **Office of the Ombudsman**

- 23.66 The Chief Ombudsman declined the correspondents' requests on the basis that she would not duplicate the enquiries of another Officer of Parliament, had no mandate to review the Auditor-General's decisions, and would not pre-empt the findings of the first principles review.
- 23.67 She also pointed out that it was unlikely that any investigation by the Office of the Ombudsman could achieve an outcome substantially different from the Auditor-General's enquiries. This was because, like the Auditor-General, the Chief Ombudsman could not provide a ruling on the legality of KDC's approach to the rates. The Chief Ombudsman referred to the potential for the first principles review to scrutinise the issues that were in dispute and to consider a remedy should this be necessary.
- 23.68 The correspondents were invited to make submissions to the Chief Ombudsman in response to these points. The correspondents voiced dissatisfaction with the approach taken by the Office of the Ombudsman and later contacted the Office of the Ombudsman again with concerns about the first principles review. The Office of the Ombudsman referred them to the OAG on the understanding that the OAG was monitoring the first principles review.
- 23.69 In November 2010, after considering submissions from the correspondents, the Chief Ombudsman confirmed her decision not to proceed with an investigation.

#### **Department of Internal Affairs**

- 23.70 The Minister continued to receive correspondence about the rates and the scheme. For example, Correspondent C complained to the Minister about:
- the legality of decisions made;
  - the technical competence, financial management, and governance exercised by the Council;
  - various legal claims that he said had been lodged against KDC;

- rumours about KDC making claims against the main engineering consultants;
- problems with the current District Plan review, including “arbitrary” decisions by KDC staff about submissions on the District Plan;
- secrecy within KDC; and
- the failure of the Mayor and councillors to do anything about the situation.

23.71 Correspondent C said there was evidence that the scheme was “in a financial mess” and that, overall, KDC was “approaching financial meltdown”. In particular, he referred to the debt for the scheme, which he said appeared to have increased from \$27 million as at 30 June 2009 to at least \$80 million.

23.72 The Minister told Correspondent C that Correspondent C had taken the appropriate course of action by referring his concerns to the OAG and the Ombudsman. The Minister said that he understood that the OAG was currently reviewing Correspondent C’s complaint to assess which particular aspects were within the OAG’s mandate. The Minister also said that the Office of the Ombudsman was waiting until after the OAG had completed its investigation before deciding on its course of action. The Minister said that he had also asked his officials to inquire into the matters Correspondent C had raised. The Minister forwarded a copy of this correspondence to the Auditor-General and asked to be informed about the outcome of the OAG’s investigation. The OAG replied to the Minister on 24 September 2010 to inform him that it had decided not to carry out an inquiry.

23.73 Department officials also contacted the OAG asking for background information on KDC so that they could brief the Minister. In relation to the wastewater targeted rate, the Department told the OAG on 29 September that “it appears highly possible that these rates have been set unlawfully” and asked for more information on the first principles review.

23.74 The OAG told the Department that it had asked KDC to provide a copy of the terms of reference for the first principles review. The OAG said that its general expectations were that the review would involve:

- *assessing the [targeted] rate against the requirements of the Rating Act;*
- *working out which factors and matters the Council was relying on;*
- *considering the concern that had been raised about whether the factor being relied on needs to exist before the start of the rate year; and*
- *defining “separately used or inhabited property” in the Funding Impact Statement.*

- 23.75 The OAG would also see how the new Council picked up the matter after the forthcoming local body elections. The OAG was also considering how the matter might affect the finalisation of KDC's annual report for 30 June 2010.
- 23.76 For the most part, the email correspondence between the OAG and the Department makes it clear that, from the OAG's perspective, KDC was responsible for the review. The OAG's concern was simply to know that the review took place. However, in one of the emails, the OAG also said that it had indicated to the complainants that it would be "monitoring" the review.
- 23.77 The Minister wrote again to the Auditor-General on 27 October 2010 to say that he understood that the first principles review had been completed. He said that he had requested a copy of the review from KDC. He wanted to know whether the report addressed the OAG's concerns. The Auditor-General replied to the Minister explaining that, once KDC had commissioned the legal review of the rate, the OAG had closed its file on the complaint. She explained that her appointed auditor would monitor progress with the review as part of ongoing audit work, but the OAG would not otherwise have any formal involvement.

#### **Office of the Auditor-General**

- 23.78 The OAG's primary concern during this period was the audit opinion on KDC's annual financial statements, due by the end of October. On 14 October 2010, KDC's Chief Executive sent the OAG a copy of a draft legal opinion provided by its legal advisers. This opinion concluded that:
- The particular targeted rate was invalid because it was not clearly identified in the funding impact statement.
  - The basis on which KDC had differentiated the rate did not accord with the Local Government (Rating) Act 2002.
  - It would be possible to remedy the defects by resetting or replacing the rate.
- 23.79 KDC's Annual Report for 2009/10 disclosed information about the problems with the rate. Because KDC, as the responsible entity, acknowledged the defects and was addressing them, the OAG determined that the audit report need not refer to the matter.
- 23.80 The primary concern of correspondents in the later part of 2010 appears to have been to find out the terms of reference for, and results of, the first principles review. As noted in paragraph 23.60, it appears that KDC regarded the legal advice set out in the draft legal opinion as the first principles review.
- 23.81 Correspondent A emailed the appointed auditor asking for the information about what he referred to as the "first principles audit". Correspondents B and C had



again been in contact with the Office of the Ombudsman with the same request. The Office of the Ombudsman advised the correspondents that it was open to them to seek information about the review from KDC through a request under the Local Government Official Information and Meetings Act 1987. It also advised that the Ombudsman could review any decisions made by KDC in response to such requests. It suggested that, if the correspondents had any concerns about the terms of reference for the first principles review that they were unable to address with KDC, they should contact the OAG because the OAG expected KDC to advise it of the terms of reference.

- 23.82 In late November, Correspondent B (who had not previously corresponded directly with the OAG) emailed the OAG about the scope of the first principles review and whether it would be truly independent. Correspondent B alleged that KDC was withholding information, excluding the public from relevant discussions, and unilaterally changing the terms it had previously agreed with ratepayers about the review of the rates. The OAG replied that it intended to monitor the outcome of the review, but it had no direct role in specifying how the review would be carried out. The OAG advised Correspondent B to refer questions about the review to KDC.
- 23.83 The OAG told Correspondent B that, although it had recommended the review, it was up to KDC to decide the approach to take, to determine how the review would be done, and to decide who would be involved. The OAG said that, although it would monitor the outcome of the review generally, it had no direct role in specifying how the work got done, who was involved, and any decisions that might be made once it was completed. The OAG advised Correspondent B to raise any questions about the review directly with KDC.
- 23.84 The OAG also wrote to KDC's Chief Executive to let him know it was still receiving correspondence about the wastewater targeted rate. It asked him to provide an update on the current status of the review generally, including:
- the current status of any legal advice KDC had received (and the contents of any final advice);
  - any consideration of this advice, and decisions taken as a result, by the Council; and
  - planned future steps.
- 23.85 The OAG told the Chief Executive that, after reviewing this information, it would decide whether any further intervention by the OAG was required.

### **December 2010: Kaipara District Council decides to replace the wastewater targeted rate**

- 23.86 On 21 December, KDC's Chief Executive wrote to the OAG enclosing copies of a report he had provided to the Council's November meeting about Correspondent A's complaint about the rate. He included a copy of the legal advice that KDC had received, the recommendations adopted by the Council as a result, and copies of the letters KDC had sent to Correspondents A and B. These letters explained KDC's position and the steps it was intending to take to remedy the problem with the rates.
- 23.87 The Council had resolved to accept that the "one-off" differential targeted rate had been incorrectly differentiated (because it had differentiated on the basis of a date). The Council resolved to use the provisions of section 120 of the Local Government Act 2002 to remedy the problem by setting the rate based on location (the original area to be serviced by the scheme).
- 23.88 The letters to Correspondents A and B also noted the disputes resolution process that KDC had put in place to address disputes about the meaning of "unit of demand". The letter also noted that a full briefing on the project (from inception to implementation) would be provided to the elected Council members, most of whom were new. The Chief Executive advised that, as part of that process, elected members would be asked whether they required a further first-principles review of the project.
- 23.89 The Chief Executive sent copies of his letter to Correspondents A and B to the Office of the Ombudsman, the Minister, and the Secretary for Local Government.

### **January to December 2011**

- 23.90 During 2011, several changes took place at KDC. In the local body elections in October 2010, five new councillors had been elected to the Council (there were eight councillors in total). A new General Manager, Policy & Governance was appointed in the middle of 2011. The Chief Executive announced his resignation, with effect from 31 October 2011, and a new Chief Executive began work in mid-November.
- 23.91 From the OAG's point of view, the issues about KDC's rates for the wastewater scheme had been closed. However, it was alert to issues that might be relevant for the audit.
- 23.92 Between January and July 2011, the OAG received no direct correspondence from ratepayers. However, the OAG received copies of correspondence between KDC

and some of the correspondents, which showed that KDC was meeting with ratepayers and was considering their request for a further review of the rates.

- 23.93 Correspondence also continued between the OAG and the Department and between the Auditor-General and the Minister on matters about KDC.
- 23.94 In January 2011, Correspondent B wrote again to the Chief Ombudsman. She was concerned that the issues she had raised would not be part of the proposed review. She said that more problems were emerging and that the community was becoming increasingly concerned. There had been no investigation by the OAG. She urged the Chief Ombudsman to investigate.
- 23.95 The Chief Ombudsman declined this request. She said that it was apparent that the Council had yet to make a decision on Correspondent B's request for a further review and that, whatever decision the Council reached, it would not be reviewable by the Office of the Ombudsman because its jurisdiction did not extend to decisions made by a full Council.

#### **PJ & Associates report**

- 23.96 In February 2011, the Council instructed PJ & Associates of Tauranga to carry out an independent review of the Council's financial health and sustainability. It received that report in July. The report raised concerns about inadequate budgeting and financial reporting, leading to unplanned debt and a lack of cash reserves.
- 23.97 One of the new councillors then wrote to the OAG. He was concerned about how KDC was being run and its "very high levels of debt". He enclosed a copy of the PJ & Associates report. He also complained that questions on key issues were being "shutdown" or "censored". He asked for advice about what he should expect in relation to timeliness and the content of the financial statements that were put before the Council.
- 23.98 The OAG told the councillor that it had referred the PJ & Associates report to the appointed auditor for KDC, who would consider the issues it raised in the course of providing an audit opinion on the 2010/11 financial statements. The OAG recommended that the councillor continue to raise his concerns with the Mayor and Chief Executive.
- 23.99 In August 2011, the Auditor-General visited KDC as part of a routine visiting programme. The OAG staff member who was to accompany her on the visit was delayed by bad weather and, as a consequence, the Auditor-General had no briefing on current issues concerning KDC before the meeting. The Auditor-General met the Mayor and the Chief Executive. The Auditor-General's file note of

the meeting records that there was brief mention of the wastewater scheme and the rates issues.

### **September 2011: The Minister of Local Government meets with Kaipara District Council and puts it “on watch”**

- 23.100 The Minister also received letters about the PJ & Associates report and concerns about other matters, including the Council’s decision-making processes and procedures, and internal disputes between elected members. The Minister was asked to use his powers to intervene under the Local Government Act 2002. The correspondents were advised of the limits on the Minister’s powers. They were told that the Minister was intending to meet the Mayor. In the meantime, it was the Minister’s view that KDC should have the opportunity to resolve its problems on its own.
- 23.101 At the request of the Mayor, the Minister met the Mayor and the Chief Executive on 8 September 2011 to discuss KDC’s financial situation. The Mayor and the Chief Executive advised the Minister of the steps that KDC was taking or had taken to address concerns raised by the PJ & Associates report – such as the appointment of debt advisers and suitably qualified senior staff, including the new General Manager, Policy & Governance.
- 23.102 The Department advised the Minister that there did not appear to be enough evidence to meet the legislative threshold for appointing a person to manage KDC. The Department put KDC “on watch” and identified areas where progress needed to be made by April 2012. KDC was required to provide regular updates to the Minister.

### **October 2011: Ratepayers’ petition**

- 23.103 In early October 2011, Correspondent B wrote to the Chief Ombudsman saying that there had been no independent legal review of the rates and that nothing had been resolved. On 22 October 2011, the Chief Ombudsman replied referring to recent developments, including a decision by the Council to obtain an independent review of the wastewater scheme and associated rating issues. The Chief Ombudsman referred to unconfirmed minutes of the Council meeting held on 28 September 2011 and the decisions the Council had taken. The Chief Ombudsman suggested that the Council was taking action to address Correspondent B’s concerns and that there would be public consultation.
- 23.104 From late October 2011, the OAG began to receive letters in a standard form from members of the MRRA asking for an independent legal review of the rates to deal with their current invalidity, a review of past rating process to enable refunds and interest to be paid, and a forensic audit of all costs associated with the scheme.

- 23.105 The MRRA said that nothing had come of the independent first principles review and that KDC had unilaterally changed the process and terms of reference for the review, which the MRRA had agreed with KDC. The MRRA also referred to two financial reviews commissioned by KDC, which the MRRA said confirmed negligence and incompetence at KDC and raised concerns about the use of its Endowment Fund and Reserves Fund. It said that a rates revolt seemed likely. It also said that the MRRA felt badly let down by the Ombudsman, the Auditor-General, and the Minister of Local Government.
- 23.106 The OAG also began to receive emails from a number of other individuals who had not written before. For the most part, they expressed the same concerns about the legality of the rates that previous correspondents had raised. However, claims were also made that KDC had contravened bank covenants and was engaged in “illicit borrowing”. One correspondent also alleged that the Auditor-General was shirking her responsibility to investigate KDC because of Audit New Zealand’s involvement as the Auditor-General’s audit service provider.
- 23.107 KDC’s General Manager, Policy & Governance told the OAG that the Council had decided to commission a further first principles review of the wastewater targeted rate. The review would not be as broad as ratepayers would like, but there was scope for the Mayor or Deputy Mayor to extend the terms of reference if there was good reason. At the start of November, the General Manager, Policy & Governance sent the OAG a copy of her report and the terms of reference for the review.
- 23.108 The OAG then replied to the correspondents who had petitioned the OAG. The OAG explained the limits of its responsibilities as auditor, which did not include in-depth reviews of specific projects. The OAG referred to recent changes in management at KDC and said that it was actively working with KDC to help it to improve its processes. The OAG said that the Council had recently commissioned another review of its rating practices by a different legal adviser and that, although the review might not be as wide-ranging as some residents might wish, KDC was taking appropriate steps to resolve the issues. The OAG maintained its position that a formal inquiry was not necessary.
- 23.109 The new chief executive took up his position in mid-November and began a process of “due diligence” to familiarise himself with KDC. Shortly after his appointment, on 24 November 2011, he and the General Manager, Policy & Governance met OAG representatives in Wellington to discuss concerns they had, particularly with governance, financial management, and the wastewater scheme. The OAG encouraged them to continue this work and provided support and guidance on an ongoing basis during the following months.

- 23.110 In December 2011, the OAG also initiated a quality assurance review of Audit New Zealand's audit files to establish what work had been carried out about the scheme and whether the auditor had raised any concerns about it. The quality assurance review covered the audits of the 2008/09 and 2009/10 Annual Reports and the 2009-19 LTP. The review was completed in October 2012. However, it was overtaken by the independent review described in Part 22.

### February to March 2012

- 23.111 In February 2012, KDC received a legal opinion from different legal advisers about the rates from 2008/09 to 2011/12. The scope of the legal opinion was wider than the previous two opinions and covered the rates and rate-setting processes generally, rather than focusing solely on the wastewater targeted rate.
- 23.112 The opinion pointed to numerous irregularities with KDC's rate-setting processes and suggested that validating legislation might be necessary.
- 23.113 Councillors considered the new legal advice, and other papers about the scheme, at the Council meeting on 15 February 2012. The Council resolved that the Chief Executive should ask the Auditor-General to investigate its decision-making, financial, and contract management processes, particularly in relation to the Mangawhai community wastewater project. The Council's view was that the emerging extent of the problems meant that it would not be able to fully resolve the issues with the Mangawhai community until there was a full and independent review of what had happened.
- 23.114 As set out in Part 1, the Auditor-General agreed to the Council's request in late February 2012. Terms of reference were released in March 2012, after consultation with the Council, community representatives (including the correspondents), the Department, and the Minister.

### My comments

- 23.115 My comments focus on the OAG and the Office of the Ombudsman and, to a lesser extent, the Department. I make brief comment about the Serious Fraud Office and the New Zealand Police in paragraphs 23.162-165.
- 23.116 I have reviewed the extensive correspondence among the correspondents, the three agencies, and KDC during 2010 and 2011, and the decisions by the OAG and the Office of the Ombudsman not to carry out a formal inquiry at that time.
- 23.117 My assessment of the performance of the agencies takes account of the information available to them at the time. Of course, time has shown that several of the allegations made by the correspondents were correct.

- 23.118 In paragraphs 23.119-161, I comment on:
- how well the three agencies responded to issues about KDC and the scheme raised by the correspondents;
  - how well the three agencies communicated with each other about the issues raised; and
  - the adequacy of the agencies' responses to the correspondents.

### **How well did the agencies respond to issues raised by the correspondents?**

#### **Office of the Auditor-General – 2002 to 2005**

- 23.119 I consider that the OAG's response to the five complaints received from 2002 to 2005 was adequate.
- 23.120 In each instance, the OAG checked with KDC to determine whether the information provided was accurate and whether KDC was taking appropriate steps to address the issues the correspondents identified. In each instance, KDC's response appeared to be satisfactory.
- 23.121 At the time, the wastewater scheme was still at the proposal stage and being consulted on. I consider that it is reasonable that the OAG expected the complainants to take up the issues with KDC as part of a formal consultation process.

#### **Office of the Auditor-General – 2010: Complaints from Correspondents A, B, and C**

- 23.122 There were no further complaints to the OAG until early 2010, by which time the wastewater scheme was completed and operating. Correspondent A first wrote to the OAG in March 2010 and to the Minister and the Department in May 2010. Correspondents B and C wrote to the Office of the Ombudsman in 2009. The three correspondents were concerned about a targeted rate for the scheme, although Correspondent C raised a range of wider concerns about the Council and the wastewater scheme.
- 23.123 The OAG promptly sought information from KDC about Correspondent A's issues about the wastewater targeted rate. Information that the OAG elicited from KDC during the next few months suggested that KDC was taking appropriate action. KDC obtained legal advice that identified some issues with the targeted rate and considered that advice. It then sought further legal advice on a wider range of issues about the rate, which appeared to satisfy the "first principles review" that the OAG proposed.

- 23.124 Both the Office of the Ombudsman and the Minister declined to pursue the issues raised by the correspondents while the OAG was considering them, although they continued to receive correspondence from the correspondents.

**Office of the Auditor-General's decision not to inquire**

- 23.125 Late in August 2010, the OAG decided not to carry out a formal inquiry because KDC appeared to be dealing with the issues about the rate. I consider that, given the information available to the OAG at the time, the decision not to inquire was reasonable, although it is now clear that the correspondents were right about many issues.
- 23.126 The OAG's decision was based on an assessment of risk – the risk that there were issues with the wastewater targeted rate and the risk that KDC (as the entity responsible) would not address them. A request to the Auditor-General to inquire into a matter must be assessed on that basis – whether there is an issue to address and whether the entity itself (or another agency) is better placed to resolve it. Such a request must also be weighed against competing work demands.
- 23.127 The information available to the OAG suggested that KDC was aware of the problem with the rate, was taking legal advice, and intended to correct defects.
- 23.128 However, the OAG's decision was based on inadequate information. When making a preliminary assessment of an issue, the OAG would usually have an independent source of information about the affected entity from the appointed auditor. However, as described in the independent review in Appendix 6, there were deficiencies in the documentation for the audits of the 2009-19 LTP and 2008/09 Annual Report, both generally in relation to the wastewater scheme (see, for example, paragraphs 169.10 and 224) and specifically in relation to the targeted rate (see, for example, paragraph 294).
- 23.129 Consequently, the appointed auditor in 2010, who had just taken over the audit, was not alert to possible problems with either the wastewater scheme or the rate mentioned in some of the correspondents' complaints. As a result, the OAG lacked full information from the appointed auditor when deciding whether to inquire.
- 23.130 I also consider that it was reasonable that the OAG did not review the legal questions about the rate in depth. KDC had external legal advisers and was seeking their advice.
- 23.131 However, in its letters to the correspondents about its decision not to inquire, the OAG did not acknowledge that it also thought that there were some problems with the wastewater targeted rate. Instead, it said that, although there were issues with "terminology", the Council's overall intention was clear and its



approach not unreasonable. The advice that it was enough for the Council's intention to be clear, even if the rate did not meet the requirements of the legislation, was not correct. I note that this is not advice that the OAG would now give.

- 23.132 The OAG's decision not to inquire into the rate issues left the wider concerns that Correspondent C had raised with the Ombudsman unaddressed. It seems that the OAG regarded those matters as dealt with, because the Ombudsman had suggested that Correspondent C take them up with KDC. Like the Office of the Ombudsman, the OAG will usually decline to investigate complaints that the complainant has not first tried to resolve with the public entity concerned.
- 23.133 The OAG began to suspect that there might be more issues about KDC and the scheme than the wastewater targeted rate only when KDC itself provided it with evidence of wider problems. That evidence came in the form of the PJ & Associates report forwarded by a new councillor; the legal opinion from the second legal adviser, which suggested that the rating issues were broader than the wastewater targeted rate; and information from KDC's new management.
- 23.134 With the benefit of hindsight, the Auditor-General now considers that it would have been appropriate to reconsider the situation more fully in late 2011, in light of the renewed correspondence from ratepayers and the additional information emerging from KDC. If the OAG had done so, this inquiry might have begun a few months earlier.

#### **Ombudsman's decision not to investigate**

- 23.135 The Office of the Ombudsman received complaints from the correspondents from 2009. It declined to investigate the rate issues when it learned that the OAG had also received complaints about the matter and was carrying out "preliminary inquiries". It wanted to avoid duplicating the OAG's work. The Office of the Ombudsman continued to decline the correspondents' repeated requests that it investigate for the same reason and then because KDC had commissioned the first principles review of the rate.
- 23.136 It is not clear to me whether the Office of the Ombudsman knew that the steps the OAG was taking did not constitute a formal, comprehensive inquiry. However, it told the correspondents that any complaints that the OAG had not adequately addressed could then be investigated by an Ombudsman.
- 23.137 The Office of the Ombudsman also declined to investigate the wider issues raised by Correspondent C, either because they did not appear to have been raised with KDC or because there was insufficient information to establish grounds for an investigation.

- 23.138 The Office of the Ombudsman, like the OAG, will usually decline to investigate complaints that the complainant has not first tried to resolve with the public entity concerned. I consider that the decision was reasonable in the circumstances.

### **How well did the agencies communicate with each other?**

- 23.139 I consider that, despite considerable contact on issues concerning KDC, there were shortcomings in communication among the three agencies.
- 23.140 Each agency focused on its own functions and the limits of that role. The Department and the Minister were concerned to establish whether the statutory threshold for intervention had been reached. The Office of the Ombudsman looked for issues affecting individuals that it could address. The OAG's primary concern was matters that might affect the audit of the Council's financial statements.
- 23.141 Viewed as a whole, the body of complaints contains allegations and, in some instances, information that could have indicated that the problems with the scheme were wider than the wastewater targeted rate. However, each agency addressed each complaint as it came. At no point did the three agencies pool their information or jointly consider what an appropriate response might be.
- 23.142 Towards the end of 2011, the Minister and the Department did raise questions about the wider local government context, in promoting legislation to give the Minister a greater range of interventions where a local authority appears to be failing (legislation that has now been passed).
- 23.143 In addition, inadequate communication among the three agencies will have contributed to the correspondents' dissatisfaction with them. For example:
- The OAG told both the Office of the Ombudsman and the Department that it was carrying out "preliminary inquiries" but did not ensure that each understood that this meant gathering information from KDC and the appointed auditor.
  - The OAG neglected to tell the Minister and the Department that it had decided not to carry out an inquiry, with the consequence that the Minister later wrote to Correspondent C telling him that the OAG was still carrying out an investigation.
  - When the OAG said that it was "monitoring" the first principles review, the Office of the Ombudsman understood monitoring to mean "active oversight". In fact, the OAG appears to have meant something less than that. Consequently, the Office of the Ombudsman referred Correspondent C to the OAG for information about the review on the assumption that the OAG would have close oversight of it.

## Were the agencies' responses to the correspondents adequate?

### Office of the Auditor-General's handling of the correspondents' complaints

- 23.144 I consider that there were shortcomings in the OAG's communications with the correspondents. The tenor of much of the correspondence is mounting frustration on the part of the correspondents and, on the OAG's part, a focus on what it would not do, rather than what it could do (and was doing). It is also possible to discern a desire on the part of the OAG to avoid initiating a formal inquiry.
- 23.145 The OAG's first response to Correspondent A said that it was carrying out "preliminary inquiries" – the OAG's standard initial response at the time. However, the OAG did not explain that preliminary inquiries meant talking to the two most likely sources of information, KDC and the appointed auditor, to establish whether the issues raised by the correspondents might have substance and whether the OAG needed to be involved or whether the issue was likely to resolve itself.
- 23.146 The OAG then did not reply formally to Correspondent A for four months, although it had spoken to Correspondent A by telephone in the interim. (The telephone calls were initiated by Correspondent A.) When it did reply, the OAG said that it could not determine the legality of the rate. Correspondent A asked, not unreasonably, why the OAG could not have told him that at the outset.
- 23.147 The OAG's letters to the correspondents informing them that it would not carry out an inquiry did not tell them that the OAG also considered that there were problems with the targeted rate.
- 23.148 The OAG did not address Correspondent C's wider concerns, other than to encourage him to pursue them directly with KDC.

### Comment

- 23.149 The Public Audit Act 2001 gives the Auditor-General the power to carry out an inquiry into a public entity's use of its resources. In the context of that role, the OAG has for many years invited complaints about public entities from taxpayers and ratepayers. The information currently on the OAG's website makes clear the limitations of the inquiries function. It says that the Auditor-General's office is not a "general complaints agency" and that it is "not an avenue for individual complaints or concerns about how a public entity has handled a particular matter".
- 23.150 The OAG's performance measures for inquiries focus on quality and timeliness. Timeliness is measured by the time taken to report findings to the "relevant parties", who include the complainant.

- 23.151 The clear implication is that, within the limitations described, the OAG will consider all requests for an inquiry that it receives from the public and will report back to the complainant both on its decision whether to inquire and, if it does inquire, on the findings of the inquiry.
- 23.152 As an Auditor-General's inquiry is concerned primarily with the accountability of the public entity, it is possible that complainants, such as Correspondents A, B, and C, will have expectations of the Auditor-General that will not be met.

**The Office of the Ombudsman's handling of the correspondents' complaints**

- 23.153 It is apparent that the Office of the Ombudsman carried out a considerable amount of work on the complaints received, many of which were lengthy and involved a complex mix of legal and technical issues, as well as miscellaneous allegations of wrong-doing at KDC that were not always clearly explained or substantiated.
- 23.154 The Office of the Ombudsman declined to investigate when it learned that the OAG had also received complaints about KDC and was carrying out "preliminary inquiries". However, the Office of the Ombudsman left open the possibility that the correspondents could again ask for an Ombudsman investigation when the OAG had completed its work.
- 23.155 As noted in paragraph 23.129, it is not clear how well the Office of the Ombudsman understood the limited extent of what the OAG was actually doing. Although the OAG had informed the Office of the Ombudsman in September 2010 that it had decided not to inquire, the Office of the Ombudsman several times referred the correspondents back to the OAG (who then referred them to KDC), on the understanding that the OAG was monitoring the first principles review.

**Department of Internal Affairs**

- 23.156 The Department's function relevant to this inquiry is to advise and support the Minister (see paragraph 21.12). I conclude that, given the limits of the Minister's statutory role at the time, the Department discharged this role appropriately about the complaints that the Minister and the Department received about the Council. The responses to the correspondents were sent promptly.

**Resources for inquiries: The Office of the Auditor-General and the Office of the Ombudsman**

- 23.157 The correspondents' complaints were made at a time when both the OAG and the Office of the Ombudsman were finding it difficult to resource inquiries and investigations.

**Office of the Auditor-General**

- 23.158 The OAG spends only 1% or 2% of its resource on inquiries (see paragraphs 21.29-21.32). In 2010, at the time of the correspondents' complaints, the OAG was handling multiple inquiries. It completed and published the results of nine major or significant inquiries in 2010. Consequently, the OAG's limited resource for inquiries was stretched. As noted in paragraph 21.30, the OAG does not have a dedicated inquiries team.
- 23.159 The complaints about the Council focused on the wastewater targeted rate. It is possible, therefore, that the OAG did not consider that an issue that presented as a technical, legal question about a single targeted rate was important enough to warrant deeper investigation.

**Office of the Ombudsman**

- 23.160 The Office of the Ombudsman operates with limited resources. The annual reports for the relevant period show an increasing number of complaints received but little increase in the resource available to attend to the complaints. In her report for 2009/10, the Chief Ombudsman acknowledges the significant pressure on her investigative staff, compounded by the loss of experienced investigating staff and the increasing complexity of the matters referred to her.
- 23.161 In this context, the Office of the Ombudsman's usual approach is to avoid premature commitment of its limited resources to a matter when it knows that alternative remedies have not been fully explored.

**Serious Fraud Office/New Zealand Police**

- 23.162 I have a brief comment on the role played by the Serious Fraud Office and the New Zealand Police.
- 23.163 The Serious Fraud Office received five complaints about the Council, between September 2011 and June 2012, alleging corruption and fraud. After examining the evidence provided, the Serious Fraud Office determined that the evidence did not suggest that a financial crime had occurred. It referred each of the complaints to the Office of the Ombudsman and the OAG.
- 23.164 The New Zealand Police received one complaint in April 2012. The Police decided in September 2012 that the matters raised did not warrant a criminal investigation.
- 23.165 I note that the much more detailed examination of events during this inquiry has uncovered no evidence of criminal offending.



## Part 24

### Our overall conclusions

#### Summary of what we found

- 24.1 Two important practical conclusions are set out in Parts 2 and 19 of this report:
- In Part 2, we concluded that KDC was correct when it decided that Mangawhai needed a reticulated sewerage system and that its process for assessing the need and making that decision were sound.
  - In Part 19, we concluded that the sewerage system that has been built is functioning well and has appropriate capacity for growth. It is too soon to assess whether the scheme is achieving the environmental goals and improving water quality in the Harbour.
- 24.2 The Parts between those two tell a story of poor governance, poor decision-making, and inadequate management of both the organisation and the project. We have identified deficiencies in the way KDC managed the overall project, contracted with the various parties, financed the construction of the scheme, took ownership of the assets, and much more. Parliament and the High Court are considering the extent of KDC's legal failings – for example, in the way it set and collected rates to fund the scheme.
- 24.3 KDC was also affected adversely by events outside its control. For example:
- The late amendments to the Local Government Act 2002 prevented the initial proposal from proceeding.
  - The financial failure of the proposed contractor's parent company meant that the Council had to abandon well-advanced negotiations.
  - The effect of the global financial crisis on the New Zealand property market and development activity reduced KDC's projected income from rates and development contributions.
- 24.4 The result was that the project took a long time to complete, the costs increased significantly, and many people lost confidence in KDC.
- 24.5 Was there corruption or theft? During the inquiry, many people raised with us their concern that the cost increases could result in part from corruption in the contracting process or misappropriation of KDC funds. Throughout our work, we have actively considered whether there was evidence of possible criminal activity. If we come across such evidence, our practice is to refer the information to the relevant law enforcement agencies for investigation. In the 21 months of our work on this inquiry, we have not found any evidence suggesting criminal activity or warranting such a referral. Instead, we have found a great deal of information that explains how the costs increased through a series of poor decisions

and inadequate management. It is extremely difficult to “prove a negative” conclusively, so we cannot definitively state that there was no wrongdoing of this kind. However, we are satisfied that the cost increases resulted from the combination of failures that we have described in this report.

- 24.6 The problems with the way the wastewater project was run drew attention to some underlying problems in the way KDC was being run. It is now apparent that KDC as a whole had weak systems in many areas and lacked in-house capacity to deal with its range of responsibilities effectively.
- 24.7 It took some time for these problems to become apparent. A new Council was elected in late 2010, and new senior management staff were appointed in 2010 and 2011. Between them, they commissioned external reviews of the financial management systems and the rates, which provided firm evidence that there were significant problems within the wastewater project and KDC more generally. As we discussed in Section D, KDC’s auditors did not identify these issues earlier.
- 24.8 Eventually, however, the Council and others began to understand the extent of the problems and several accountability processes began to operate. For example:
- The Auditor-General agreed to begin this inquiry to independently assess what happened.
  - The Minister intervened and ultimately replaced the Council with Commissioners.
  - Ratepayers received considerable information after making requests under the Local Government Official Information and Meetings Act 1987.
  - The MRRA eventually began judicial review proceedings to seek a clear ruling on the legality of a number of KDC actions.
- 24.9 Between these various processes, and the ongoing work of the Commissioners and KDC staff, a great deal of effort has now gone into understanding what happened and how the problems can be fixed. That work is continuing.

## The underlying causes

### Lack of capability

- 24.10 This report has identified numerous failings in the way KDC planned and managed this project. The common theme, throughout all of the particular issues, is the question of capability.
- 24.11 **Governance capability:** This project spanned 14 years, during which time various mayors and councillors came and went as part of the electoral cycle. We spoke with some (but not all) of these people as part of this inquiry. We have no doubt



that the individuals took their responsibilities seriously and brought useful skills and perspectives to the role. However, there is always a risk that an elected council in a small area will not include all of the skills needed for effective governance of an entity with significant legal and financial responsibilities. Several elected members volunteered that “you don’t know what you don’t know” and that they were very aware of how much they depended on the advice provided by KDC staff and external advisers.

- 24.12 Time and again, our work throughout the public sector shows how important it is for members of a governing body to have the confidence and ability to test and challenge the advice they receive and to maintain an overall view of the entity’s direction and risks.
- 24.13 **Management capacity and capability:** The former Chief Executive explained to us that, when he arrived at KDC, there was a conscious policy that the organisation needed to shrink. Throughout the business, there was a systematic move to contract out much of the work so that KDC was a very lean organisation. For example, engineering services were contracted out to a private company and KDC had only one in-house engineer to oversee engineering matters across all of its functions.
- 24.14 This approach was a way of managing cost and also a response to the difficulty of recruiting and retaining specialist expertise outside the main centres. However, the challenge with this approach is always to retain enough capacity and capability to be able to manage the contracting relationships effectively, so that the council retains overall responsibility and control of its activities. In our view, KDC became too lean and did not have enough capability to monitor and control all that it was responsible for. This is a risk that many public entities need to consider.
- 24.15 **Project management capacity and capability:** Guidance on PPPs places a lot of emphasis on the fact that partnering arrangements require a considerable investment of staff time to provide the necessary direction and control throughout the project. In our 2006 report on partnering, we commented:
- 3.68 *Public entities require a high level of expertise to implement partnering arrangements successfully, and face significant risks without this expertise. It will be vital for public entities to ensure that they have people on their staff with a high degree of commitment and the right level of skills and expertise before entering into this type of arrangement. However, it is likely that most public entities will have to use external expertise to manage specific aspects of the procurement – for example, to provide commercial, technical, financial, and legal advice, and to manage*

*both the procurement process and aspects of contract management once the contract comes into effect.*

3.69 *The public entity will need to retain overall responsibility for effective project management and the major decisions that will be part of this, and external experts will need to be managed. Therefore, it is vital that the public entity ensures that:*

- it has internal experts that have been adequately trained to carry out this role effectively; and*
- the terms of reference, timescales, and basis of fees for external experts are clearly defined.*

24.16 The Victorian state government guidance that was available at the time of the wastewater project also emphasised the investment in capacity the entity needed to make to ensure good project and contract governance, management, and monitoring.

24.17 KDC employed a consortium of external project managers, who effectively reported directly to the Chief Executive and the Council for most of the project. There was no additional mechanism within KDC for overall governance and management of the project and its wider risks, to provide advice from that broader perspective to the Council. The initial Beca proposal included a structure of this kind, but we do not know why it was not implemented.

24.18 The quality of information that KDC held on the budget, costs, and funding for the project was a particularly striking example of why more coherent oversight and monitoring were needed. We commented in Part 8 that we found no documentation to suggest that there was a system for planning, management, reporting, or budget purposes. The Council does not seem to have tracked in any systematic way what the estimated costs were going to be or how it was going to fund them within the parameters of the available funding sources and KDC policy. Appendix 5 sets out the information that we have been able to bring together to track the changing costs. It is drawn from a range of sources, and many of the amounts are not directly comparable.

24.19 The Council might have been concerned about the overhead costs of additional management and monitoring. In our view, this project is a salutary lesson in the value that management and monitoring arrangements add. Better overall management of the project and KDC's risks could have avoided some of the problems and additional costs that we have described throughout this report. It would also have given the project more visibility within KDC's systems, which might have increased the chances of it attracting attention earlier from the auditor and other external accountability agencies.

- 24.20 **Specialist resources:** We have identified in several places throughout this report where we considered that the Council suffered because it did not have access to enough specialist or professional advice. In particular, we consider that the Council needed access to a greater level of financial expertise to embark on and manage a project of this kind. We have also commented on the fact that legal expertise was not systematically used throughout the project as a whole. The project managers provided legal advice about the development of the commercial contract, but any work beyond this was outside their contracted role and had to be specifically requested. This was done sporadically.
- 24.21 **Procurement:** Sections A and B describe how KDC carried out the procurement processes to engage a project manager and to select a partner to deliver the wastewater scheme. Our overall conclusion was that KDC followed the right basic steps to go to the market, but the quality of the work at each stage was not adequate. In our view, this reflects the lack of depth in the resources KDC was able to draw on. It effectively had no capacity to test and supplement the advice it received from its contracted project managers.
- 24.22 Overall, we concluded that KDC was out of its depth in embarking on a PPP of this scale and complexity. On its face, the wastewater project was a reasonable candidate for a PPP approach. However, the Council went into a PPP for the wrong reasons and did not equip itself to manage it properly.

### **Inadequate focus on public sector obligations and accountability**

- 24.23 KDC is a small organisation where councillors and staff work closely with one another. Because the community they serve is also relatively small, they will often know the members of the community they interact with. In small towns and rural communities of this kind, a level of informality in the way business is done is to be expected.
- 24.24 However, in our view, this informality should not extend to council decision-making or the way a council operates. It appears that, at least in relation to the wastewater project, KDC and the Council sometimes acted too informally. This informality extended beyond how people interacted with one another to also affect how KDC discharged its basic responsibilities. Our main concerns were:
- the informal approach to decision-making, with a lack of clarity about who was responsible for particular decisions, the basis on which decisions were being made, and the detail of what was being decided;
  - the use of Council workshops for considering significant information and making decisions;

- the lack of attention to compliance with internal procedural requirements, such as delegations and Council policies; and
- the poor state of KDC's records.

- 24.25 We also noted that KDC's contracts with external contractors did not include any provisions about accountability. It is common for contracts with public entities to include provisions specifying how the work of the contractors will be bound into the general public sector accountability processes, such as public access to information under the Local Government Official Information and Meetings Act 1987 and scrutiny by auditors and the Auditor-General if required. These provisions feature in the various model PPP contracts we have seen in guidance material, including the Victorian state government material that KDC and its advisers apparently drew on.
- 24.26 Overall, we saw little evidence during our work on this inquiry to suggest that KDC paid adequate attention to its obligations as a public entity to explain and account for its actions. In simple terms, we were left with the impression that too much of KDC's work was carried out through informal discussions, meetings, and agreements between the main people involved, rather than by presenting formal papers to formal meetings with formal minutes. This type of approach is dangerous.
- 24.27 There is a tendency to discount such points as bureaucratic, but we regard them as fundamental to an effective and trusted public sector. In several reports recently, we have emphasised that, in the public sector, decisions have to not only be right but also be seen to be right. The process by which decisions are made also matters, because the use of public money and power has to be clearly and properly authorised. People are entitled to information about how and why such decisions are made. We repeat a comment we made in our report on the Citizenship inquiry: "In our experience, accusations of wrongdoing flourish when there is a lack of information about what actually happened."<sup>1</sup>
- 24.28 Good records are the foundation for any accountability process. Records need to be able to explain what happened and why, and can also protect an organisation by providing evidence to rebut unfounded allegations of improper action.
- 24.29 This point is reflected in the purpose of the Public Records Act 2005, which is "to enable the Government to be held accountable by ... ensuring that full and accurate records of the affairs of central and local government are created and maintained".

1 Auditor-General's overview (March 2013), *Inquiry into decision by Hon Shane Jones to grant citizenship to Mr Yang Liu*, page 10.

24.30 The Public Records Act includes the following obligation:

**17 Requirement to create and maintain records**

- (1) *Every public office and local authority must create and maintain full and accurate records of its affairs, in accordance with normal, prudent business practice, including the records of any matter that is contracted out to an independent contractor.*
- (2) *Every public office must maintain in an accessible form, so as to be able to be used for subsequent reference, all public records that are in its control, until their disposal is authorised by or under this Act or required by or under another Act.*
- (3) *Every local authority must maintain in an accessible form, so as to be able to be used for subsequent reference, all protected records that are in its control, until their disposal is authorised by or under this Act.*

24.31 This is not substantially different to the obligation underlying the previous Archives Act 1957 or the general requirements of good administration. We draw specific attention to the obligations to keep records of work that is contracted out and for all records to be accessible for subsequent reference. In our view, KDC's records fell well short of this standard.

24.32 In our view, accountability, including attention to legality, procedural requirements, and record-keeping, should be at the heart of a public entity's systems and operations.

## The consequences for the entity and the community

24.33 Although the wastewater project has provided Mangawhai with a reticulated sewerage system, the achievement of this goal has been accompanied by big financial, political, personal, and social costs. Effectively, much of the community in Mangawhai, and some of the broader Kaipara region, has lost trust in the Council. It is hard to remedy this kind of reputational damage.

24.34 In another inquiry report, we said:

*There is a great deal of writing on the importance of voluntary compliance in regulatory systems. In any regulatory context, it is too hard to achieve high levels of compliance through force or coercion – effective systems depend on people choosing to participate and follow the rules. For people to want to comply, they have to trust the system and see it as providing an overall benefit. The evidence this inquiry gathered showed that many ... do not have this view ... at present... In our view, the [entity] needs to maintain a clear overall focus on the need to build and maintain trust in the [entity]. To build trust, it needs to behave fairly*

*and reasonably at all times, and make sure that this is apparent to all those interacting with it. It needs to build the values of openness, accountability, integrity, and fairness into all aspects of its work. It is important that the people the [entity] regulates, and who fund its work, are able to see and understand what it is doing and why.<sup>2</sup>*

- 24.35 Those words apply equally to the relationship between this Council and the community it serves. Parliament has given the Council substantial powers and responsibilities – to regulate, govern, tax, and enforce. Its ability to operate effectively depends on the community’s voluntary compliance with its requirements, which in turn depends on trust. The basic social contract of government breaks down when that trust disappears, as the Mangawhai rates strike has made apparent.
- 24.36 We encounter this situation, when a public entity appears to act without proper regard to its own legal obligations, from time to time in our work in the public sector. Many of the people we met in Mangawhai basically told us that they would be happy to meet their legal obligations to pay rates again – once it was clear that the Council understood that it had to obey the law when it imposed those obligations on them. We emphasise to public entities that there can be significant consequences when they fail to take their legal responsibilities seriously enough.

## Accountability of elected members under section 44 of the Local Government Act 2002

- 24.37 During this inquiry, many people identified the possible relevance of the powers in the Local Government Act 2002 that enable individual councillors to become personally financially responsible for council losses. Counsel for the MRRA specifically wrote to us to ask us to consider whether these powers should be invoked.

### What is the surcharge power under the Act?

- 24.38 The relevant provisions are sections 44 to 46 of the Local Government Act 2002. These provisions are often referred to as “the surcharge power”, and versions of this power have been included in local government legislation for many years. The power has been exercised, but only rarely. Effectively, it is a mechanism for making individual elected members liable for losses suffered by the local authority if those losses result from unlawful action that the elected members supported.
- 24.39 Section 44 provides that, if the Auditor-General is satisfied that a local authority has incurred a loss in terms of the definition in that section, the Auditor-General may report on that loss to the local authority, along with recommendations on

2 Auditor-General’s overview (July 2010), *Inquiry into the Plumbers, Gasfitters and Drainlayers Board*, pages 8-9.

recovering the loss and preventing further loss. Copies of that report must be sent to every elected member of the local authority and to the Minister.

- 24.40 Section 44 states that a local authority is regarded as having incurred a loss if any of the following have occurred and the local authority has not been fully compensated:
- The local authority's money has been unlawfully expended.
  - An asset of the local authority has been unlawfully sold or disposed of.
  - The local authority has unlawfully incurred a liability.
  - The local authority has intentionally or negligently failed to enforce the collection of money it is entitled to receive.
- 24.41 Section 45 then provides that the local authority has to respond in writing to the Auditor-General's report within 28 days and provide a copy to the Minister. The response must respond to each of the Auditor-General's recommendations and state what action the authority intends to take. Individual elected members may respond separately. The local authority must then present the original report and all the responses to a public meeting of the authority.
- 24.42 Section 46 states that, if the Auditor-General has made a report on a loss under section 44, then that loss is recoverable as a debt due to the Crown from each elected member of the local authority jointly and severally. In simple terms, each and every elected member of the authority becomes personally liable for that loss. The Crown can bring proceedings to recover the amount on behalf of the local authority.
- 24.43 There are defences available to the elected members under section 46. A court cannot enforce recovery from an elected member if:
- the person did not know about the action or failure leading to the loss;
  - the person knew but protested against the relevant action;
  - the person voted against the action; or
  - the person supported the action, but acted in good faith and relied on professional advice given by an apparently competent and reliable employee or adviser.

### **Our decision on use of the surcharge power in this case**

- 24.44 This surcharge power is very unusual. It effectively gives the Auditor-General a power to rule that individual elected members have been a party to an unlawful act and are personally liable for the loss that results.

- 24.45 On the rare occasions that the power has been used, the facts have been reasonably contained and straightforward. There has been little if any room for debate about the legal basis for exercising the power.
- 24.46 In this case, the facts and the legal position are far from straightforward. This report has described a long and complex saga, involving sophisticated commercial transactions, considerable professional advice, and decisions made by successive Councils over a long period of time. The legal status of some of the more significant decisions and actions is at present before the High Court.
- 24.47 For the Auditor-General to be able to exercise this power, we would need to be certain that:
- KDC's losses could be attributed to a particular action or series of actions;
  - the particular action or actions were unlawful;
  - individual councillors effectively supported one or more of those unlawful actions; and
  - it was not reasonable for individual councillors to rely on the advice they received.
- 24.48 These requirements set a high factual and legal threshold. We do not consider that this case meets that threshold for the following reasons:
- We cannot confidently attribute KDC's eventual debt (or losses in terms of the Act) to particular actions by the Council. This report describes a long history of cumulative problems and poor decision-making. However, section 44 envisages a reasonably direct relationship between an individual decision and a specific loss.
  - We cannot say with certainty which of the many decisions and actions involved in planning the wastewater project, agreeing to the various contracts, and authorising payments were "unlawful" for the purposes of section 44, if any. These are complex legal questions, and many of them are currently before the High Court in the judicial review proceedings brought by the MRRA. It would not be appropriate for the Auditor-General to pre-empt a ruling by the Court.
  - We have not attempted to identify exactly which individual elected members supported or opposed which decisions during the project. We doubt that it would be possible to establish these facts with any certainty, given the state of the records.
  - As this report makes clear, it has not been possible to establish exactly what advice the elected members received from KDC staff or from external advisers for most important decisions during the wastewater project. This means that it would be very difficult to establish whether it was reasonable for elected



members to rely on the advice they received. From the information that is available and described in this report, it is likely that a defence under section 46 would be available to many elected members in relation to some or all of the decisions they participated in.

- 24.49 Therefore, we do not intend to exercise the discretion in section 44 and make a report to KDC in this case. In our view, this statutory power is suited to relatively contained and simple situations, where there is good evidence available to demonstrate that the threshold for the exercise of the power has been met. In our view, it would not be appropriate to exercise the power in this case, where the facts and legal issues are very complex, are already before the Court, and defences are likely to be available.



## Part 25

# What can we learn from the wastewater project?

25.1 From our perspective, there were two main reasons for investing so much time and resource into this inquiry. The first was to provide the community and others with an independent description of what happened. The second was to draw out any lessons that can be learned for the sector as a whole. In this Part, we distil those more general lessons in the following areas:

- accountability;
- governance;
- management;
- PPP arrangements;
- lessons for auditors;
- lessons for accountability agencies; and
- how members of the public can raise concerns effectively.

## Accountability

### Public entities should be meticulous about legality

- 25.2 The obligation to act lawfully is fundamental for any public entity. As we discussed in Part 24, a significant failure to comply with the law can have a profound effect on the level of trust between the entity and the community it serves.
- 25.3 Local authorities have many legal obligations, arising from a wide range of legislation as well as general common law obligations. For the most part, the forum for testing whether an entity has complied with the law and for holding it to account for its actions is the legal system and the courts.
- 25.4 As we explained in Section D, all auditors consider some issues of legal compliance as part of their annual audit work, to assess whether there is any obvious legal problem that could affect the reliability of the financial statements. In the public sector, we broaden that consideration to take account of the public sector context. In general terms, this means that we consider generally whether an entity is complying with the core legal requirements affecting how it governs itself, operates, and holds itself accountable.
- 25.5 For the local government sector, the Local Government Act 2002 and the Local Government (Rating) Act 2002 are the obvious touchstones. The Local Government Act 2002 governs how a local authority sets its strategy and plans, operates, makes decisions, interacts with the community, and reports. The Local Government (Rating) Act 2002 sets strict requirements for how local authorities can require ratepayers to pay rates of various kinds.

- 25.6 It is obvious that KDC failed to pay adequate attention to legal matters during this project. The fact that Parliament is currently considering a substantial Validation Bill is enough evidence of that. Throughout this report, we have also noted inadequacies in the attention that KDC paid to legal issues when the project got under way, as well as problems with the ad hoc way it sought legal advice.
- 25.7 The lesson for the local government sector – and for all public entities – is that managing legal risk is vital. We acknowledge that perfection is unattainable in this or any other area of activity. Legal errors can and do occur. However, entities should strive to ensure that such errors are infrequent, are not particularly significant (in terms of risk or harm), and are addressed promptly. In principle, a commitment to legality should be at the heart of the culture of any public entity.
- 25.8 Legislative obligations affect all aspects of a local authority's work: how it operates, how it consults, how it runs meetings and makes decisions, and also what it actually does. At a subsidiary level, internal rules, such as policies and delegations of authority, can also affect the lawfulness of individual decisions and actions.
- 25.9 In our view, a public entity should see being meticulous about legality as a strength, not as nit-picking. The governors of the organisation can and should set that tone.

### **Good record-keeping is the foundation of effective accountability**

- 25.10 Throughout this report, we have made it clear that we consider KDC's records to be inadequate. It did not keep records that would enable it to explain what it had done, and why, for many important decisions. We were particularly concerned with the poor records of what information was provided to Council meetings. One of the principles in the Local Government Act 2002 is that the local authority should ensure that its governance structures and processes are effective, open, and transparent. We doubt that the Council's past practices met this standard.
- 25.11 Good records can help public entities when they are challenged. Without good records, it is very hard for a public entity to show that it has acted carefully, followed good processes, and made decisions for good reasons. Given that public entities can and will be regularly challenged to explain themselves, whether in the media, in the courts, or through some other accountability process, keeping good records should be seen as basic risk management.
- 25.12 As we discuss elsewhere, keeping good records is also a core legal obligation for all central and local government entities covered by the Public Records Act 2005.

### **Workshops can supplement formal Council meetings, but not replace them**

- 25.13 We highlight one particular practice that we regard as undesirable. The Council's elected members received most of their briefings on the wastewater project through informal workshops, held just before formal Council meetings. Although this might be a sensible way of enabling open discussion with those providing the briefing, it cannot be a substitute for submitting formal monitoring reports to Council meetings that go on the record.
- 25.14 As we understand it, most of the briefings were supported by presentations. Elected members were not usually provided with either papers in advance or papers that they could take away and consider later. The workshop briefings did not make it into KDC's files, so there is no formal record of the information that was provided. Decisions were often recorded in the minutes that were hard to understand without seeing the supporting papers or information. One former councillor gave us all of the papers she had accumulated while in office, and we searched through those to see if we could find the information presented in workshops. We could not.
- 25.15 We repeat: workshop discussions and briefings can be a useful way of providing information and enabling discussion. However, they must be in addition to formal reports that form part of the public record, not instead of them. Councils cannot make decisions in workshops; they must be made in formal meetings.

### **Contractors need to be tied into public sector accountability mechanisms**

- 25.16 When a public entity uses contractors to carry out work for it, it must make sure that those contractors are properly bound in to the entity's accountability obligations. We note that the Public Records Act 2005 requires public entities to keep records of the work that contractors have done for them. Both the Official Information Act 1982 and the Local Government Official Information and Meetings Act 1987 also include provisions dealing with the ability of people to access information held by a contractor to a public entity. Similarly, the statutory powers in the Public Audit Act 2001 enable us to require information from "any person" in New Zealand – not just public entities – so that we can follow public money through to contractors and others working alongside public sector entities.
- 25.17 When we reviewed the contracts that the Council made with its various providers, we did not find any provisions that tied those contractors into these various accountability mechanisms. In our view, that should be standard practice for public sector entities. It is particularly important when contractors carry out major projects or activities for a public entity.

- 25.18 We note that the model standard contract published by the Treasury's National Infrastructure Unit includes specific and detailed provisions on record-keeping, access to information, and compliance with public sector accountability obligations. We commend this approach.
- 25.19 We have been told that there can be problems when consultants are used, because they sometimes refuse to provide papers on the basis that they need to protect their intellectual property. This can result in the entity not holding important technical information in its files and needing to re-hire the consultants to access that information. This is obviously an unacceptable outcome. We encourage public entities to focus on information issues when they negotiate the terms of engagement for any contractor. Public entities need to strike a deliberate and appropriate balance between protecting the intellectual property of consultants and ensuring that the entity has ongoing access to the information it needs to function effectively and to meet its accountability obligations.

## Governance

### Understand the role and stick to it

- 25.20 Councillors, as with members of the governing body of any public entity, need to clearly understand their role and that of management. The governance role is about maintaining the broad view. It is about setting direction and policy, making significant decisions, testing advice to ensure that it is sound, monitoring the activities of management to ensure that what is being implemented will achieve the objectives, keeping an eye on risks of all kinds, and safeguarding the overall quality of the relationship between a council and its community. When members of a governing body become too involved in operational matters, the risk is that nobody maintains the broad view for the organisation and checks that the overall direction is still appropriate.
- 25.21 In this case, we consider that the governance and management of KDC were too focused on solving the problem of the day, whether that was the need for a new contractor or a disposal site. The result was that there was no effective "keeper of the long view". The project was set up so that elected members were informed about some day-to-day issues through periodic briefings directly from the project managers. However, no structure was established to provide the Council with strategic advice that focused on the overall objectives and risks.
- 25.22 We acknowledge that sticking to this high-level role can be difficult in small local authorities, where many of the community's problems are immediate and practical. Ratepayers expect to be able to approach their local councillor to get those problems fixed. That representational role and connection with the

community is part of the role of an elected member, but so is the responsibility for steering and governing a substantial organisation with complex responsibilities.

### **A governing body is entitled to information and advice that it can understand and test**

- 25.23 Throughout this report, we have commented on the difficulties we had in establishing exactly what information and advice was provided to elected members. Although it is clear that elected members received regular briefings on the project, this was generally done through informal workshops with little information on paper.
- 25.24 In our view, a project of this financial and political significance should be accompanied by much more systematic and comprehensive reporting to the elected members on progress, cost, and risks. This should not be taken as contradicting the previous point, about elected members sticking to the governance role. Effective discharge of the overall governance role requires good information about what is happening.
- 25.25 We have noted several instances when a Council meeting asked the Chief Executive to provide the Council with advice about an issue or an aspect of risk and we could find no record that the advice was provided. In each case, the request was a wise one and it was unfortunate that the Council did not follow up the request and insist that the advice be provided.
- 25.26 The role of a governing body is to test and challenge the advice it is given to satisfy itself that the proposed decisions are appropriate. Part of the function of an elected member is to bring a community perspective to the local authority. This is the democratic oversight and steering of the organisation. If the information provided is overly technical, is incomplete, or simply cannot be easily understood, elected members are entitled to question it and ask for more. It is better for a member to “ask the dumb question” and ensure that they understand what they are deciding than to assume that the technical advice must be appropriate.

### **Common sense is a legitimate governance tool**

- 25.27 In a similar vein, members of any governing body should not hesitate to use their own common sense to check the advice they receive and the decisions they are asked to make. It is not unknown for expert analysis of a complex problem to produce a complex solution. Sometimes, standing back and applying common sense can produce a much simpler solution.

- 25.28 In KDC's case, standing back and applying common sense might have resulted in some different decisions. Examples include proceeding to sign a contract for construction without identifying a disposal site, agreeing to a disposal site that required treated effluent to be piped some 11 kilometres across private land, treating effluent to a high standard before storing it in an open dam for many months so that the quality degrades again, and expecting that there would be a market for reuse of the treated effluent in a region that is not particularly dry.

### Understand what assurance is needed and where it can be obtained

- 25.29 Organisations face all sorts of risks. The governing body has to maintain an overview of those risks and have systems or advice streams in place to assure itself that those risks are being appropriately managed. Many organisations establish a dedicated audit committee to help with this task.
- 25.30 When individuals are elected to a local authority, they need to familiarise themselves with the main areas of risk, how those risks are being managed, and how they can get assurance on them. This inquiry has highlighted a particular risk that elected members might not fully appreciate what assurance they can take from the work of their auditor and from an unqualified audit opinion. In our experience, it is common for people to misunderstand the purpose of an audit and to assume that it provides more general assurance about the health of an organisation than it does. We discuss this issue further in Part 26, because we see it as a permanent risk in the local government sector. However, we also record it here as an important lesson for members of governing bodies.

### Audit committees can provide useful support

- 25.31 An audit committee can help a local authority carry out its governance duties. The Foreword to our 2008 guide, *Audit committees in the public sector*, commented that:
- Audit committees have a valuable contribution to make in improving the governance, and so the performance and accountability, of public entities. They can play an important role in examining an organisation's policies, processes, systems, and controls. An effective audit committee shows that an organisation is committed to a culture of openness and continuous improvement.*
- An audit committee does not displace or change proper accountability arrangements. Accountability for good governance rests with the public entity's governing body ...*
- Effective audit committees can provide objective advice and insights into the public entity's strategic and organisational risk management framework. In doing so, they can identify potential improvements to governance, risk management, and control practices.<sup>3</sup>*

3 Brady, K (26 March 2008), "Foreword", in Office of the Auditor-General, *Audit committees in the public sector*, page 2.



- 25.32 Audit committees are a particularly useful way of a governing body managing any gaps in the skills and knowledge of its own members because of the ability to appoint members for their particular expertise and experience. We encourage entities to aim for the following combination of experience in their audit committee:
- financial reporting;
  - broad governance experience;
  - familiarity with risk management disciplines;
  - understanding of internal controls and assurance frameworks;
  - a good understanding of the roles of internal and external audit; and
  - industry or sector expertise.<sup>4</sup>

## Management

### The limits to contracting out

- 25.33 This inquiry provides a clear lesson about the limits of contracting out by public entities. It is not our role to take a view on the ideological debates about the appropriateness of contracting out any particular activity or function. It is our role to take a view on whether any particular contracting arrangement enables a public entity to carry out its responsibilities effectively. In this case, we consider that KDC contracted out too much.
- 25.34 By this, we mean that KDC did not retain enough in-house capacity and capability to effectively control what was being done on its behalf. It did not maintain the capacity and capability to effectively manage and monitor the contracts that it entered into. When contracting out became a feature of public management literature in the 1990s, it was often framed in terms of the metaphor that the public entity needed to steer the boat but could contract someone else to do the rowing. Our caution is that, because the public entity remains responsible and must be able to account back to the community for what is done, the entity must be careful to ensure that it always maintains the capacity to steer.

### Financial management

- 25.35 There are two main lessons about financial management from this inquiry. The first is the importance of maintaining in-house capacity and capability in this core area that is appropriate for the size and complexity of the organisation. The second is to confine financial activity to transactions that are within an entity's sphere of competence. The Council's willingness to enter into a PPP arrangement in the first place, and then to follow up with complex swap arrangements, makes the point. We commented in the earlier Sections of this report that we would

4 Office of the Auditor-General (2008), *Audit committees in the public sector*, page 20.

discourage public entities from engaging in transactions such as swaps if they do not maintain an in-house treasury function or have some other established arrangement for access to specialist treasury advice. These are sophisticated financial transactions that require sophisticated assessment and advice. Entering into these transactions without that advice proved to be expensive for KDC.

- 25.36 We also highlight several other more specific lessons:
- For a long-term infrastructure project, careful long-term planning and forecasting is essential. That forecasting should allow for different scenarios, including low- and high-growth projections. It needs to be revisited regularly to check whether any decisions need to be reviewed.
  - It is important to choose the right indicators for monitoring how a project is going, including its affordability. In this case, the Council monitored affordability by considering whether the annual cost to ratepayers changed significantly. Using that indicator masked the size of the debt that was accumulating.
  - Financing costs can be a significant part of the cost of a long-term project. It is just as important to check whether the offered financing arrangements provide value for money as it is for ordinary contracts for goods and services. That was not done in this case.

### Project management

- 25.37 In the earlier Sections of this report, we have made clear our view that, when the Council first set up the project, it did not properly consider how the project should be managed and monitored. Appointing external project managers was not enough. The scope of their services was limited. The Council needed to make its own arrangements for considering and responding to broader risks, outside the scope of the project managers' work. By default, the Chief Executive became personally responsible for the project, supported by the external project managers. However, there were no clear boundaries around what decisions he would make, what decisions the project managers would make, and what needed to be decided by the Council.
- 25.38 The lesson for the sector is that project governance and management is important. If a project is significant, it is appropriate to invest in appropriate support, advice, and assurance systems for it. Cutting back on these set-up and overhead costs can be a false economy.
- 25.39 Circumstances changed significantly at several points during this project. A good project governance model can ensure that such changes are taken as an opportunity to stand back and assess whether it is sensible to continue. It is a

hard decision, but sometimes it can be appropriate to put a project on hold, or even stop it altogether, if the circumstances have changed significantly or critical assumptions have not held up. We did not see this happening with this project. When such changes occurred, how to respond was considered but not whether to continue at all. Those responsible for major public sector projects must always maintain enough overview and distance to be willing to end the project if required.

## Public private partnership arrangements

### Do not underestimate what is involved in a PPP arrangement

25.40 In our view, KDC did not fully understand how complex using a PPP arrangement would be and the additional project management that this approach requires. It appears that KDC thought that using a PPP would make delivery of the project easier for it, especially because it had few internal resources to run a major infrastructure project. In fact, using a PPP arrangement is complex and requires significant technical skills beyond those required for a traditional design/construct project.

25.41 Because PPPs are complex undertakings, they require a high level of understanding of the risks involved and how best to manage them:

*PPPs are a complex undertaking, and part of a broader set of procurement strategies possible for major infrastructure. Moreover, while they have strengths and weaknesses, they may well apply to only a minority of projects, given the decision to adopt a PPP or not is governed by whether the approach achieves value to the community over the life of the asset. ...*

*In summary, PPPs can work well in the right situation. However, they are complex and generally require a very large financial transaction, due caution and high levels of expertise.<sup>5</sup>*

### Accounting should not drive the decision to enter into a PPP

25.42 The research on PPPs is clear that the accounting treatment of a PPP project should not be the main determinant in deciding to use a PPP. As we set out in the report, the Council appears to have had two main reasons for wanting to use a PPP – to have the debt off the balance sheet and to manage the risk that the scheme would not operate as intended once constructed.

25.43 With a PPP, the public entity ultimately pays for the project, whether by paying for the infrastructure on completion or by paying for the services that the project provides during the partnering arrangement. The main issue to consider in this

<sup>5</sup> Duffield, C, “Different delivery models”, in G Hodge, C Greve, A Boardman, eds (2010), *International handbook on public-private partnerships*, Edward Elgar, United Kingdom, page 213.

regard is whether the project is affordable, not whose books the infrastructure asset and associated debt will appear on:

*PPPs are said to offer finance for projects which would otherwise be unaffordable (off-balance sheet financing): PPPs that are financed by service payments from government create a liability to make regular payments over the life of the project. ... The provision of private sector finance is therefore only an advantage in so far as it strengthens the incentives to obtain the benefits [of using a PPP].<sup>6</sup>*

- 25.44 Before the Council decided to use a PPP, it was clear that it had limited financial capacity to construct the scheme itself without significantly raising its debt and its revenue. There is no evidence that the Council fully explored the options it had to fund the scheme before deciding to use a PPP.
- 25.45 As we set out above, PPPs are complex undertakings and research shows they do not automatically provide value for money. They will only be a cost-effective way of delivering infrastructure if they are well managed. If an entity cannot afford to construct infrastructure itself, and chooses a PPP to deliver that infrastructure, then it needs to be strongly focused on whether the project will be affordable.

### Transfer of risk is not an end in itself

- 25.46 PPPs can offer a number of advantages in terms of providing value for money over traditional procurement. For example, a PPP can result in savings over the whole life of the project and greater certainty about the cost of construction. However, these benefits are likely to arise only when risks have been appropriately allocated between the public entity and the private partner. This is because the careful allocation of risks creates incentives to achieve the overall benefits sought.
- 25.47 Shifting as much risk as possible to the private sector partner was one of the Council's main objectives, alongside affordability. However, experience has shown that the transfer of risk should not be seen as an end in itself:

*PPPs are said to offer the advantage that risk is transferred to the private sector. Risk transfer is not an advantage in itself, as it can be expected to be offset by a risk premium in the price for the project. The advantage of risk transfer is that it provides the incentive for obtaining the benefits....<sup>7</sup>*

6 National Infrastructure Unit of the Treasury (October 2009), *Guidance for PPPs in New Zealand*.

7 National Infrastructure Unit of the Treasury (October 2009), *Guidance for PPPs in New Zealand*.

### **PPPs are unlikely to succeed fully if the contract is not for “the complete package”**

- 25.48 One of the advantages of using a BOOT<sup>8</sup> type of PPP is that the public entity does not need to be concerned about the detail of how the private partner will provide a solution to its problem. The public entity buys services from the private partner to address the problem.
- 25.49 Under a BOOT approach, the private partner is required to provide a complete solution to the problem. Unless the complete solution has been provided, the Council is unable to assess what the overall costs of the solution will be and whether it will provide value for money.
- 25.50 Under the BOOT approach that the Council started the project with, it went to the market seeking an affordable solution to the wastewater problem in Mangawhai. It did not put any restrictions around disposal of the treated effluent, other than noting the preference of stakeholders that it be disposed of to land. With the BOOT approach, the Council did not need to be concerned about how the outcome – the cleaning up of the Harbour – was to be achieved. The private sector partner needed to work out how that outcome could be achieved and provide an appropriate solution for it.
- 25.51 None of the three tenderers provided disposal sites that were acceptable to the Council. Therefore, none of them provided complete solutions to the Council’s problem. This should have caused the Council to either tender again or consider whether it needed another project delivery model.
- 25.52 Therefore, the main advantage of using a PPP was undermined when the Council signed the contract in 2005 that left the disposal site unresolved. In effect, it signed a contract for a two-thirds solution to its problem. The Council failed to appreciate that, in signing the contract in 2005 with the disposal site unresolved, it had no way of knowing whether the contract was going to be affordable or whether it would provide value for money. The Council also effectively committed itself to being involved in the practical development of the overall solution. It had lost some of the “hands off” advantage of a PPP. This was exacerbated by the many modifications KDC made during construction.
- 25.53 There is no evidence to suggest that the Council understood quite how big the risk was that costs would increase significantly. As we set out in this report, we estimate that the disposal costs were \$14 million, a significant increase on the \$361,000 included in the 2005 contract for disposal costs.
- 25.54 The lesson here is that considerable effort is needed to prepare and develop the contract for a PPP. Once the contract is signed, the public entity should be able

to rely on the contract to deliver the outcomes it seeks. If the contract is not complete, that will not be possible and further engagement will be needed.

## Lessons for public sector auditors

### Understand the entity as a whole

- 25.55 In the private sector, the formal work of an auditor is focused on the information presented in the financial statements. Public sector auditors have additional responsibilities:
- Auditors must audit information that the entity reports on its performance in providing services, as well as the financial information.
  - Local government auditors must audit LTPs, which require an overall understanding of the entity's position, challenges, and strategy;
  - Auditors must maintain a broader awareness of more general issues that may be of interest to the Auditor-General. Auditors are expected to act as the Auditor-General's "eyes and ears" and alert the OAG to anything they encounter that might raise more general questions about whether a public entity is operating appropriately.
- 25.56 Therefore, the Auditor-General expects public sector auditors to look beyond the financial statements and maintain a broad understanding of the entity as a whole. They also need to consider trends and developments in the entity across successive years. In any sector, auditors are able to add more value to the entity when they are able to comment on emerging challenges and risks from this more general perspective.

### Assessing the strength of the management control environment is fundamental

- 25.57 The independent review of the work of the auditor identified concerns about the quality of the assessment of the management control environment. All auditors must assess the strength of the management control environment in the entity they are auditing. What this means, in simple terms, is that auditors look at the overall policies and procedures, and the main supporting systems, operating within the organisation. Auditors then need to decide whether the management control environment is likely to produce reliable information for the entity. If auditors consider that it is reliable, then they will test key controls to confirm the reliability of the supporting systems. If a system is weak, the auditor will need to use different techniques to form an opinion on whether the information being produced is reliable. The weaker the system, the more "substantive testing" an auditor will need to do.

- 25.58 This assessment is a basic part of how an auditor plans and carries out an audit. However, it can also provide very useful information for the governors and managers of the entity about how good their systems and controls are. Effectively, it is a perspective on whether the organisation is being well run. A weak management control environment and weak systems could signal a whole range of more general risks.
- 25.59 In the public sector context, this annual assessment of whether the entity is well run can be extremely valuable if it is done well. We encourage public sector auditors to take a broad view of this part of their work. We also encourage them to bear in mind their more general “eyes and ears” role when they assess the strengths and weaknesses of the public entities they are auditing. Although not determinative, this perspective from an auditor can be a useful indicator of risk that the OAG can contribute to the pool of information held by accountability agencies.
- 25.60 We note one other point in this regard. Smaller and apparently stable organisations are often assessed as low risk. The reasoning is that little changes each year, the public entity’s staff have been doing their jobs for many years, and the community’s issues are well known. This is a relatively shallow assessment of risk. It is equally common for stable organisations to have significant risks or failings that have been embedded in the organisation for many years and have simply not yet come to light. We expect public sector auditors to look more deeply at what each organisation is actually doing when they assess the strengths and capability of its governance, management, systems, and procedures.

### **Good and open communication between auditor and entity is vital**

- 25.61 Throughout this report, we have drawn attention to the lack of good information flows through KDC, both in terms of the information provided to the Council and the information that was stored in files. The quality of information within an organisation also affects the work of auditors.
- 25.62 Auditors have a professional obligation to keep confidential the information they receive from their clients. This obligation is important because an effective audit relationship depends on free and frank communication between the auditor and the entity.
- 25.63 Entities do not always realise that, if they limit the information they disclose, their auditor’s work is unlikely to be as effective and provide as much value as it could. When the relationship with an auditor is fully open, and the auditor understands the entity well, the independent perspective and comment of the auditor can provide significant value back to the entity. This value is in addition to the general benefit of being able to receive the assurance that an audit provides about the financial and service performance information reported by the entity.

- 25.64 Auditors need to work to ensure that the entities they work with understand how important it is to maintain good and open communication, so that they can obtain maximum value from their auditor.

## Lessons for accountability agencies

### The agencies need to talk to one another

- 25.65 We have discussed with the Office of the Ombudsman what we can each learn from our experience with KDC. Both organisations continue to reflect, but we have also each acknowledged:
- the value that can be gained from pooling our knowledge when we assess the issues correspondents raise with us; and
  - the need to have a clear understanding of the work that we are each doing when we receive correspondence on related issues and when we refer matters to one another.

### It is important to keep an eye on the bigger picture

- 25.66 From the OAG's perspective, we have also acknowledged the risks that arise when we focus too much on the individual detailed issues that are raised with us and do not pause to assess the bigger picture and the cumulative effect of the information we are gathering. In simple terms, we need to remember to "join the dots" – within our own organisation and with our colleagues in other parts of the public sector.

### Do not assume that people are familiar with an agency's role and how it works

- 25.67 The other lesson we take from the review set out in Part 23 is the need to communicate clearly with the people who contact us. The settings that we and other agencies work under, and the niceties of what we can and cannot do, are not matters of everyday public knowledge. In all our work, we must try to communicate clearly what we are doing and why, as well as what we are not doing.
- 25.68 Particular points that warrant emphasis are that accountability agencies:
- must always form their own independent view of the issues and are not there to act as advocates for members of the public;
  - will always begin by assessing whether the information suggests that there is a real issue and that the entity is not able to resolve the issue itself; and
  - do not generally have any power to intervene or direct entities about what to do, but can simply investigate and report their findings.



## Part 26

### What needs to change?

#### What has already changed?

- 26.1 This report covers events dating back to 1996. Many things that we might have commented on as needing to change have already changed in the intervening years. As part of understanding how to prevent such problems arising again, it is worth specifically noting what has already changed.

#### Kaipara District Council

- 26.2 KDC is now quite a different organisation to the one that embarked on the wastewater project. In recent years, it has been restructured and has employed new senior management, including a new chief executive. The Minister has appointed Commissioners to replace the previous elected members. The Commissioners are “to work with the community and other stakeholders to develop and implement enduring solutions to the challenges currently facing the Council”. Commissioners are expected to hold office until October 2015. The Auditor-General has also appointed a new audit service provider to carry out the audits of the information in the Council’s annual reports and LTPs.
- 26.3 At a management level, the Council has instituted many reviews and implemented new systems.

#### Guidance on PPPs

- 26.4 When the Council first decided to embark on a PPP arrangement, there was very little experience of them in New Zealand and little local guidance available. Looking overseas, the state of Victoria in Australia had the most experience and the most developed public guidance, but even that was in its early stages.
- 26.5 Since then, many countries have tried PPP arrangements in different contexts and much has been written about when they do and do not work well. There is now a great deal of experience to draw on and accessible advice and guidance.
- 26.6 In New Zealand, the National Infrastructure Unit was established within the Treasury in 2010. One of its roles is to provide support and guidance to government agencies when they prepare PPPs. It has produced several publications on PPPs. These include some general guidance on PPPs, which covers when and how to go about establishing and managing a PPP arrangement, and a draft PPP contract with model terms. The National Infrastructure Unit’s practical support for PPP contracting is confined to central government, but its publications and advice are publicly available for any public entity to use.

## Reporting requirements for financial and service performance

- 26.7 During the last decade, there have been significant changes to financial reporting standards and practices internationally and in New Zealand. The general direction of change is not just towards more disclosure of information but also towards more disclosure of more meaningful information. These changes are continuing. The changes to standards automatically apply to most public entities, including local authorities, because the governing legislation requires them to report in accordance with generally accepted accounting practice, or GAAP.
- 26.8 The requirements within GAAP relating to accounting for PPP arrangements changed with the adoption of the New Zealand equivalents to the International Financial Reporting Standards (NZIFRS). The changes meant that, in many cases, public entities were required to recognise both the asset and the associated debt arising from the PPP on the balance sheet. Local authorities adopted NZIFRS in 2006/07. However, the changes relating to PPPs became effective in 2008/09.
- 26.9 When the wastewater project began, the statutory requirements on local authorities to prepare LTPs for the next 10 years were still new. The local government sector was learning how to best carry out such forecasting and planning, and how to present the information to communities for meaningful engagement. Ten years on, the sector has gained considerable experience, which shows in the quality of the information and documents it now produces. We also note that the legislative requirements have been refined to help focus the information provided to the community.
- 26.10 Alongside the changes in the law, standards, and practice that govern how information is prepared for the public, the standards and practice governing the auditing of that information have also developed significantly. There have been recent reforms to how auditing standards are set and how the auditing profession is regulated. More are being debated.
- 26.11 One imminent change that is likely to be relevant to public sector audits is a proposed change to the standards governing the form and content of audit reports. The standards tightly prescribe the form and content of these documents, which accompany an entity's annual report. The proposed changes would require auditors to include a description of the main matters that had arisen during the audit, rather than just the auditor's overall conclusion.

## Intervention powers

- 26.12 Another recent change occurred in 2012, with the enactment of a significant set of amendments to the Local Government Act 2002. Those amendments made significant changes to the Minister's powers to intervene in local authorities. Previously, the powers had been reasonably blunt. If a local authority was in difficulty, the Minister's main power was to replace the elected members with appointed Commissioners. The process and grounds for doing so were constrained.
- 26.13 The Act now contains a more graduated set of powers that enable a response that is more tailored to the nature and scale of the problems. The Minister's options include requiring information; appointing a Crown Review Team, Crown Observer, or Crown Manager; replacing the Council with a Commission; or calling a fresh election.

## Permanent risks that need to be managed

### Capacity and capability in public entities

- 26.14 In a small country such as New Zealand, maintaining capacity and capability is a challenge for many organisations in both the public and private sectors. The challenge is arguably greater in the public sector. For example, it can be difficult for public entities to pay the market rate for scarce specialist expertise or to keep enough specialists in one location to make a particular function viable. Local authorities operating in remote and rural settings can have particular problems in attracting and keeping specialist staff. There are also limits to what entities with limited funding bases can afford in terms of the number of staff and their skill level. Public sector accountability disciplines and risks can also reduce the pool of people willing to take on governance or senior management roles.
- 26.15 There are no easy answers to this risk. It is simply something that all New Zealand organisations have to find ways to manage. Common strategies include collaborating with other entities to create critical mass or pool scarce resources, contracting out of some functions (with appropriate oversight and safeguards), and realistic appreciation of what is and is not possible for an organisation of that size and sophistication. For example, the obvious question from this report is whether it is sensible for small organisations with limited internal resources to contemplate sophisticated commercial arrangements such as PPPs.
- 26.16 We also suggest that good long-term forecasting and planning can help. If an entity has good quality information about its current and future role and responsibilities, the assets it holds, its current capability, and the assets and

capability it will need in the future, then it is well positioned for an open discussion with its community about the funding that will be needed. In the local authority context, the direction of recent and proposed reforms is towards improving the quality of this type of information. Better information of this kind should enable a better discussion with the ratepaying community about any choices or trade-offs that need to be made.

### **The community response when councils make controversial decisions**

- 26.17 Sometimes public entities must make decisions that are controversial. Decisions to invest significant sums in major infrastructure, whether a sports stadium or a sewerage system, will often attract strong supporters and opponents. Emotions can run high, and opponents will often seek a range of ways to attack what is being done.
- 26.18 When a local authority knows that a project will be controversial, it can do some things to encourage public debate to remain focused on the real issues. It needs to recognise from the outset that every aspect of such a project will be scrutinised closely. As a result, the entity needs to take care to ensure that its work on the project is of a high quality and that it can demonstrate this. For example, the entity can work to ensure that it:
- has good quality information and analysis on which to base decisions;
  - follows all legal and administrative requirements carefully;
  - maintains good records that are easily accessible when information is requested; and
  - takes a broad view when it identifies and manages risks associated with the project.
- 26.19 Obviously, a public entity cannot and should not neutralise public debate. The better approach is to welcome scrutiny and debate. Local authorities can prepare for that scrutiny and debate by ensuring that good quality, factual information is regularly and easily available to anyone who is interested. Local authorities should also be prepared to explain and account for the actions that they are taking. These types of steps can help focus debate on the substantive issues and minimise the risk of attacks on the entity's management or integrity.

### **Misunderstanding the assurance provided by an audit**

- 26.20 Even when there are no concerns about the quality of the audit work performed, it is common for there to be an "expectation gap". This describes the gulf between the popular impression of what an audit involves and the level of assurance that an audit actually provides. In the local government sector, there are regular

illustrations of this gap when entities with an unqualified audit opinion are described as having “got the big tick” or similar. The suggestion is that an unqualified audit opinion means that everything in the organisation has been checked and is fine.

- 26.21 In fact, an annual audit has a much narrower and more technical focus. The basic task of an auditor is to give an opinion on whether the financial statements that the entity has produced are reasonably reliable. In the public sector, that task is broadened to cover information about the entity’s service performance as well as the information in the financial statements. All of the work of an auditor is directed towards being able to give this opinion. Auditors do not check everything in an organisation. They check the systems and processes that help produce the information that is subject to audit and check samples of transactions within those systems. The work is also based on the concept of “materiality”. An auditor does not need to be concerned with transactions or areas of business that are too small to have a material effect on the information being audited.
- 26.22 Auditors report on their work to the governing body of the organisation and to the public in the audit report that accompanies the entity’s annual report.
- 26.23 In the commercial world, the role of the auditor is well understood because people pay careful attention to any comments from an auditor when they make investment decisions. Company directors usually have a good understanding of the role of the auditor and the matters that auditors consider and provide assurance on.
- 26.24 In the public sector, understanding is often much more limited. There is a popular misconception that auditors check every aspect of how an organisation works and have checked that every transaction has been properly entered into and recorded. Auditors cannot and do not do this. Although every audit report and the supporting correspondence and contractual documents spell out what an audit involves and the limits of an audit opinion, there remains a risk that the governors and managers of a public entity do not have a good understanding of the audit function. The risk is that the entity places too much reliance on the work of an auditor and does not take adequate steps to manage its own risks.
- 26.25 From the perspective of those governing or working in public entities, it is important that they take the time to ensure that they understand what comfort, or assurance, they can take from the work of the entity’s auditor. Public sector auditors also need to keep working with the entities they audit to ensure that the entities understand what an audit involves.

### **The responsible entity needs to have an opportunity to solve its own problems first**

- 26.26 We have already noted that accountability agencies will generally not investigate a matter if the correspondent has not raised it with the responsible entity. This deference is not simply a way of ensuring that resources are used efficiently; it is also constitutionally appropriate.
- 26.27 The entity is responsible for carrying out its functions and for addressing any problems in the way it delivers services. Many entities that provide services directly to the public maintain their own internal complaints functions, to make it easy for people to raise concerns so that mistakes can be corrected quickly and easily.
- 26.28 Agencies such as the OAG and the Office of the Ombudsman generally see themselves as avenues that are available when ordinary complaints and corrections mechanisms have not been able to resolve the problem. For such agencies, the first stage is always to assess whether there is likely to be an issue of substance and whether the responsible entity has or will fix the problem itself. This initial assessment does not usually involve fully investigating the detail and merits of an issue. Rather, it involves assessing, from the limited information initially available, whether the matter appears to be being dealt with appropriately. These agencies will fully consider the substance of an issue only if it becomes clear that the matter is unlikely to resolve itself and the agency decides that substantive involvement is warranted.
- 26.29 The risk that requires constant management is that members of the public who are unhappy with a public entity will be impatient with this approach. Not surprisingly, they will often hope that the accountability agency will function as a superior authority that will intervene immediately to “put the matter right”. As we have explained, there is no agency in the local government sector that sits above local authorities with capacity to intervene in their work and apply discipline when it may be warranted. The roles of the public sector accountability agencies are specific and limited. The ultimate discipline on local authorities is the electoral process and the power wielded by the electorate.
- 26.30 This is a matter that requires constant and careful explanation if accountability agencies are to avoid being seen as frustrating or ineffective.

## Challenges that need further thought

### Do current public sector structures and allocation of responsibilities support effective development and maintenance of infrastructure?

- 26.31 This report has highlighted two obvious challenges for local authorities that are responsible for building, maintaining, and renewing much of the infrastructure that our communities need. Those challenges are:
- capability, because infrastructure projects are often technical, large, and complex; and
  - affordability, because good quality infrastructure can cost a lot and small local authorities have limited ability to raise funds.
- 26.32 Under the current distribution of responsibilities between central government, regional authorities, and territorial local authorities, it is often central and regional agencies that drive the need for infrastructure. They do so when they set regulatory standards – for example, for the quality of drinking water or for acceptable levels of discharge to the environment. Local authorities must then build and maintain infrastructure assets to meet those standards. The risk is that the standards set by one part of government cannot be delivered by another.
- 26.33 In terms of capability, the question is how to give local authorities access to more support, advice, and appropriately skilled expertise. Options include strengthening the support available from sectoral groups such as Local Government New Zealand and the Society of Local Government Managers, promoting collaboration between authorities, and structural reform through the reorganisation and merger of existing authorities. No doubt there are other solutions too. These are matters of current debate within the public sector.
- 26.34 In relation to affordability, the question is how to ensure that the funding tools available to local authorities are able to generate income that matches the scale and cost of their responsibilities. There have been periodic reviews of the funding tools available to local authorities in the form of rates and charges. These questions continue to be challenging and warrant ongoing consideration. These are policy questions, and they are not new. It is not the role of the Auditor-General to attempt to solve them. However, this inquiry highlights that these challenges for local authorities are real and that the consequences can be very significant when local authorities do not carry out their responsibilities well. We encourage the sector and the Government to continue to discuss them.

### Does New Zealand need more effective remedies for holding local authorities to account?

- 26.35 During the last few years, we have been acutely conscious of the frustration felt by those in Mangawhai who tried to attract some attention to their concerns about the Council. Those concerns evolved and grew as those individuals learned more, but it took some time before the wider system acknowledged and responded to the emerging problems. In Section D, we reflected on whether there was more that we or other accountability agencies could have done in response to the correspondence we received.
- 26.36 This issue is not confined to Mangawhai and KDC. We are aware that it is often difficult to find the right forum for exploring concerns about the conduct of local authorities. We regularly receive correspondence expressing concern or looking for assistance about matters that we have no ability to consider. There is often no obvious other agency to refer the correspondent to.
- 26.37 In Section D, we briefly described the different accountability arrangements that operate in the local government sector. The question that we are left with, at the end of this inquiry, is whether those existing avenues are adequate. Is there an accountability gap?
- 26.38 In particular, we note the difficulty that ratepayers have faced in raising their concerns about the legality of KDC's actions. In formal terms, the proper answer is that it is the role of the High Court to rule on whether public entities are acting lawfully. However, in practice, it is rare for a community to have the willpower or resources to bring proceedings in the High Court against its local authority. We encounter this issue regularly, across the full range of public sector entities.
- 26.39 Many correspondents are looking for a more accessible way of obtaining an independent view on whether a public entity is acting lawfully. However, it is not a natural or obvious role for the OAG or the Office of the Ombudsman. Although both offices will look into legal questions in appropriate cases, it has to be a matter that is within their legal mandate and area of expertise. Neither agency provides a general forum for looking at questions of legal compliance.
- 26.40 Two recent reforms might provide new avenues for investigating issues of this kind. They are the recent changes to the Minister's powers to review and intervene in the work of local authorities and the creation of new inquiry mechanisms under the Inquiries Act 2013.



- 26.41 Again, these are not matters that we can or should attempt to solve on our own. They raise policy questions about the accountability system that central and local government might wish to consider. For current purposes, we simply draw attention to these questions and suggest that the matters might warrant consideration and debate.



# Appendix 1

## Terms of reference for our inquiry

### 16 March 2012

The Auditor-General, Lyn Provost, has decided to carry out an inquiry into the Kaipara District Council's management of the Mangawhai community wastewater scheme. This document sets out the terms of reference for the inquiry.

### Background

The construction of the Mangawhai community wastewater scheme has been a significant project for the Kaipara District Council since 1998.

Local ratepayers and the Council have raised concerns about various aspects of the scheme, including the Council's financial management and planning for the scheme. There has been a significant increase in the total cost of the scheme. Other concerns relate to the lawfulness of the Council's decision-making processes and the development contributions and rates used to fund the scheme.

The Council has been carrying out a number of reviews of the scheme, including legal and financial reviews. The Council asked us to carry out an investigation into its decision-making, financial, and contract management processes for the scheme. We agreed to do so.

### The inquiry

The inquiry will examine Kaipara District Council's development, implementation, and oversight of the Mangawhai community wastewater scheme (and any related projects), from inception, including:

- the Council's planning and decision-making, including how well it complied with its policies and strategies, and the legal and other requirements for decision-making;
- the governance, management, and contracting arrangements for the project;
- the Council's financial management, monitoring, and reporting;
- the funding for the scheme, including the use and setting of rates, borrowing, and development contributions;
- the overall suitability and cost-effectiveness of the scheme that has been constructed.

The inquiry will also consider:

- the role played by the Council's auditor;
- the role played by other relevant agencies; and
- any other matters that the Auditor-General considers it desirable to report on.

The inquiry is being carried out under section 18(1) of the Public Audit Act 2001. We will publish a report when the inquiry is completed. It will also be presented to Parliament.

### **How to contribute**

We encourage members of the public to let us know their views on the Mangawhai Wastewater Scheme and any concerns they may have about how it has been developed and implemented by the Council and its contractors.

We will arrange some community meetings in Mangawhai for people to talk to us directly.

Written comments can be sent to us, in confidence:

- by email to [kaipara@oag.govt.nz](mailto:kaipara@oag.govt.nz); or
- by post to “Kaipara inquiry”, Office of the Auditor-General, Private Bag 3928, Wellington 6140.

### **Contact for queries**

For media queries, please contact:

- Tamar McKewen on (04) 917 1879, Communications Advisor (Media); or
- Lynley Jenkins on (04) 917 1520, Manager, Reports and Communications.

For general queries about the inquiry, please contact:

- Nicola White, Assistant Auditor-General, Legal on (04) 917 1500.

## Appendix 2

### Summary time line

1997	Mangawhai Planning study.
1998	Mangawhai Infrastructural Assets Study (the Study) carried out for Council by Beca.
June 1999	Council commissions and receives report on its ability to borrow.
September 1999	Council agrees to implement recommendation in the Study for a reticulated wastewater treatment system.
April 2000	At a workshop, Council considers strategic plan for implementing the infrastructure identified in the Study that had been prepared by Beca. Plan outlines methods for delivering project, including PPPs.
May 2000	Council agrees to tender implementation of the Study, to appoint members to a project steering team, and to establish a Community Advisory Group.
May to August 2000	Council runs a tender for a Project Manager.
September 2000	Beca Consortium selected to be the Project Manager.
February 2001	Council workshop on Council's preferred risk profile for private sector participation. Council agrees at workshop to use a Build Own Operate Transfer (BOOT) PPP.
April 2001	Expressions of interest for a BOOT project to develop a wastewater scheme are advertised.
August 2001	Simon Engineering, NorthPower, and EarthTech shortlisted to proceed to the RFP stage.
October 2001	Council elections.
August 2002	Council decides to award preferred proponent status to Simon Engineering. Council starts negotiating with Simon Engineering.
September 2002	Chief Executive of Council decides to assure himself about the process used for the project, and appoints Larry Mitchell to carry out this work.
December 2002	Larry Mitchell provides his assurance report to the Chief Executive. Local Government Act 2002 is enacted, meaning Council can no longer use a BOOT for its wastewater scheme project.
January 2003	Council decides to change project from a BOOT to a Design Build Finance Operate (DBFO) project and to continue negotiations with Simon Engineering on that basis.  Council also decides to seek funding from central government through the Sanitary Works Subsidy Scheme (SWSS).
June 2003	Council changes its borrowing management policy, by including segmentation of debt and changing its borrowing limits.
July 2003	Council puts out first statement of proposal on the wastewater scheme for consultation. No costs specified, but statement of proposal advises pre-tender estimates were for capital costs of less than \$17 million, and annual operating costs of \$800,000.

November 2003	Council successful in obtaining \$6.63 million as SWSS subsidy.
July 2004	Council adopts Development Contributions Policy for Mangawhai wastewater.
October 2004	Council elections.
January 2005	Simon Engineering's parent company is placed in voluntary administration.
February 2005	Council withdraws Simon Engineering's preferred proponent status and begins negotiations with EarthTech and NorthPower.
March 2005	NorthPower advises it is no longer interested in the project.
June 2005	Council agrees to contract with EarthTech to deliver the scheme, The construction price is estimated as \$26 million and annual operating price is \$748,000.
August 2005	Council accepts the offer from EarthTech, including loan funding to be provided by ABN Amro. Council suspends its Development Contributions Policy.
October 2005	Council, EarthTech, and ABN Amro sign contract documents.
February 2006	Council adopts second statement of proposal for wastewater scheme for consultation as part of the consultation on Council's LTCCP. Capital costs of the project are estimated to be \$35.6 million.
March 2006	Council agrees to adopt the draft audited 2006-2016 LTCCP for consultation.
March 2006	Chief Executive of Council makes an offer to purchase the Lincoln Downs farm for the disposal site.
May 2006	Council provisionally approves purchase of the farm.
June 2006	Council changes its Revenue and Financing Policy and Liability Management Policy to include debt segmentation, with the effect that EcoCare debt is excluded from the borrowing limits applying to the rest of Council's debt. Council adopts a new Development Contributions Policy.
September 2006	EarthTech carries out work on growth assumptions to understand sizing requirements for the scheme.
September 2006	Council and EarthTech file application for resource consents for scheme.
October 2006	Beca and EPS provide paper to Council on growth assumptions and charges to ratepayers. Council adopts recommendations in paper. Project costs are increased to an estimated \$57.7 million.
December 2006	Council contracts to buy the farm.
March 2007	Resource consents granted for the scheme.
October 2007	Council elections.

November 2007	Council signs amended project contract documents. Construction costs are now estimated to be \$37.8 million, and total loan to be provided by ABN Amro is \$53 million. Scheme to be bought by Council in two stages.
January 2008	Construction of the scheme starts.
May 2008	Council fixes the interest rate on the loan using a swap.
July 2008	Changes in the ownership of EarthTech. The part of EarthTech responsible for constructing and operating the scheme becomes Water Infrastructure Group.
February 2009	Date for completing the first part of construction is unable to be met. This was due to the Council requiring additional work to be carried out. This meant the swap needs to be broken, costing \$840,000.
June 2009	Council agrees to adopt the draft audited 2009-2019 LTCCP for consultation.
July 2009	Project Director issues certificate of commercial acceptance for second part of scheme that had been constructed, although works not completed. Council buys second part of the scheme.
January 2010	Official opening of the scheme.
March 2010	OAG and Office of the Ombudsmen start to receive complaints about the targeted rate for the Mangawhai wastewater scheme.
August 2010	OAG asks Council to legally review its targeted rate for wastewater.
October 2010	Council elections. Council receives legal advice that there were problems with the targeted rate for wastewater.
January 2011	Total project costs estimated to be \$63.3 million.
September 2011	Minister of Local Government advises Council it is “on watch” and identifies areas where progress needs to be made by April 2012.
October 2011	Chief Executive resigns.
November 2011	Council appoints a new Chief Executive.
February 2012	Council receives legal advice identifying issues with its rates.
March 2012	Auditor-General begins inquiry.





## Appendix 3

### Our review of the initial allocation of risk under the proposed contract (February 2001)

Risk	Risk Allocation		Comment
	Council	Promoter	
1. Planning – Construction, Consents and Rulings			
a. Tax – these are the tax benefits to the Promoter in owning the infrastructure – for example, depreciation.		✓	This allocation is appropriate.
b. Planning – this is the planning of the various tasks in the project		✓	There might be some tasks where the risk has been allocated to Council. Transferring entire planning of these to the Promoter will result in additional cost in the tenders to cover this risk.
c. Consents – these are all the statutory consents required under legislation administered by Kaipara District Council, Northland Regional Council, and any other government agency as required.		✓	This risk is better managed by Council. Obtaining consents is highly uncertain and transferring this to the Promoter will result in significant costs in the tenders to cover this risk.
2. Design and construction risk			
a. Specification and capacity of facilities – this covers the drafting of specifications for construction and the confirming the scheme capacity to meet the demands now and into the future.		✓	This is appropriate, provided the Council has given certainty on the scheme capacity and demand requirements.
b. Design and construction of facilities – this covers the design and construction of facilities to meet the capacity requirements outlined in 2(a).		✓	This is appropriate, provided the Council has given certainty on the scheme capacity and demand requirements.
c. Construction cost overruns – i. Caused by Kaipara District Council ii. Caused by contractor iii. Force majeure	✓	✓ ✓	The allocation of risk cost overruns to those that cause them is appropriate. The allocation of “force majeure” risk to the Promoter will result in increased costs, particularly the insurance cover. Depending on the Promoter’s risk profile with insurers, it is suggested that this risk would better being allocated to Council.
d. Construction timing		✓	This allocation is appropriate.
e. Industrial relations		✓	This allocation is appropriate.
f. Continuation of services during construction		✓	This allocation is appropriate.

Risk	Risk Allocation		Comment
	Council	Promoter	
g. Load and volumes		✓	This allocation is appropriate.
<b>3. Commissioning, Operating &amp; Maintenance Risk</b>			
a. Commissioning new plants		✓	This allocation is appropriate.
b. Operation of plants		✓	This allocation is appropriate.
c. Service performance		✓	This allocation is appropriate.
d. Illegal discharges and connections			This allocation is appropriate.
i. Identification		✓	
ii. Pursuit of legal remedies/damages	✓		
e. Outflow characteristics and achievement of estuary standards		✓	This allocation is appropriate.
<b>4. Occupational safety and health</b>		✓	Health and safety cannot entirely be delegated to the Promoter. Council has the statutory obligation to ensure H&S is implemented on all its work. This must be a risk shared by both parties.
<b>5. Commercial terms</b>			
a. Proponents' bid costs		✓	This allocation is appropriate.
b. Inflation/foreign exchange and/or interest movements		✓	This allocation is not appropriate. Transferring the uncertainty of this to the Promoter will cost the Council. Managing the risk of this uncertainty would be better managed by the Council.
c. Insurance		✓	This allocation is appropriate.
d. Taxation		✓	This allocation is appropriate.
e. Finance availability/structure		✓	This allocation is appropriate.
f. Provision of security		✓	This allocation is not appropriate. Transferring the uncertainty of obtaining security to the Promoter will cost the Council. Managing the risk of this uncertainty would be better managed by the Council.
g. Assignment/novation		✓	This allocation is not appropriate. Transferring the assignment and/or novation of commercial terms to the Promoter will cost the Council. The Council needs to approve this.

Risk	Risk Allocation		Comment
	Council	Promoter	
h. Corporate structure		✓	This allocation is appropriate.
i. Changes in law		✓	This allocation is not appropriate. Transferring the uncertainty of changes in law to the Promoter will cost the Council. Managing the risk of this uncertainty would be better managed by Council.
j. Transfer of facilities on completion			This allocation needs to be shared. It is in Council's interest that all the facilities are transferred in quality condition, functioning, and fit for purpose.
i. Asset condition		✓	
ii. Residual value		✓	
<b>6. Regulatory Issues</b>			
a. Obtain and retain consents		✓	This risk of obtaining consents is better managed by Council. Transferring this risk to the Promoter will result in significant costs in the tenders to cover this risk. The risks with retaining consents should be shared as the Council still needs to ensure it is not compromised.
b. Monitor NRC Rulings and meet increased licence standards		✓	This allocation is appropriate.
c. Monitor and address changes in regulatory regime		✓	This risk would be better managed by Council. Any changes in the regulatory regime can then be implemented by Council rather than allocating this risk to the Promoter. The Promoter will add extra cost to cover the uncertainty with this risk allocation.
<b>7. Site issues</b>			
a. Kaipara District Council sites			These are sites owned by Council so the risk allocation is entirely appropriate for all of these except for the Iwi agreement. Presumably, the Iwi agreement is with Council and therefore Council needs to manage this risk and have mechanisms in the contract to cover potential impacts on agreement.
i. Environment report	✓	✓	
ii. Site availability	✓		
iii. Contamination	✓	✓	
iv. Archaeological/heritage	✓	✓	
v. Iwi agreement		✓	

Risk	Risk Allocation		Comment
	Council	Promoter	
b. Other Sites i. Environment report ii. Site availability iii. Contamination iv. Archaeological/heritage v. Iwi agreement		✓ ✓ ✓ ✓ ✓	These sites are not owned by Council so therefore there is uncertainty as to availability. This risk should have remained with Council. The risks associated with the environment reports, any contamination, and the archaeological/heritage aspects contained some uncertainty and therefore should have at least been shared if not completely allocated to Council. Presumably, the Iwi Agreement is with Council and therefore Council needs to manage this risk and have mechanisms in the contract to cover potential impacts on agreement.
<b>Customer interface issues</b>			
c. Community liaison	✓	✓	This allocation is appropriate.
d. Manage customer interface including billing and accounts	✓		This allocation is appropriate.
e. Public health		✓	This allocation is appropriate.
f. All other risks		✓	This is the “catch-all” for risks not identified. Given the uncertainty around this, it should have been allocated to Council or at least shared. Not appropriate that the Promoter carries the uncertainty for all risks not identified. This would definitely add more cost to the project.

## Appendix 4

# Explanation of main parties discussed in this report

### **KDC**

The organisation as a whole, comprising the governing body and staff.

### **Council**

The group of people elected as members and mayor of KDC.

### **Chief Executive**

The Chief Executive referred to in the report is the Chief Executive who held office until October 2011.

### **The project managers advising KDC**

Beca Consortium, made up of:

- Beca Carter Hollings & Ferner Limited;
- EPS Consultants (International) Pty Limited;
- PricewaterhouseCoopers, Australia; and
- Blake, Dawson and Waldron (Australian legal firm), with assistance from Bell Gully.

### **The Project Director overseeing construction for KDC**

EPS representative.

### **The bidder originally selected for negotiation**

Simon Engineering (Australia) Pty Limited (parent company Henry Walker Eltin).

### **The company awarded the contract to build and operate the scheme**

EarthTech Engineering Pty Limited (it became Water Infrastructure Group in July 2008).

### **Bank providing construction and loan financing for the scheme**

ABN Amro.

### **MRRA**

Mangawhai Ratepayers and Residents Association.

### **OAG**

Office of the Auditor-General – the head office that supports the overall work of the Auditor-General and deals with requests for inquiries.

### **Audit New Zealand**

A business unit of the Office of the Auditor-General that carries out audits of public entities on behalf of the Auditor-General.



## Appendix 5

### Summary of information on costs from Kaipara District Council records

Date	Document	Capital cost (\$million)	Operating cost per year (\$)	Other costs	Comment
May 1999	<i>Preferred Options</i> report	10.84	62,000		Capital cost also stated as being \$7.7 million
March 2002	Wastewater benchmark design, Beca	18.0	290,000 in 2002 375,000 in 2027		Includes \$2.5 million contingency and \$1.3 million for additional reticulation in 2015
August 2002	Paper to the Council recommending preferred proponent	23.5 (net present value) 13.5 (guaranteed maximum price)	570,000 to 980,000		
May 2003	Paper to the Council from Chief Executive	15.0	500,300 in year 1 1,115,800 in year 25	Financing rate 7.62% (5 year interest only loan)	Based on population of 1350 rising to 2800 Capital cost includes most expensive disposal option
November 2003	Stage 2 SWSS application and additional information provided	16.0 + 2.5 house connection costs 16.8 interim guaranteed maximum price	Initially 600,000 excluding inflation		System design based on an expected capacity of 7500 equivalent population
February 2004	Paper to the Council from Chief Executive	17.5 21.7 (net present value)			Capital cost includes: • \$15.6 million construction • \$0.8 million council fees • \$1.1 million project fees (financing, legal, interest)
June 2004	Long-Term Council Community Plan	17.5	1,712,000 in year 1 (includes depreciation)		
August 2004	Paper to the Council from Chief Executive	19.0	560,000 in year 1	5 year fixed interest loan	Capital cost includes: • \$16.1 million construction • \$2.9 million fees and interest

Date	Document	Capital cost (\$million)	Operating cost per year (\$)	Other costs	Comment
August 2005	Council minutes recording information provided by Chief Executive	26.264	711,050 in year 1		Caters for up to 1970 sections
October 2005	Project Deed	26.264923 (guaranteed maximum price)	711,050 plus power costs (and 10% of power costs)		Project costs of \$29.8 million includes: <ul style="list-style-type: none"> <li>• \$2.7 million financing costs</li> <li>• \$0.8 million Council costs (note did not include all project management costs)</li> </ul>
February 2006	Statement of Proposal	35.6	711,050 in year 1		Based on 1970 allotments, but treatment plant capacity between 2500 and 3000 allotments  Includes financing costs and Council fees
June 2006	Long-Term Council Community Plan	35.6	711,050 in year 1		As above in Statement of Proposal
October 2006	Council minutes setting out presentation provided by Chief Executive at meeting	42.638 + purchase price for farm			Total cost of \$57.764 million includes: <ul style="list-style-type: none"> <li>• additional reticulation (\$13.050 million)</li> <li>• part of farm costs, pipeline, irrigation (\$11.1 million)</li> <li>• house connections (\$2.35 million)</li> <li>• Council costs and finance fees (\$10.126 million)</li> </ul>
December 2007	Project Deed	37.835211 (guaranteed maximum)	930,166 in year 1	\$53 million loan from ABN Amro	Contract for 1216 sections only, additional sections to be covered by a modification  Water treatment plant capacity 2000+ properties



Date	Document	Capital cost (\$million)	Operating cost per year (\$)	Other costs	Comment
March 2008	Paper to the Council from Chief Executive	44	1,000,000		Total costs \$57.7 million includes: <ul style="list-style-type: none"> <li>• \$5.5 million for future modifications, project management fees of \$3 million</li> <li>• financing costs of \$5.2 million and farm</li> </ul>
June 2009	Long-Term Council Community Plan	50.526	5,348,000 in year 1 (includes depreciation)		
July 2009	MDHL invoice for sale of plant and reticulation assets	51.477 incl GST			Invoice includes construction costs, ABN Amro financing costs, as well as \$0.8 million provided to Council to cover its costs
January 2011	PowerPoint presentation on project review prepared by Beca	46.4			Total project costs \$63.3 million, includes: <ul style="list-style-type: none"> <li>• modifications (\$8.6 million)</li> <li>• project management fees (\$4.5 million)</li> <li>• financing costs (\$5.2 million) and</li> <li>• farm (\$7.2 million)</li> </ul>



## Appendix 6

# Report on independent review of audit work for Kaipara District Council

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# **KAIPARA DISTRICT COUNCIL**

*INDEPENDENT REVIEW OF THE AUDIT SERVICES  
PERFORMED BY AUDIT NEW ZEALAND ON  
KAIPARA DISTRICT COUNCIL: 2003 - 2012*

*FINAL REPORT-15 NOVEMBER 2013*

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## 1. INTRODUCTION

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1. The Auditor-General is carrying out an inquiry into the Kaipara District Council's (the Council) management of the Mangawhai Community Wastewater Scheme. The purpose of the inquiry is to examine the Council's development, implementation and oversight of the Mangawhai Community Wastewater Scheme (and any related projects), from inception, including the:
  - Council's planning and decision-making, including how well it complied with its policies and strategies, and the legal and other requirements for decision-making;
  - governance, management and contracting arrangements for the project;
  - Council's financial management, monitoring, and reporting;
  - funding for the scheme, including the use and setting of rates, borrowing and development contributions; and
  - the overall suitability and cost-effectiveness of the scheme that has been constructed.
2. The inquiry will also consider:
  - the role played by the Council's auditor;
  - the role played by other relevant agencies; and
  - any other matters that the Auditor-General considers it desirable to report on.
3. Under the Public Audit Act 2001, the Auditor-General is the auditor of the Council. The Auditor-General appointed Audit New Zealand to provide the audit and assurance services over the period being considered by the inquiry. As part of the inquiry work, the Auditor-General has commissioned an independent review on the sufficiency and appropriateness of the planning, performance and reporting of the audit work over this period. This independent review report forms part of the overall report resulting from the Auditor-General's inquiry.

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## 2. EXECUTIVE SUMMARY AND OUTLINE OF KEY REVIEW FINDINGS

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4. The Auditor-General has commissioned this independent review to assess the sufficiency and appropriateness of the audit work undertaken by the Kaipara District Council's auditor, Audit New Zealand. Specifically, my terms of reference require me to consider Audit New Zealand's audits of the Council's Annual Reports, Long Term Council Community Plans (LTCCP)<sup>1</sup>, Long-Term Plan (LTP) and Annual Plans between 2003 and 2012. This review forms part of the Auditor-General's broader inquiry into the Council's management of the Mangawhai community wastewater scheme ("the wastewater project").
5. Given the emphasis of the Auditor-General's inquiry, I have focused my review on significant, or material, matters that are directly relevant to the broader inquiry. In particular, I have focused on those aspects of the audit engagement where the auditor considered (or would have been expected to consider) the risks and audit implications associated with the Council's management and development of the wastewater project. In performing my review, I have also focused on the auditor's understanding and consideration of:
  - Matters that impact the Council's activities and operations;
  - The Council's management control environment;
  - Key audit risks associated with matters reflected in the Council's annual report or planning documents;
  - Council's overall framework and system for ensuring compliance with applicable laws and regulations;
  - Those auditing, assurance and professional standards applicable to the planning and performance of particular audit engagements; and
  - Whether the overall objective of the audit has been met.
6. At the time this review was performed, there was significant public interest in the Council's management and funding of the wastewater scheme. Numerous deficiencies and irregularities had become public knowledge, many extending back over multiple financial periods. Irregularities in the Council's setting and assessment of rates, and other procedural matters, are now the subject of a Bill before Parliament. The community continues to express concerns about the funding and financial implications of the wastewater project.
7. It is therefore understandable that questions have been asked about why the Council's auditor did not identify the irregularities. The high level of public interest and scrutiny have made completing this review especially challenging. In particular, there is a risk that heightened public scrutiny of the auditor's performance may result in misplaced expectations, or a misunderstanding about the purpose of the audit, the audit process, and the role and responsibilities of the auditor – especially compared with the responsibilities of the Council or its independent advisors. This risk is commonly referred to as the *audit expectation gap*.

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<sup>1</sup> Throughout this report I have referred to the LTCCP and LTP, collectively, as Council's planning documents.

## Understanding the purpose of the audit, and the auditor's role and responsibilities

8. In preparing this report, I have been mindful of the need to carefully consider and clarify the role, purpose and responsibilities of the auditor; and to clearly establish the scope and objectives of the audit engagement. My aim has been two-fold. First, doing so has helped me clearly identify the benchmarks and standards against which to assess the performance of the audit, and to determine the reasonable expectations that intended users of the annual report or planning document could have of the auditor. Second, it has ensured that those who read this report have a broader context of understanding about the audit process, its purpose and inherent limitations.
9. In the local government context, the purpose of an audit is to enhance the degree of confidence that intended users can have in a Council's annual report or long-term planning documents. In performing the audit, the auditor's overall *objective* is to obtain reasonable assurance that these documents are:
  - free from any material misstatement; and
  - presented in a manner consistent with a recognised or prescribed reporting framework or in accordance with applicable legislative requirements.
10. Importantly, the concept of *reasonable assurance* does not mean that the auditor has obtained absolute assurance or that they have tested every transaction or disclosure in the annual report or long-term planning document. Nor does it mean that the auditor has looked at and assessed whether every aspect of the Council's operations and activities complies with applicable laws and regulations. It is recognised that most of the audit evidence from which the auditor draws conclusions, and bases their opinion on, is persuasive rather than conclusive.
11. In addition to understanding the objective of the audit, I have been careful to consider the *scope* of the audit engagement – the nature and extent of the matters on which the auditor is required to express an opinion, and also what matters the auditor's opinion does *not* address. The scope of the audit engagement is determined by the requirements and provisions of the Local Government Act 2002 (the Act).
12. In the case of the Council's *annual report*, the auditor is required to express an opinion on the presentation of the Council's financial statements, group of activity statements and whether the Council's annual report complies with the requirements set out in Schedule 10 of the Act. To the extent that an activity, project or transaction has a direct material impact on the annual report or on the presentation of the Council's financial statements, then it is reasonable to expect that the auditor would take this matter into account when planning and performing the audit. If, however, a project or activity does not have a direct material impact on the Council's financial statements, then, depending on its general nature or significance, the project or activity may have a limited role only in the auditor's planning of the audit.
13. In the case of the Council's *planning documents*<sup>2</sup>, the auditor is required to express an opinion on whether the planning document complies with the requirements of the Act, and to separately assess the quality of the information and assumptions underlying the forecast information. The Act explicitly prohibits the auditor from commenting on the merits of the plan's policy content.

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<sup>2</sup> The local Government Act 2002 requires that the Council's LTCCP and LTP be audited. There is no separate requirement for the Council's annual plan to be audited.



14. Finally, in the case of the *audit of public entities*, auditors are expected to take account of, or be alert to, matters that are of direct interest or concern to the Auditor-General. These matters derive from the Public Audit Act 2001 and reflect public and parliamentary expectations of the Auditor-General. In broad terms, the Auditor-General is concerned with matters of performance, authority, waste and probity in public entities. Auditors are expected to bring the Auditor-General's attention to matters of interest in any one of these areas.

### **Professional expectations of the auditor in the planning and performance of the audit engagement**

15. Auditors are required to plan and perform the audit in accordance with specific professional and ethical standards applicable to each audit engagement. In all cases the auditor is required to be independent of the public entity that they are auditing. They must plan and perform the audit with professional scepticism – an attitude that requires a *questioning mind, alertness to conditions that may indicate a possible misstatement, and critical assessment of audit evidence* (including avoiding the risk of over-reliance on management's explanations and representations). In discharging their professional obligations, the auditor must also exercise significant professional judgment – *making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement*. Furthermore, intended users of the auditor's report are entitled to expect that the planning and performance of the audit meets the required quality standards and benchmarks.
16. Over the period covered by this review, certain auditing, assurance and ethical standards applicable to various audit engagements have changed, evolved or have been updated. I have been mindful of these changes when considering what was reasonable and appropriate at the time that the auditor planned and performed the engagement.
17. In addition, Audit New Zealand has suggested that in order to assess whether an auditor has demonstrated compliance with underlying standards of behaviour or performance, certain changes in general audit industry practice over the same period must be taken into account. For example, what may be considered sufficient documentation in 2012 may differ from that considered sufficient in 2003. Audit New Zealand contends that the underlying auditing standards, and the general industry approach to what is sufficient and appropriate to demonstrate compliance, collectively form the benchmark against which to assess whether the work planned and performed is that which could be expected of a reasonable auditor.
18. While there is no single verifiable body of evidence to benchmark general industry practice at a particular point in time, I have accepted Audit New Zealand's arguments. I accept that it would be inappropriate, and unreasonable, to assess the performance of the 2003 audit on the basis of a higher standard or expectation applicable to the 2012 audit. I am satisfied that there is publicly available information corroborating Audit New Zealand's assertion that the practices and expectations of auditors changed between 2003 and 2012. For example, reports from independent audit regulators, standard-setting groups and oversight bodies reveal changes in expectations of auditors' documentation practices and of the way they exercise professional judgment and scepticism. In addition, I note that Audit New Zealand's own audit methodology also reflects changes in general industry practice, even in areas where the underlying requirements in the Auditing Standards may not have changed. I note also that during the period covered by my review Audit New Zealand has subjected its audit methodology and quality control practices to

independent reviews by both the New Zealand Institute of Chartered Accountants and the Australasian Council of Auditors-General, which identified no matters of concern.

19. Without limiting this conclusion, I have noted that while documentation on the audit file may be consistent with general industry practice, and therefore demonstrate the auditor's compliance with the auditing and professional standards, there may be instances where it is not possible for me to assess the sufficiency and appropriateness of the work performed by the auditor – as there may be insufficient documentation from which I am able to undertake my assessment. I intend to clarify this in respect of the matters identified or reported through this report.

### **Key findings and observations from this review**

#### **General:**

20. Audit quality varies significantly over the period covered by this review – although, overall, there has been a noticeable improvement in quality. There is evidence that the performance of audit test procedures has not always met the standards and expectations required of the auditor. Significant areas of deficiency or non-compliance principally relate to:
  - the auditor's planning of the audit engagement;
  - the identification and assessment of audit risks;
  - the sufficiency and appropriateness of audit documentation; and
  - the collection of sufficient appropriate audit evidence.
21. In addition, I have also identified deficiencies in the way the auditor considered the impact of the wastewater project on the annual report or planning documents – specifically, how the auditor applied their professional judgement or the nature and extent of scepticism exercised by the auditor in understanding the impact of the wastewater project on the Council's financial statements.
22. In addition to this high-level assessment of variable audit quality, I have also identified variability in the sufficiency and quality of the work performed at the level of specific components (for example, cash and bank, expenditure etc.). The standard of work varies depending on the nature of the component, the audit approach adopted for that component, and the knowledge and experience of the auditor performing the audit test procedures.
23. However, despite the deficiencies noted through this report, and with the exception of the auditor's consideration of the wastewater project during the period of construction, audit work on rates and work performed in planning the audit and identifying audit risks, I have found that much of the audit work planned and performed at a component level within the audit had been sufficiently and appropriately planned and performed in accordance with the standards expected of that particular work.
24. Overall, I am satisfied that the audit methodology and approach developed by Audit New Zealand and/or the Office of the Auditor-General (OAG) provided a reasonable and appropriate basis from which the auditor could plan and perform the audit engagements. The audit methodology is aligned to the requirements of the auditing and assurance standards applicable at the time each audit engagement was undertaken. Moreover, Audit

New Zealand's audit methodology and its quality control systems, processes and procedures were subject to independent quality assurance review on at least three separate occasions during the period of this review. No significant issues or deficiencies were noted. In the case of the audit of the LTCCP/LTP, the OAG developed the audit methodology and approach for its appointed auditors.

### **The auditor's knowledge and understanding of the wastewater project**

25. By any measure, the wastewater project was a significant undertaking for the Council. Its funding and financial implications were of significant interest to the community. From discussions with each auditor, and my review of the documentation and evidence available on the audit files, I find that that the auditor was generally aware of the progress and development of the wastewater project.
26. As the wastewater project progressed, its potential impact on the Council's annual reports and planning documents changed significantly. The auditor needs to have a sufficient understanding of the wastewater project, and its impact on the annual report or planning document, in order to effectively plan and perform the audit engagement. It therefore follows that as the scope and management of the project changes the auditor would need to update their assessment and understanding of the project.
27. In my view, the auditor did not have a sufficiently complete understanding of the wastewater project – once the final contract had been signed and construction was underway – in order to properly plan and perform the audit. The wastewater project should have been a significant and increasing area of focus throughout the 2006 – 2009 audits, but it was not. Importantly, through this period the auditor did not identify the wastewater project as a significant audit risk or area of audit focus and there is no evidence that the auditor independently considered the nature of the contract entered into by the Council, and the impact that this had on the accounting for the wastewater project in the financial statements. I consider this to be a significant deficiency. As was subsequently discovered the Council did not correctly account for the wastewater project. In the case of the 2009 annual report, the effect of these errors is that the financial statements are materially misstated.
28. I have looked closely at this issue during my review. The auditor notes that their understanding was that the wastewater project should be accounted for *off-balance sheet*. This understanding was formed through discussion and reliance on the advice from Council management. It was also influenced by the auditor's continued reliance on the 2005 assessment of the overall project management. There is no evidence that the auditor ever independently reviewed or considered the wastewater project, once the final contract had been signed, or tested/confirmed whether the Council's accounting treatment of the wastewater project was consistent with the substance of the arrangement or that it complied with generally accepted accounting practice.
29. In my view the auditor was over-reliant on advice from, and discussions with, management. It is reasonable to have expected that the auditor should have independently developed their understanding of the wastewater project and assessed the impact on the annual report, including whether the Council had adopted the most appropriate accounting treatment. Further, the auditor inappropriately placed reliance on work performed in 2005 without sufficiently updating this assessment to take account of changes in the nature and scope of the project during 2006 – 2009. Both of these matters are significant deficiencies in the auditor's planning and performance of the audit. As a consequence of these deficiencies the auditor has failed to detect that the accounting

treatment adopted by the Council was incorrect and that the result of this would be errors and omissions in the Council's financial statements. In the case of the 2009 annual report, these errors and omissions were material. As a consequence, the auditor has not satisfied the overall audit objective – they have not obtained *reasonable assurance* that the financial statements are free from material misstatement – and has incorrectly issued an unqualified audit opinion.

30. Given the significance of this finding, and for the sake of completeness, I briefly summarise the extent of the auditor's understanding during critical periods of the review.

### 2003-2005

31. Audit New Zealand suggests in this period, the wastewater project was at a stage of development that meant it was unlikely to have a material or significant impact on the Council's annual report. As a result, Audit New Zealand contends that the testing required to be performed by a *reasonable auditor* at that time would have been limited in its nature and extent, and certainly less than was required in subsequent periods. After carefully considering the stages of development of the wastewater project over this period, I accept that the nature and extent of audit testing performed between 2003 and 2005 was reasonable: it put the auditor in a position to properly express an opinion on the Council's annual report.
32. However, I consider that the *judgment* exercised by the auditor in reaching their position on the impact of the wastewater project on the annual report is not clearly or sufficiently documented on the audit files. Between 2003 and 2005 there is evidence that the auditor completed an annual assessment of the management of the wastewater project. This assisted the auditor's understanding, enabling the auditor to effectively plan the audit engagement. However, it is noticeable that this assessment was narrowly focused and did not specifically consider amongst other matters:
- the nature and extent of the Council's oversight, governance and management of the project;
  - the Council's overall risk management strategy, framework and risk identification for the project;
  - the project's funding and financial implications, including the accounting treatment of the project;
  - the robustness or quality of project budgets and financial projections; or
  - the project's impact on the Council's funding and financial policies and financial strategy.
33. It is reasonable to suggest that the auditor's knowledge and understanding of the wastewater project, and its impact on audit risk, would have initially developed during 2003-2005. As the development of the wastewater project progressed and changes were made to scope and financial impact of the project, it is reasonable to expect that the auditor would have updated their understanding and assessment of the impact of the project on the annual report or planning document.
34. Audit New Zealand suggests that much of the information required to undertake a comprehensive assessment of the matters identified in paragraph 32 above did not exist at the time of the 2003 – 2005 audits – as the contract was not signed until October 2005.

Between 2006 – 2009, Audit New Zealand agrees that the assessment should have been updated subsequently to reflect the different stages of the wastewater project once the final contract had been signed. I concur with Audit New Zealand’s general position on this matter. However, I remain concerned over the sufficiency of documentation on the file to support this. In my view, there is insufficient documentation on the file to indicate whether the work performed by the auditor was a preliminary assessment only. Second, in the context of the work performed, if in the auditor’s professional judgement the matters identified above were not matters that needed to be acted upon until after the contract was signed then it is reasonable to expect that this judgement would be documented. Third, with respect to the auditor’s consideration of the governance and oversight arrangements that the Council had in place, in my view, these are equally relevant to both the Council’s planning and set up of the project (pre-contract signing) and during the period of development or construction (post-contract signing) and therefore were matters that should have been considered by the auditor and documented on the file. Notwithstanding these limitations, I accept Audit New Zealand’s assertion that, based on the current stage of development, this would not have influenced the auditor’s planning and performance of the audit.

## 2006-2009

35. Between 2006 and 2009, the auditor continued to rely on work undertaken as part of the 2005 review. There is no evidence or documentation indicating that the auditor ever updated their understanding of the project, or addressed the gaps and deficiencies noted during the 2005 review.
36. Also between 2006 and 2009, the auditor failed to identify any significant audit risks associated with the wastewater project and did not adequately assess its potential on the Council’s annual report or planning documents. Nor is there evidence or documentation showing the auditor sufficiently assessed or considered the implications of changes in the project’s scope, or the funding and financial implications of these changes. Critically, the auditor did not independently consider or assess whether the Council’s proposed accounting treatment of the wastewater project was consistent with the substance of the arrangement, or that it complied with generally accepted accounting practice. Continued reliance on management’s understanding as the primary source of audit evidence, without independently corroborating this understanding, was inappropriate.
37. As a result of these deficiencies, between 2006 and 2009, the auditor’s planning and assessment of audit risk provided an insufficient basis from which to effectively plan and perform the audit of Council’s annual report and planning documents. It is reasonable to expect that the wastewater project would have been an increasingly significant consideration in the audit during this period.
38. Based on my review of the audit files during this period, I also found that limited testing and consideration was given to the wastewater project during the actual performance of the audit. Errors, omissions and deficiencies related to the wastewater project were never identified or detected – either because they were not tested or considered, or because test procedures were performed incompletely or inadequately. The significance of the wastewater project on the forecast financial and funding information, as set out in the planning documents was also not sufficiently reflected in the auditor’s planning and performance of these audits. These deficiencies also meant that the auditor was not sufficiently aware of matters of performance, authority, probity and waste, as required by the OAG’s standard.



39. Of particular concern is the fact that the Council's financial commitments under the contract, the treatment of expenditure and the recognition of the resulting assets and liabilities were not appropriately accounted for in the Council's financial statements. The fact the auditor never identified this deficiency was due to a lack of understanding of the wastewater project and how it should have been accounted for in the Council's financial statements.
40. In the case of the 2009 annual report, these errors and omissions meant the Council's financial statements are materially misstated and therefore the auditor's opinion on these financial statements is incorrect. In my view, it is reasonable to have expected the auditor to have identified these errors and omissions in the planning and performance of the audit.

## 2010-2012

41. Commercial acceptance of the wastewater project took place in July 2009. In 2010–2012, the auditor became aware of deficiencies in the way that the Council had accounted for the wastewater project in the financial statements during the period of construction. There is evidence that the auditor sufficiently considered this issue, and the impact on prior period financial statements, and in respect to the audit opinions issued previously by the auditor. The 2011 annual report discloses the nature and extent of the errors and omissions. There is extensive disclosure of the restatement of comparative financial information to reflect the impact on the 2008 – 2010 financial statements if the wastewater project had been appropriately accounted for. These disclosures highlight the potential material misstatement of the 2009 financial statements. Throughout this period there is evidence that the auditor discussed and liaised with the OAG to understand and address the implications of the errors and omissions.

## The auditing of Council's rates

42. At the time this review was undertaken, irregularities in the Council's setting and assessment of rates were the subject of a local Bill<sup>3</sup> before Parliament. These are therefore matters of considerable concern to the community, and there is a strong public interest in understanding why the irregularities were not identified by the auditor.
43. Accordingly, my review specifically examines the sufficiency and appropriateness of the work performed by the auditor on rates. I have focused primarily on the period covered by the Bill, and reached the following conclusions and findings:
  - 43.1. The Council is responsible for setting and assessing rates, and for ensuring compliance with appropriate legislative requirements – in the case of rates, this means setting and assessing rates in accordance with the Local Government Rating Act 2002 (LGRA). The auditor is responsible for planning and performing the audit to ensure the overall audit objectives are satisfied. The auditor's work on rates cannot be relied upon as a legal review of the Council's compliance with the applicable legislative requirements. In circumstances where the Council requires some form of legal sign-off or assurance, then it is reasonable to expect it to seek such assurance directly from appropriate independent legal counsel. Evidence on the audit files indicates that, during the period of this review, the Council did seek and obtain independent legal advice on its setting of rates.

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<sup>3</sup> The *Kaipara District Council (Validation of Rates and Other Matters) Bill* (the Bill), introduced to Parliament in June 2013

- 43.2. Considering the overall objectives of the audit engagement, I found that the auditor's methodology and approach to auditing rates – including the performance of test procedures to assess compliance with applicable legislative requirements – provided a reasonable and appropriate basis from which to plan and perform the audit engagement. However, my review of the audit files reveals significant deficiencies in:
- the actual performance and documentation of the audit test procedures;
  - the collection and evaluation of appropriate audit evidence;
  - the manner in which the auditor exercised professional judgment to form a conclusion from the audit work on rates.
- 43.3. Of particular concern is the auditor's failure to adequately document the performance of audit test procedures so as to support their conclusions about legislative compliance. In most instances, the auditor simply noted on the audit file that the Council had complied with the requirements of the LGRA, despite contrary evidence now before Parliament in the form of the Bill. The files I have reviewed neither demonstrate nor provide any evidence for how the auditor reached their conclusions.
- 43.4. I found the auditor did not adequately consider or assess the Council's systems, processes and procedures for ensuring compliance with legislative requirements for setting and assessing rates. The auditor was over-reliant on the Council's control environment and underlying systems of control, and did not sufficiently test whether the Council's systems, processes and controls were operating as described or understood, or whether they were effective. Documentation on the audit file indicates the auditor was unduly reliant on discussions and enquiries with management. As a consequence, the auditor was not sufficiently alert to the potential risk of non-compliance.
- 43.5. In 2009 the Council introduced a new targeted rate to fund the wastewater scheme. There is no evidence that the auditor ever considered or assessed whether the basis of this targeted rate complied with the LGRA. Audit test procedures required the auditor to adopt a sampling approach when selecting and testing targeted rates, and when checking whether the basis for these rates complies with the LGRA. I accept that this is a reasonable approach and that it would be unreasonable to expect the auditor to consider and test *all* targeted rates, in every audit, in order to satisfy the audit objectives. However, in my view, given the significance of the wastewater project, the impact of the Council's funding decisions on the community and the fact that the targeted rate had been introduced for the first time in 2009, I consider it reasonable that the auditor should have selected this targeted rate for testing. The auditor did not, and there is insufficient documentation to understand the basis for this decision. I queried this matter with Audit New Zealand, who responded that ... "The contention that the Mangawhai targeted rate should have been tested can be supported given the significance of the rate both financially and in the context of the Council's environment". Had the auditor selected this rate, there is a reasonable expectation, based on the test procedures specified in the audit file, that the irregularities in the setting of the rate would have been identified by the auditor.

- 43.6. Audit test procedures required the auditor to ensure that all rates set out in the rates resolution were as set out in the Council's Funding Impact Statement (FIS). In addition, the auditor was required to assess whether the Council's rates assessment notice contained all the elements and requirements set out in the LGRA. Irregularities subsequently identified in the Bill show that the Council had not complied fully with either legislative requirement.

Over the period covered by the Bill (2006/2007 – 2009/2010) the audit files indicate that the auditor has performed the test procedures prescribed. No instances of non-compliance, and no errors or omissions, were identified in any period.

In the majority of the audits performed during the period covered by the Bill, the documentation and evidence on file makes it difficult to determine with sufficient certainty what work was carried out in accordance with the audit test procedures or why the irregularities were not identified.

Given the nature of the test procedures the auditor was required to perform, it is reasonable to expect the auditor to have identified the irregularities and deficiencies subsequently identified in the Bill. Had they been, they would have been brought to the attention of the Council and the OAG.

- 43.7. The auditor did review and consider the independent legal advice the Council obtained on various rating matters. The first such advice was provided when the Council became aware of potential irregularities in the setting of rates for the wastewater scheme during the 2010 audit. There is sufficient evidence to indicate that the auditor appropriately considered this advice, discussed the issues it raised with the Council, and considered and assessed the consequences for the auditor's report on the Council's annual report.

Notwithstanding these actions, the way the auditor documented the results of their audit test procedures and formed conclusions were at odds with the matters identified in the Council's independent legal advice. And, after considering that advice, the auditor did not review and update the work they had already performed as might reasonably have been expected.

- 43.8. Once aware of the potential irregularities, the auditor brought the matter to the attention of the OAG in a reasonable and timely manner. Evidence and documentation supports this, and also shows that the auditor and the OAG carefully considered how the irregularities might affect the audit report. The Council disclosed the irregularities in its 2010 annual report, which it did by way of a note to the financial statements. No adjustment was considered necessary to the recognition of rates revenue. In light of the disclosures made by the Council, and based on the information and understanding available at that time, the auditor concluded that an unqualified audit report was appropriate. This judgement is supported by sufficient appropriate evidence on the audit file.

By the time the 2011 and 2012 annual reports were audited, the Council had carried out more detailed analysis of the nature, extent and impact of the irregularities. The Council provided more detailed disclosure of these matters in the notes to the financial statements. Based on the disclosures made by Council and after considering the further analysis undertaken by management since 2010 the auditor concluded that an unqualified audit report was still appropriate, but



that audit report should include additional commentary to draw users' attention to the irregularities and matters disclosed by the Council. Again, the judgement exercised by the auditor is supported by sufficient appropriate evidence on the audit file.

43.9. In my view, the deficiencies identified in the previous paragraphs 43.1 – 43.8 are significant. A root cause analysis does not sufficiently explain why the auditor did not identify the irregularities through the performance of the audit test procedures. Based on the audit test procedures the auditor was required to perform, it is reasonable to expect the auditor to have detected the following rates-related irregularities subsequently identified in the Bill:

- differences between the FIS and the Council's rates resolution;
- uncertainties over whether the rates assessment notice correctly contained all matters required by the LGRA;
- uncertainties over the basis for "key" targeted rates selected by the auditor during the 2006/2007 and 2007/2008 audits;
- uncertainties over the basis for the targeted sewerage rates selected by the auditor for testing in the 2007/2008 and 2008/2009 financial periods; and
- uncertainties over the basis for the targeted rate to fund the wastewater scheme in 2009 (on the basis that the auditor could have been reasonably expected to select this particular rate as part of their sample testing). It is reasonable to have expected that the auditor's performance of the test procedures would have identified most of the irregularities relating to the setting and assessment of rates subsequently identified in the Bill.

43.10. Following discussions with the auditor, I have determined that the primary reasons for the deficiencies outlined above were:

- a lack of understanding of the requirements of the LGRA;
- a lack of understanding of the objective or purposes of the audit test procedure; and
- a failure to adequately identify the risks and significance of non-compliance.

These lapses meant the auditor was not in a position to apply sufficient appropriate professional judgement when performing the audit test procedures, or to identifying potential material non-compliance, or irregularities, should they be present. The deficiencies noted in the auditor's work were not identified or addressed through the engagement quality review processes.

43.11. Cumulatively, these deficiencies mean the auditor's performance of test procedures on rates did not comply with the auditing and professional standards applicable to the audit engagement. They have also influenced my view on whether the auditor has satisfied the objectives of the audit during the period covered by the Bill.

## Other significant matters arising from the auditor's work

### Documentation:

44. The standard of the auditor's documentation varies across the period and/or between individual components of the audit engagement. Between 2003-2009, I have found deficiencies relating to sufficiency and appropriateness of documentation that:
- supports the performance of test procedures and other audit work;
  - recorded meetings and discussions with Council management and staff;
  - showed the professional judgment exercised by the auditor – whether it provided an adequate basis from which the auditor could rely on work performed in previous audits, and to show compliance with the necessary auditing and professional standards.

I have carefully considered what impact deficiencies in audit documentation may have on whether the audit file contains sufficient audit evidence to support the audit opinion. I note that auditor oversight regulators, and the quality review programs of most audit firms, generally take the approach that if audit work is not documented, the presumption is that the work has not been performed – in the absence of evidence to the contrary. Based on my review I have identified instances where there is no documentation to support the performance of a test procedure or the professional judgement exercised by the auditor, and instances where the documentation is insufficient.

### Understanding of relevant laws and regulations

45. I consider that the auditor was sufficiently aware of those laws and regulations that the Council was required to comply with, including those that had a material impact on the recognition and disclosure of items in the annual report and planning document. There is evidence on file to indicate that the auditor has considered and assessed category 1 legislation (which includes significant legislation such as the Local Government Act 2002, Local Government Rating Act 2002). However, except for 2006, I found no evidence that the auditor ever tested, or considered the possible impact of non-compliance, with other category 2 or 3 legislation – legislation that may have a fundamental effect on the Council's operations or that may result in significant financial, operational or political exposure (such as, the Resource Management Act 1991, Building Act 1991, Goods and Services Tax Act 1985 etc.).
46. I found that although the auditor has assessed the overall legislative control environment, and the systems and controls for ensuring compliance with applicable laws and regulations, the documentation to support the auditor's performance of test procedures, or as evidence of the auditor's professional judgement has not always sufficiently allowed me to form a view on whether the auditor has obtained sufficient appropriate audit evidence.
47. I have found significant deficiencies in the work performed by the auditor to assess the Council's compliance with the LGRA when setting and assessing rates. I have separately commented on this matter above.
48. My discussion with the auditors has highlighted the subjective nature of the auditor's work in the legislative compliance area. Audit New Zealand provides guidance and training to auditors to assist the auditors' understanding of what the auditing standards

expect of the auditors. Auditors identified the professional judgement that is required in determining whether they have obtained *reasonable assurance* as a particular area of subjectivity. Confusion on the part of the auditor as to what constitutes sufficient appropriate audit evidence could affect the auditor's conclusion. Audit New Zealand acknowledges this is an area that may need further attention.

49. I found that the auditor has appropriately communicated to the Council their responsibility for ensuring compliance with applicable laws and regulations. I also found that the auditor clearly understood their responsibilities in the context of the overall objective of the audit.

### Understanding of the Council's management control environment

50. The onus is on the auditor to understand the Council's business, activities and operations to the extent necessary to effectively plan and perform the audit. Moreover, the methodology and audit approach developed by Audit New Zealand requires the auditor to consider and assess the effectiveness of the Council's management control environment: this includes the financial management control environment, and its internal control systems.
51. Between 2003 and 2009 the auditor assessed the Council's management control environment as good, or effective. I found that there was often insufficient documentation available to demonstrate the auditor's professional judgement in reaching this conclusion. In addition, I found that the auditor's consideration of the Council's financial management environment was based on a narrow assessment of the budgeting and performance monitoring practice at an entity wide level, supplemented by an assessment and testing of underlying control systems. The auditor placed reliance on their current knowledge of the Council's business and discussions with management as the primary source of evidence for the entity wide assessment.
52. In 2011 an independent financial health check was commissioned by the Council. That review identified significant deficiencies in the Council's financial and budgeting management practices, and highlighted significant financial challenges faced by the Council in managing the current forecast debt levels. The auditor was aware of the review, but noted that the scope differed from the assessment that the auditor completed in planning the audit.
53. In 2011 and 2012, the emergence of significant issues and irregularities (including those matters identified in the financial health check) was persuasive in the auditor's reassessment of the Council's control environment – which the auditor now assessed as ineffective. I found that the auditor's assessment in 2011 and 2012 to be more complete and comprehensive. There was good documentation of the auditor's professional judgement on the audit file.

### Quality control

54. The auditor's work was subject to quality control review procedures, both at the level of the individual audit engagement and within Audit New Zealand's overall system of quality control. Over the period covered by this review, Audit New Zealand sought three independent reviews of its quality control system and its engagement performance. One review was conducted by the Australasian Council of Auditors General (ACAG) on invitation by the then Auditor-General. There were also two independent reviews conducted by the New Zealand Institute of Chartered Accountants (NZICA). These reviews

were similar in scope to those performed on other chartered accounting practices. In all three cases, the independent reviewers issued reports. No adverse findings were made.

55. At an engagement level, the audit has been subjected to Audit New Zealand's engagement quality control review (EQCR) processes. There is evidence of the performance of these review processes. In 2009 the auditor inappropriately requested dispensation from an EQCR after the initial planning of the audit. The auditor's request was approved. I have found that Audit New Zealand was contractually obliged to provide an EQCR reviewer for the 2009 audit. This was set out in the Council's letter of undertaking. EQCR was performed over the planning stage of the 2009 audit but not on the fieldwork and finalisation components. I have noted that the full cost of the EQCR review was incorporated into the audit fees paid by the Council. The contractual obligation was not brought to the attention of Audit New Zealand's professional practices group at the time that the request for dispensation was being considered.

### **How did these deficiencies affect the objectives of the audit and the audit opinion?**

56. Having completed my review, and having identified my key findings and observations, I am now in a position to consider and assess the impact of these on whether:
- the auditor has satisfied the overall objective of the audit;
  - there is sufficient appropriate audit evidence to support the conclusions reached by the auditor; and
  - the audit report and opinion issued by the auditor were appropriate.
57. I have set out below my overall analysis and conclusion as they apply to the following clusters of audit:
- Audits performed 2003-2005
  - Audits performed 2006-2009
  - Audits performed 2010-2012.

### **Audits performed 2003-2005**

58. My principal concern throughout this period is that the audit file does not always contain sufficient documentation for me to assess whether the auditor:
- had adequate audit evidence to support the conclusions they reached;
  - appropriately carried out the audit test procedures required; and
  - documented their professional judgement.
59. Audit New Zealand asserts that the nature and extent of documentation on the audit file was consistent with industry practice at that time. It is difficult for me to fully assess this now, although I accept that industry views on what constitutes sufficient appropriate audit documentation has increased since 2003.
60. With respect to the auditor's consideration and assessment of the wastewater project, I found that this was a specific area of audit focus throughout the planning of these audits. There is documentation and evidence showing the auditor reviewed the project

management annually. While this assessment of the overall project management was, in my view, overly narrow in scope and consideration of the most relevant aspects of the Council's governance and management of the project, it is unlikely to have influenced the auditor's planning and performance of the audit – given the current state of the project at that time. In my view the auditor's level of knowledge, understanding and testing was sufficient to enable them to understand the impact of the wastewater project on the Council's annual report or planning document, and thereby satisfy the objective of the audit.

61. Notwithstanding these comments, in my view the audit files generally provide sufficient appropriate evidence to support the overall conclusions the auditor reached. The auditor has satisfied the overall audit objective, and there is no evidence or documentation on the audit file to indicate that at the time that they issued their audit report that the opinion should be qualified.

### **Audits performed 2006-2009**

62. Based on my review of the audit files, I found that the auditor's understanding of the wastewater project – once its final scope and contract arrangement had been agreed – was insufficient to properly plan and perform the audit of the Council's annual reports/planning document. The potential impact of this failing is significant: it affected the auditor's overall conclusion and the audit report issued, and is therefore crucial to my determination of whether the objectives of these audits were satisfied.
63. The wastewater project should have been a major focus for the auditor during this period. While the auditor was generally aware of the project's progress, I consider that level of awareness was not a sufficient basis on which to effectively plan and perform the audit. The auditor's understanding of the project's nature and scope did not allow a proper appreciation of its impact on the annual report. In contrast to 2003-2005, in this period the auditor identified no significant audit risks relating to the project.
64. I have heard from the auditor that they relied on the project management assessment performed by the previous auditor in 2005, and on management's general understanding of the project. I find the fact that the auditor regarded these sources as appropriate audit evidence during the 2006 – 2009 period a major concern. In my view, the auditor should have been independently updating their understanding and assessment of the project as its scope was finalised, the construction contract was awarded, and construction got underway. The fact that the auditor identified no significant audit risks is also a concern, as it meant there was no assessment or testing of the contract arrangement and its impact on the Council's annual report during 2006 – 2009.
65. During the 2006 – 2009 period I have noted significant deficiencies in the auditor's work on rates, and have found that many of the irregularities since identified in the Bill before Parliament should have been detected by the auditor through their test procedures. While these shortcomings may not have changed the decision to issue an unqualified audit opinion, they are nonetheless significant concerns that mean the overall performance of the audit was sub-standard.
66. Finally, there were a number of more general deficiencies – for example, the sufficiency of audit documentation, that were apparent during this period – as they were in other periods. Again, I have taken these into account in my assessment of whether the auditor has met the standards expected and satisfied the overall audit objective.

67. Overall, after reviewing the 2006-2009 audit files and carefully considering the issues and deficiencies identified, I have concluded that there are reasonable grounds to question whether the auditor has satisfied the overall audit objective in this period. In addition, as there is evidence to indicate that the Council's 2009 annual report was materially misstated, I also conclude that the auditor incorrectly issued an unqualified audit opinion on that annual report: it should have been qualified.
68. The nature, extent and impact of the misstatement of the 2009 annual report is brought to light in the Council's 2011 annual report. The notes to the financial statements in the 2011 annual report provides additional disclosure by outlining the impact on comparative information had the Council correctly accounted for the wastewater project in the 2009 financial statements. This shows that for 2009, total Council expenditure was understated by \$12.412m, property plant and equipment was understated by \$27.273m and Council borrowings understated by \$36.120m. These figures highlight the size of the errors in the 2009 financial statements which, I find, exceeds the materiality levels set by the auditor.
69. There is no evidence to suggest that an unqualified opinion was incorrectly issued for the other audits performed during this period, despite the fact that the auditor did not satisfy the objectives of these audits. However, a significant body of evidence from 2011 suggests that, had the auditor detected irregularities in the setting and assessment of rates, they would have asked the Council to make additional disclosures in the annual report and would have referred to these disclosures in the audit report.

### **Audits performed 2010-2012**

70. In general, the quality of audit planning and performance significantly increased in this period. The sufficiency and appropriateness of audit documentation and evidence improved markedly, showing extra effort and resources were applied to auditing the Council's annual reports/planning document once the irregularities I have referred to came to light.
71. Apart from the initial planning of the 2010 audit, where the auditor did not initially identify any significant audit risks associated with the wastewater project, I find only minor deficiencies in audit quality over this period. Those I have identified were unlikely to affect the auditor's conclusion or whether the auditor had satisfied the objective of the audit.
72. It was during 2010-2012 that significant irregularities in the management and funding of the project came to light, including irregularities in the setting and assessment of Council rates. From my review of audit files, I am satisfied that the auditor sufficiently and appropriately considered these matters when planning and performing audits in this period, and in forming an overall conclusion on the audit evidence available.
73. After completion and commercial acceptance of the wastewater project in 2009, the infrastructure asset and related borrowings were brought into the Council's financial statements for the first time as part of the 2010 audit. As noted, the Council did not fully comply with generally accepted accounting practice in its accounting treatment of the project during construction. It addressed this issue as part of the 2011 annual report. The impact of the incorrect accounting treatment on the 2010 annual report was not material.
74. In my view, the audit files for this period generally provide sufficient evidence to support the auditor's overall conclusion. There is no reason to suggest that the auditor did not satisfy the overall audit objective at the time that they issued their unqualified audit

report. Moreover, the auditor's 2011 and 2012 reports provide additional explanatory information that draws attention to the Council's disclosure of the irregularities, and their effect on the annual report.



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### 3. ABOUT THIS INDEPENDENT REVIEW: PURPOSE, SCOPE, CONTEXT AND APPROACH

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#### Purpose and Scope of the Review

75. This review assesses the sufficiency and appropriateness of Audit New Zealand's audits of Kaipara District Council from 2003 to 2012.<sup>4</sup> It forms part of the Auditor-General's broader inquiry into the Council's development, implementation and oversight of the Mangawhai Community Wastewater Scheme.
76. The full terms of reference for the inquiry appear as *Appendix 1*. In summary, they require me to assess whether Audit New Zealand's work was carried out in accordance with the auditing and assurance standards (including those issued by the Auditor-General) that applied at the time. Specifically, I am required to assess its audits of the following Council accountability documents:
- Long Term Community Council Plans ('LTCCPs') for 2006 and 2009
  - Long Term Plan for 2012
  - Annual Reports for 2003 to 2012
  - Annual Plans for 2003 to 2012<sup>5</sup>.
77. Given the emphasis of the Auditor-General's broader inquiry, my own review focuses particularly on those aspects of the audit engagement where the auditor considered (or could have been expected to consider) the Council's development of the wastewater project.
78. My review addresses the following areas and questions:

#### ***Planning and performance of the audit engagement***

When planning and performing the audits, did the auditors sufficiently and appropriately:

- focus on significant material risks or financial matters, including in relation to the Mangawhai scheme?
- plan the audits so that they addressed matters required in the relevant legislation, and then ensure these matters were actually addressed when the audits were performed?
- plan the audits with due care, competence and independence, and with sufficient professional judgment and scepticism?
- develop and apply appropriate quality control mechanisms?
- take into account significant issues affecting the Council's financial management?

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<sup>4</sup> Audit New Zealand was appointed to provide audit and assurance services to the Council by the Auditor-General who, under the Public Audit Act 2001, is auditor for all public entities, including local government.

<sup>5</sup> The local Government Act 2002 requires that the Council's LTCCP and LTP be audited. There is no separate requirement for the Council's annual plan to be audited and therefore it is not further considered in this report, except to note that there have been no audits performed on Council's annual plan during the period covered by this review.



- communicate with Council staff?
- use adequate and appropriate resources, including appropriately-skilled staff or experts?

#### ***Audit reporting and conclusions***

- Were the auditors' conclusions supported by sufficient and appropriate evidence?
- Were the auditors' conclusions appropriately reported, both in the audit report and management letters?

#### ***Audit documentation***

- Do the audit files contain sufficient and appropriate documentation of the audits?
- Do the audit files show the auditors obtained sufficient and appropriate audit evidence to support their conclusions?

#### ***Audit methodology***

- Were audits of the Council consistent with, and supported by, Audit New Zealand audit methodology?

#### ***Audit communications***

- Were the audit opinions expressed in the audits appropriate?
- Were the management letters communicating the results of the audits appropriate?

### **Structure of this Report**

79. This report examines the audits of each Council accountability document, as well as the auditors' assessment of the Council's statutory compliance, in light of the topics and questions listed above:
- Section 4.1 examines the audits of the Council's Annual Reports.
  - Section 4.2 examines the auditors' approach to assessing the Council's compliance with legislative requirements.
  - Section 4.3 examines the audits of the LTCCP and LTP.
  - Section 4.4 looks at the quality control mechanisms used by the auditor in each of these audit engagements.
  - In Section 4.5, I turn to the auditing of the Council's rates revenue. For reasons I set out in paragraphs 84-86, I consider it essential to examine this aspect of Audit New Zealand's performance even though the Terms of Reference do not specifically require me to.
  - Finally, Section 4.6 examines the merits of the auditors' conclusions following each audit engagement, and the appropriateness of the reports and opinions issued.

- Throughout, I describe what happened, draw conclusions and, where appropriate, make findings. My conclusions and findings are brought together in a short summary in Section 4.6.
80. Before moving onto the substantive part of the report, it is necessary to set out some important context. The next section describes the high level of community interest in the matters which prompted this inquiry, and how this has influenced my approach. I then briefly summarise the nature of the auditor's role and responsibilities when auditing local authorities, and the purpose and scope of the audit function. Finally, I outline my methodology.

## **The context for the review**

### ***Significant Public Interest***

81. Numerous deficiencies and irregularities in the Council's management and funding of the Mangawhai wastewater project were identified when this review was initiated, and have since become public knowledge. Many extend back over multiple financial periods. Understandably, these irregularities have prompted considerable community concern, and questions have been asked about why the Council's auditor did not identify them.
82. The high level of interest presents me with particular challenges in performing this review. Whenever there is public alarm about the performance or management of public entities, confusion can arise about the role of an auditor, the extent to which their work can be relied on, and the degree of assurance that can be taken from an audit opinion. The risk of misplaced expectations and misunderstandings about the audit process is often referred to as the *audit expectation gap*.
83. In preparing this report, I have therefore been mindful of the need to clarify the role, purpose and responsibilities of the auditor; and the scope and objectives of each audit engagement. (The next section of this report, *Purpose and objectives of an audit*, deals with these matters.) I have also been careful to clearly differentiate between the respective roles and responsibilities of the auditor and those of the Council. My objective is to ensure that people who read my findings and observations have a broader context of understanding about the audit process, its purpose and inherent limitations.
84. The *Kaipara District Council (Validation of Rates and Other Matters) Bill* currently before Parliament<sup>6</sup> has also attracted significant public interest, and thus forms an important part of the wider context for my review. The Bill, which was promoted by the Council during the course of this inquiry, seeks to validate irregularities in its setting and assessment of rates under the Local Government (Rating) Act 2002 (the LGRA) and the Local Government Act 2002. The Council acknowledges irregularities occurred in the financial years 2006/2007 – 2011/2012 (inclusive).
85. Although these rating irregularities fall within the overall period covered by this review, my terms of reference do not explicitly require me to consider the matters addressed in the Bill. However, those irregularities relate specifically to the Council's primary source of income, as disclosed in both the financial statements and Council planning documents. In addition, I am aware that Audit New Zealand's audit methodology specifically requires the auditor to plan and perform test procedures designed to assess the Council's compliance with key requirements of the LGRA. Moreover, as I have noted, the progress of the Bill is

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<sup>6</sup> As at 1 October 2013.

being keenly followed by the community. Notwithstanding the scope or objectives of the audit engagement, there is significant public interest in understanding why the auditor did not identify the rating irregularities.

86. For all these reasons, my review specifically examines the auditor's approach to the auditing of rates revenue during those periods in which the Council has acknowledged irregularities occurred.

### ***The audit process and local authorities: an overview***

#### ***Introduction***

87. Any assessment of an auditor's performance must be informed by a clear understanding of several things. First, it is imperative to understand in a general sense what an audit is and what it is not. Second, an understanding is needed of the requirements, benchmarks and expectations of the particular auditor and audit engagements under review. It is particularly important to understand the expectations of the auditor and the audit in effect *at the time* that the audit was performed.
88. Any assessment also needs to acknowledge the risk of retrospection. When performing an audit, auditors must exercise significant professional judgment and scepticism as they consider the sufficiency and appropriateness of the evidence available to them. By contrast, in undertaking my review, I have had access to many years of audit files that may not have been available to the auditor at the time the audit was performed, and of course the advantages of hindsight. This risk needs to be carefully managed.
89. In this instance, I am examining audit engagements performed between 2003 and 2012. During that time, there were three different auditors<sup>7</sup> appointed by the Auditor-General to carry out the audit engagement. The methodology and standards applying to the audit continued to evolve, as did the nature and extent of issues associated with the wastewater project. Because of this ongoing change, it is entirely possible to reach different conclusions about the various audit engagements carried out over the period.
90. The performance of the audit requires interface between the audit team, Audit New Zealand and the OAG. The nature and extent of the interface varies depending on the nature of the audit engagement, the extent of issues identified and the consideration of reporting matters. For example, the audit of the Council's annual report is performed in accordance with the methodology developed by Audit New Zealand. In contrast, the methodology and approach to the audit of the Council's planning documents is determined by the OAG. Further, significant issues that may have an impact on the report issued by the auditor require discussion and consideration by the OAG before the report is finalised. These interfaces influence where responsibility for key decisions in the planning and performance of the audit ultimately rest.
91. This section begins by briefly outlining:
- the statutory requirements for preparing and auditing local authority accountability documents; each of the Council's accountability documents (LTCCPs for 2006, 2009; the Long Term Plan for 2012; Annual Reports and Annual Plans for 2003-2012);

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<sup>7</sup> All three auditors, appointed by the Auditor-General to perform the audit of the Council's annual report and planning document, were employees of Audit New Zealand. Each auditor used the staff and resources of Audit New Zealand (collectively the audit team) to carry out the audit. The audit, and the audit work performed, was subject to Audit New Zealand's quality control processes and procedures. Overall responsibility for the performance of the audit rests with the appointed auditor.

- the basis for appointing the Auditor-General as the auditor of all public entities, and the expectations for the audit of public entities;
  - the role and purpose of an audit;
  - the intended scope and objectives of each audit engagement; and
  - any other factors directly relevant to understanding the expectations or obligations on the auditor, or on the performance of the audit.
92. I also describe the basis on which Audit New Zealand discharges its obligations as the Council's auditor and the auditing, assurance and professional standards that the auditor must follow in planning and performing the audit. Collectively, these standards form the essential criteria, or benchmarks, against which I go on to assess Audit New Zealand's performance in Sections 4.1- 4.6.

### ***Statutory requirements for preparing and auditing local authority accountability documents***

93. The Local Government Act 2002 (the Act) requires local authorities to prepare and adopt certain key accountability documents, and requires some to be independently audited by the Auditor-General.
94. Of direct relevance to this review is the requirement for councils to prepare:
- ***Annual reports*** – under section 98, a local authority must prepare an annual report in respect of each financial year. The report must contain the information required by Part 3 of Schedule 10 of the Act. Section 99 requires that the annual report also contain the Auditor-General's report on certain information, including the local authority's financial statements for that year.
  - ***Long-term plans (LTCCPs and LTPs)*** – under section 93, a local authority must prepare and adopt a long-term plan that covers at least 10 consecutive financial years and includes the information required by Part 1 of Schedule 10 of the Act. Section 94 requires that the long-term plan also contain a report from the Auditor-General that specifically addresses the matters set out in section 94(1) of the Act.
  - ***Annual plans*** – under section 95, a local authority must prepare and adopt an annual plan for each financial year and include the information required by Part 2 of Schedule 10 of the Act. There is no requirement that the annual plan be audited.

### ***The role of the Auditor-General***

95. In accordance with the Public Audit Act 2001, the Auditor-General is the auditor of all "public entities", including local authorities such as the Kaipara District Council. The Auditor-General appoints Audit New Zealand – a separate business unit accountable to the Auditor-General – and private sector audit firms to plan, conduct and report on the financial statements of public entities and undertake other auditing functions required by the Public Audit Act. Collectively, Audit New Zealand and the private sector firms who perform audit and assurance engagements on the Auditor General's behalf are referred to as *audit service providers*.



96. As the organisational diagram shows, the Office of the Auditor-General (the OAG) sits alongside Audit New Zealand. Its role is critical to the separation of governance and accountability between the Auditor-General and the audit service providers. The OAG's responsibilities include planning the Auditor-General's work; setting auditing standards; allocating audits to appointed auditors; overseeing auditors' performance; carrying out performance audits; undertaking special studies and inquiries; and advising and reporting to Parliament.
97. The OAG directly influences how audit service providers perform audit and assurance services in several ways – by planning the Auditor-General's work, by developing and setting auditing standards, and by overseeing auditors' performance. Thus, the OAG's discharge of its responsibilities – in so far as they impinge on the audit of local government accountability documents – are directly relevant to my review, even though my terms of reference do not require me to consider the activities and functions of either the OAG or of Audit New Zealand. My decision to do so is based on two reasons:
98. Assessing whether an auditor has adequately planned and performed an audit requires a clear understanding of the professional and ethical standards that have influenced the audit and the auditor's behaviour. These are set out, in part, in the auditing and assurance standards developed by the OAG.
99. The OAG has been responsible for the methodology and approach used in auditing local authorities' LTCCPs and LTPs since audits of these planning documents became mandatory. Audit New Zealand is responsible for implementing that methodology, and ensuring its expectations and requirements are met, when it plans and performs any audit engagement. Audit New Zealand must also be aware of any other wider mandated expectations relevant to the Auditor-General's role and function.<sup>8</sup>
100. Therefore, while the terms of reference for this review do not require me to consider the activities and functions of either the OAG or Audit New Zealand, it seems critical to provide a clear picture how both organisations discharged their respective roles and responsibilities in the overall planning and performance of the Council's audits. It is also essential to see how and where expectations of audit performance were established, and how the reporting of audit results and findings were managed and dealt with.

### ***The purpose of an audit***

101. In broad terms, the purpose of an audit is to enhance the degree of confidence intended users can have in considering a matter of accountability (such as, the preparation of a long-term planning document for consultation, the annual financial statements or the requirement to comply with applicable laws and regulations) that is the responsibility of another party (usually expressed in terms of the responsibilities or obligations of

<sup>8</sup> As set out in, or derived from, the Public Audit Act 2001.

management and/or the governing body of an organisation). The confidence with which intended users regard the auditor's work and their audit opinion depends on the independence, objectivity and competence of the auditor and their ability to perform a high-quality audit.

102. Thus, in the context of local authorities, the Local Government Act requires every council to prepare an annual report at the end of each financial year. One of the stated purposes of the annual report is "*to promote the local authority's accountability to the community for the decisions made throughout the year by the local authority*"<sup>9</sup>. The purpose of auditing the annual report is to enhance the degree of confidence that ratepayers (and other intended users) can have in the information prepared and reported by the council. That information may include the results of the council's operations, its service performance in that financial year, and whether it has complied with the requirements of Schedule 10 of the LGA.
103. In conducting an audit, the auditor's overall objective is to obtain reasonable assurance that the document (or other matter of accountability) is free from any material misstatement. Where appropriate, the auditor will also seek assurance that the document is presented in a manner consistent with a recognised or prescribed framework for reporting. Such frameworks may cover compliance, preparation, presentation and/or reporting. The auditor achieves these objectives by obtaining sufficient, appropriate audit evidence – all information and explanations that the auditor considers necessary. On the basis of this evidence, the auditor expresses an opinion on the document or other matter of accountability. This is the benchmark that the audit must meet.
104. The concept of *reasonable assurance* – an important consideration for both the auditor and intended users – must not be misinterpreted. *Reasonable assurance* is considered to be a high level of assurance. It is reached only when the auditor has obtained sufficient appropriate audit evidence to reduce to an acceptably low level any audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the document or other matter of accountability is materially misstated). A *material misstatement* generally occurs when an annual report omits, or contains differences in, amounts or disclosures, and these differences or omissions would affect the intended users' overall understanding of the report. Auditors must exercise significant professional judgment to determine whether a material misstatement has been made.
105. Importantly, *reasonable assurance* does not mean an absolute level of assurance. The auditor does not necessarily examine every transaction or record in order to be 'reasonably assured'. The auditor does not provide a guarantee of the absolute accuracy of the information set out in the document or other matter of accountability. Nor does an auditor discover or prevent all instances of fraud or non-compliance with legislative requirements. Finally, an audit is not a guarantee of a council's future viability.
106. In planning and performing an audit, the auditor understands these inherent limitations. It is recognised that most of the audit evidence from which the auditor draws conclusions and bases their opinion is persuasive rather than conclusive.
107. Consequently, there is an unavoidable risk that some material misstatements or non-compliance may remain undetected when auditing a matter of accountability. Notwithstanding, intended users have the right to expect that the auditor will plan and perform a high-quality audit to ensure that the overall objectives of the audit are satisfied.

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<sup>9</sup> Section 98 (2) (b) of the Local Government Act 2002.



108. When planning and performing audits of a council's annual report and planning documents, Audit New Zealand prepares and issues an Audit Engagement Letter (AEL) as required by the auditing standards. The AEL is addressed to the mayor as a representative of the council's governing body. It clearly outlines the purpose or objective of the audit, and states what intended users may expect of the auditor and from the performance of the audit engagement. The AEL also identifies the respective roles and responsibilities of council management and the auditor – both in preparing the annual report or planning document, and performing the audit. The AEL is thus an important means of managing the potential risk of an audit expectation gap.
109. I am satisfied that Audit New Zealand has effectively communicated the audit objectives and responsibilities in every audit engagement. The AEL sufficiently and appropriately addresses those matters required to be covered by the OAG's auditing standards.

### *The scope of specific audit engagements*

110. As outlined above, Audit New Zealand was appointed by the Auditor-General to independently audit the Kaipara District Council's annual report and planning documents. There is no legislative requirement for Audit New Zealand to audit any council's annual plan and so it was not appointed to do so. However, the auditor generally reviews and considers councils' annual plans when auditing their annual reports.
111. The scope and objectives of an audit of a council's annual report differ from those of a planning document. Accordingly, the work that the auditor must perform to obtain a reasonable level of assurance, the opinion the auditor expresses, and the degree to which that opinion can be relied on all differ also. It is important to understand these differences in scope when assessing the sufficiency and appropriateness of the auditor's work.

### *Annual reports*

112. The audit's scope includes the council's financial statements, group of activity statements, and the council's compliance with the requirements of Schedule 10 of the Act applying to annual reports. The auditor's report must provide an opinion on whether:
- the council's financial statements comply with generally accepted accounting practice in New Zealand, and fairly reflect both the council's financial position at balance date and the financial performance and cash flows for the financial year;
  - the council's group of activity statements comply with generally accepted accounting practice in New Zealand, and fairly reflect the levels of service for the financial year; and
  - the council has complied with the requirements of Schedule 10 of the Act that apply to the annual report

### *Long-term plans and Long-term Council Community Plans*

113. Unlike an audit of the annual report, the Act specifies the scope of the auditor's report on the long-term plan. Section 94(1) requires the auditor to report on:
- the extent to which the council has complied with the requirements of the Act in respect of the long-term plan; and

- the quality of the information and assumptions underlying the forecast information in the long-term plan.
114. Importantly, section 94(3) of the Act clarifies that the audit of the long-term plan must not comment of the merits of the plan's policy content.
115. These statutory requirements apply to both the preparation and consultation of the initial planning document, and any subsequent amendments of a council's long-term plan.
116. Significantly, the above requirements were set out in the 2010 amendment to the Act.<sup>10</sup> In the context of this review, they therefore apply only to the audit of the Kaipara District Council's 2012-2022 long-term plan. Earlier audits were subject to the pre-2010 requirement for the auditor to report on:
- the extent to which a council has complied with the requirements of the Act in respect of the long-term council community plan;
  - the quality of the information and assumptions underlying the forecast information in the long-term council community plan; and
  - the extent to which the forecast information and proposed performance measures in the long-term council community plan provide an appropriate framework for the meaningful assessment of the actual levels of service provision.

#### *Annual plans*

117. As already noted, there is no requirement for Audit New Zealand to audit councils' annual plans. However, my review considers and assesses whether the auditor has met and satisfied the objectives of the audit, as specified above.

#### ***Other factors relevant to audits of council's annual report and planning documents***

118. Other factors which may influence the scope, planning and performance of audits, and expectations of the auditor's performance, include the following:

#### *Auditing standards*

119. Audits of public entities are conducted in accordance with auditing standards that the Auditor-General issues and publishes (by way of a report to Parliament). These standards are based on those issued by the New Zealand Auditing and Assurance Standards Board (NZAuASB),<sup>11</sup> which are in turn based on equivalent international standards. The Auditor-General adds to, or amends, the NZAuASB's standards to take account of the particular scope and nature of public entity audits, and may develop separate standards when there is no equivalent NZAuASB standard.
120. Intended audit users can have confidence in the fact that the Auditor-General's standards outline appropriate benchmarks and expectations for auditors performing the audit of public entities.
121. This review specifically considers the auditing standards applicable to each audit engagement. Reflecting my terms of reference, I have focused particularly on standards

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<sup>10</sup> Local Government Act 2002 Amendment Act 2010 (2010 No 124).

<sup>11</sup> Prior to 1 July 2011 auditing standards were developed and issued by the New Zealand Institute of Chartered Accountants.



relating to documentation, the consideration of laws and regulations, knowledge of the audit environment, risk assessments and internal control. I have also examined the specific standards dealing with reporting and communication to councils.

*Obligation to advise the OAG about problems of performance, waste and probity*

122. While performing an audit of a public entity, the auditor is expected to keep in mind the Auditor-General's overall role and concerns. These derive from the Public Audit Act 2001 and reflect public and parliamentary expectations of the Auditor-General as they have emerged over time.
123. In particular, the auditor must be alert to any potential problems with a public entity's performance, authority, waste and probity. If a significant problem is identified or suspected, the auditor is obliged to consult with, or refer the matter to, the OAG.
124. This expectation sits alongside the auditor's primary responsibility to plan and perform the audit. While detecting performance, authority, waste and probity issues is not the primary aim of auditing a public entity's financial statements, they are important considerations the auditor is expected to remain alert to. Standards and guidance are provided in the *Auditor-General's Auditing Standard 3: The Auditor's Approach to Issues of Performance, Waste and Probity* (AG-3).
125. In this review, I consider whether the auditor was (or should have been) aware of, matters relating to performance, waste and probity at the Kaipara District Council. I also examine whether those matters were dealt with in accordance with the expectations set out in AG-3.

*Quality control and quality assurance*

126. Audits performed by Audit New Zealand must be conducted within an overall quality control framework or system which applies both at an overall firm level (where a private sector audit firm has been appointed to perform an audit) and to each individual audit engagement. The Auditor-General's Statement on Quality Control establishes the benchmarks for quality control systems.
127. The terms of reference do not specifically require me to review Audit New Zealand's overall quality control system. However, I do so because aspects of that system and related policies are directly relevant to the supervision, oversight and peer review of the audits that fall within the scope of my review.

**Review methodology**

128. The focus of this review is the sufficiency and appropriateness of the work performed by the auditor. The terms of reference do not require me to independently review or audit the Kaipara District Council's annual report or planning documents. Rather, I base my observations and findings on the documentation and evidence provided in the audit files or other sources (such as the Rates Validation Bill before Parliament).
129. In summary, I have followed the following process in undertaking this review:

*Planning the review*

- Forming an understanding of the issues associated with the Council and the wastewater project.

- Clarifying the role, purpose and objectives of each audit engagement.
- Determining the audit performance expectations, benchmarks and standards applicable to the planning and performance of the particular audit engagement.
- Considering and assessing the methodology and approach used to plan and perform each audit engagement.
- Identifying key areas of focus – risk assessments, the auditor’s understanding of the entity/management control environment, legislative compliance etc.

#### *Conducting the review*

- Reviewing audit files and the documentation and evidence obtained by the auditors.
- Reviewing quality assurance reviews or reports.
- Holding discussions with auditors, relevant OAG staff and Audit New Zealand management.
- Considering and assessing the sufficiency and appropriateness of the audit files, audit evidence and the conclusions reached by the auditor.
- Identifying and confirming key issues and deficiencies.

#### *Preparing the review report*

- Drafting findings, conclusions, observations and recommendations.
- Consulting with Audit New Zealand.

#### *Completing the review report*

- Finalising and publishing the completed document.

### ***Note on the OAG’s quality assurance review of Audit New Zealand’s work***

130. In preparing for this review, I was keen to fully understand the background to the broader OAG inquiry and also the potential implications of reported issues or irregularities relating to the wastewater project. By any measure, the wastewater project was clearly a major Council activity that was likely to significantly impact the annual report, the planning of audits, and the identification of risks. Moreover, the project’s considerable financial implications would have triggered a high level of community interest that the auditor would have been aware of. These factors should have alerted the auditor to their responsibilities under the OAG’s auditing standard that deals specifically with performance, authority, probity and waste. To better appreciate these contextual issues, I consulted several useful information sources including an independent quality assurance review of Audit New Zealand’s audit work on the wastewater project. The review, undertaken by the OAG’s Quality Assurance team, is narrower in scope than my own review: the OAG considered only the 2009 audit of the Council’s LTCCP, and the 2009 and 2010 annual report audits. Notwithstanding these limitations, in the course of my own review I have:

- considered all the analysis, findings and observations contained in the quality assurance review;

- independently confirmed the basis of those findings and observations by referring back to the audit files. I am satisfied that the OAG's Quality Assurance team reasonably formed its findings on the basis of the documentation and evidence in the audit files, set against the standards expected of the auditor;
  - considered Audit New Zealand's response to the findings of the quality assurance review (which Audit New Zealand largely accepted).
131. I am therefore confident that it is reasonable and appropriate for me to refer to the key observations and conclusions from the OAG's quality assurance review in making my own independent findings. The OAG review found that the auditor had an inadequate understanding of the wastewater project, and consequently –
- no audit risks associated with the wastewater project were identified;
  - the audit files fail to demonstrate that the auditor specifically focused on or tested the implications of the wastewater project;
  - no consideration was given by the auditor to the setting of rates required to fund the wastewater project.
132. Audit New Zealand concurred with the overall key findings, conceding that ... “the risks associated with the MEWS<sup>12</sup> project were not understood and that this impacted the testing and resulting judgements made in the 2009 LTCCP, and 2009 and 2010 annual audits.” However, for completeness, it is noted that Audit New Zealand did not fully agree with all the findings and observations made by the OAG's quality assurance team. Matters of disagreement were communicated to the OAG's quality assurance review team. I have reviewed and considered the matters identified in Audit New Zealand's response as part of my review.

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<sup>12</sup> Mangawhai EcoCare Wastewater Scheme.

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#### 4. KEY FINDINGS, OBSERVATIONS AND CONCLUSIONS FROM THE INDEPENDENT REVIEW

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133. The key findings, observations and conclusions from the review of the audits performed by Audit New Zealand are set out in the following sections of this report:

Section 4.1: Key Findings and Observations – Audit of the Council’s Annual Report

Section 4.2: Key Findings and Observations – Auditor’s Approach to Considering and Assessing the Council’s Compliance with Legislative Requirements

Section 4.3: Key Findings and Observations – Audit of the Council’s Long Term Council Community Plan (LTCCP) and Long Term Plan (LTP)

Section 4.4: Key Findings and Observations – Quality Control Systems, Processes and Procedures

Section 4.5: Key Findings and Observations – Auditing of Council’s Rates Revenue

Section 4.6: Key Findings and Observations – Audit Reporting, Conclusions and Communications

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## 4.1 KEY FINDINGS AND OBSERVATIONS – AUDIT OF THE COUNCIL’S ANNUAL REPORT

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### **Purpose and scope of the audit of the Council’s annual report:**

134. The terms of reference require me to assess Audit New Zealand’s audits of the Council’s annual report between 2003 and 2012.
135. The background section of this report outlines the basis, objectives and requirements for annual report audits. In broad terms, the auditor must determine whether:
- the Council’s *financial statements* comply with generally accepted New Zealand accounting practice, reflect the Council’s financial position at balance date, and reflect the financial performance and cash flows for the financial year;
  - the *group of activity statements* comply with generally accepted New Zealand accounting practice and fairly reflect the levels of service for the financial year; and
  - the Council has *complied with the requirements of Schedule 10 of the Local Government Act 2002*, to the extent they apply to the preparation and disclosure of information in the Council’s annual report.
136. Any assessment of audit planning and performance must reflect the scope and objectives for each audit.

### **Important contextual considerations**

137. In planning my review, I identified some important contextual matters that I needed to understand and respond to. They were likely to influence my review in several ways – how I would determine particular areas of focus, clarify benchmarks for measuring the adequacy of the auditor’s work at the time of the audit, ensure my review fits within the context of the broader OAG inquiry, and report my findings so as to meet the needs of a broad range of interested parties. These contextual considerations included:
- 137.1. *Impact of the extended period covered by the review* – This review encompasses 10 annual reporting cycles and the audit of 10 annual reports. It considers work undertaken by three different auditors, and a period in which there were several important changes to the underlying audit methodology and to auditing and professional standards. My review needed to acknowledge the benchmarks and expectations applying to the auditor, and the audit, at the time the audit was completed. Because my review extended over a considerable time period, I needed to focus on the documentation available on the audit files - it was vital I understood how the auditor exercised their judgment *at the time the audit was performed*, and appropriately manage any risk of hindsight.
- 137.2. *Matters relating to the auditor’s consideration of the wastewater project’s impact on the Council’s annual report* – Taking into account the scope of the OAG inquiry and the significant public interest in the wastewater project, it is appropriate to focus my review on the auditor’s work on that project – including the auditor’s planning, audit risk assessments and test procedures.

Without a doubt, the wastewater project was likely to have a significant impact on the Council's annual report at some stage during the period 2003-2012. But it is equally likely that the nature and extent of this impact would differ from year to year, and that the auditor's response would change accordingly – as would the auditor's assessment of risk associated with the project. My review examines these changes.

- 137.3. *The auditing of rates revenue* – With the *Kaipara District Council (Validation of Rates and Other Matters) Bill* currently before Parliament, and given that rates are such a significant component of the Council's financial statements, my review considers the auditor's work on rates. My findings on this matter appear separately in section 4.5 of this report, although I have integrated the key findings and observations into this section in order to provide a complete understanding and assessment of the work performed by the auditor on the Council's annual report.
- 137.4. *The need to ensure Council's compliance with laws and regulations* – Again, given the significance of this subject, my findings are reported separately in section 4.2 and referred to here where relevant.
- 137.5. *Matters to consider in assessing the sufficiency and appropriateness of audit work on the Council's annual reports* – In planning and performing my review I intend to address the following aspects of the audit process:
- Methodology and approach to the planning and performance of the audit;
  - The auditor's planning consideration, how they developed an understanding of the Council's activities and environment and the identification and assessment of key audit risks and areas of audit focus;
  - The identification, planning and performance of audit test procedures; and
  - Evaluating the impact of any issues or deficiencies in the planning and performance of the audit on whether the auditor has satisfied the objectives of the audit and, separately, on the audit opinion issued by the auditor.
- 137.6. *Audit quality and industry practice* – I am mindful that over the period of the review that the standards and benchmarks of what is reasonable and appropriate in the context of the planning and performance of the audit engagement has changed. In addition, Audit New Zealand has suggested to me that there has been a noticeable change in industry practice since 2003. They cite that expectations as to what was, or was not, sufficient by way of the standard of documentation to demonstrate compliance with the auditing standards, or as evidence of the professional judgement exercised by the auditor, has changed since 2003.

Without understating any of the findings and observations identified during this review I have found merit in the argument put forward by Audit New Zealand. Information from publicly available reports and documents from standard setting bodies, regulatory and oversight bodies, from the results of independent quality assurance reviews performed on Audit New Zealand's methodology and work practices as well as changes to the underlying methodology and guidance to auditors highlight a change in the expectations and standards that auditors were expected to demonstrate over time.

The challenge is to reconcile what may have been industry practice at a particular time with the underlying expectations set out in the auditing and professional standards. There is no *single verifiable body of evidence* to demonstrate what was considered to be industry practice at a point of time.

Over the period covered by the review there has been a noticeable improvement in audit quality, particularly around the practice of documentation and evidencing of work to support the conclusions reached by auditors. I intend to manage this issue through discussions with the auditor and by carefully considering the results of my review of individual files in relation to earlier and later files.

138. Because of these contextual considerations, I have chosen to organize my analysis and findings from the annual report audits in the following order of priority:
- First, where appropriate I have identified general findings and observations that apply broadly across all audits (2003-2012);
  - Second, I will identify key findings and observations that relate specifically to only one audit; and
  - Where it is not appropriate to apply either of the previous two categories then I intend to identify those findings and observations across the following cluster of audit engagements:
    - Audits performed during 2003 – 2005;
    - Audits performed during 2006 – 2009; and
    - Audits performed during 2010-2012.

### **The auditor's planning, understanding of Council operations and identification of audit risks: was it adequate?**

139. The starting point for my review of the work performed by the auditor on the Council's annual report is to understand and consider the nature and extent of the auditor's planning of the audit engagement, the key audit risks identified and the areas of audit focus identified by the auditor.
140. Auditing standards require the auditor to plan the audit so that it will be performed effectively. This usually involves developing an overall audit strategy and plan which identify, among other things, what the auditor considers to be the most significant areas of audit risk and focus. More broadly, the auditor's planning will include:
- an assessment of key issues affecting the Council's functions and activities;
  - an understanding of the Council's overall management control environment;
  - the identification and assessment of key audit risks, including risks of material misstatement of the annual report;
  - the auditor's response to past issues and deficiencies; and
  - the auditor's response to local government sector-wide issues, or OAG areas of focus.



141. In planning the annual report audit, the auditor must demonstrate a high level of understanding of the Council's business, operations and activities; adequately document the audit strategy and plan; and adequately document how they have exercised their professional judgment. The auditor is expected to design and implement audit procedures that respond to key audit risks or areas of focus.
142. I have reviewed each audit file in order to identify and assess how the auditor determined which matters were likely to be relevant and appropriate to the planning of the audit engagement. I have also considered whether the auditor has adequately responded to the identified audit risks by designing appropriate audit test procedures.
143. In the case of each audit planned during 2003-2012, the audit files demonstrate a methodical and structured approach to planning. The methodology, approach and matters that the auditor is required to consider are reasonable. The audit methodology requires the auditor to document, among other things:
- Their knowledge of the Council's business, operations and activities ;
  - Their assessment of the Council's management control environment – including its financial management environment and systems, service performance information systems, and systems for ensuring compliance with laws and regulations;
  - The key audit risks and areas of audit focus they have identified.

I found that each of the audit files was structured in a way that demonstrated that the auditor had considered and addressed these areas of focus.

144. This methodology is supported by guidance and checklists which help the auditor exercise their professional judgment or plan the audit engagement. There is evidence on each file that these checklists and procedural steps were completed. The auditor has brought together and documented the key planning considerations and risk assessments into an Audit Planning Memorandum (APM). Each APM has been reviewed and approved by the auditor.
145. Audit New Zealand's audit methodology was subject to independent quality assurance reviews by the New Zealand Institute of Chartered Accountants and the Australasian Council of Auditors-General. No significant adverse findings were identified.

### *General findings and observations*

146. In general, the documentation supporting the auditor's consideration of key planning matters and the identification of key audit risks or areas of audit focus is reasonably consistent, year on year. The APMs identify anything that might affect significant disclosures in the annual report.
147. For the 2003-2005 audits, the planning documentation shows the auditor has developed an audit strategy or plan that addresses risks and planning considerations (both Council- and sector-specific) relevant to the annual report. The wastewater project is identified as an area of focus. As a minimum, the auditor kept a watching brief on the project as it was not assessed as having a significant impact on the annual report at that time. Project management and asset management were key planning considerations. The files contain evidence of early ratepayer complaints about the wastewater project. There is evidence that these complaints were considered by both the OAG and auditor at the time that the complaints were raised.



148. For the 2006-2009 audits, the planning documentation considers general Council- or sector-wide risks/areas of focus. These include the Council's conversion to new IFRS accounting and financial reporting standards, transport and roading project funding, and general matters related to the annual report. While the auditor appears aware of the wastewater project's current stage of development, no significant areas of audit risk or focus are identified. It follows that the auditor would not have designed or performed any specific audit test procedures relating to the project.
149. For the 2010-2012 audits, the planning documentation largely supports the Council, sector and annual report risks identified by the auditor. Initial planning for the 2010 audit does not identify the wastewater project as a significant area of audit risk. The wastewater project had been completed, commercial acceptance had been agreed and the wastewater plant was now operational. There is evidence that the auditor reconsidered this initial risk assessment as the audit progressed and issues emerged with the project. Planning documentation for the 2011 and 2012 audit addresses key Council, sector and emerging issue risks and specifically addresses the wastewater project as a significant area of audit risk.
150. Overall, I am satisfied based on my review of the audit files that the auditor has identified general Council- or sector-wide matters that were relevant to the planning of the Council's annual report audit, or that were relevant to ensuring that the objectives of the audit would be satisfied. However, I am concerned that the planning documentation does not sufficiently or adequately identify the wastewater project as a significant area of audit risk or focus during the key period of development (2006 – 2009) until irregularities began emerging from 2010. While accepting that the auditor was generally aware of the progress of the project this has not been sufficiently translated into the auditor's planning of the audit engagement during this period. As a consequence, planning documentation fails to outline any specific audit testing other than general '*business as usual*' audit procedures that are conducted as part of the normal recognition and disclosure of items in the Council's financial statements.
151. The audit files indicate that the auditor planned their response to each key component of the annual report (such as cash and bank, rates etc) and assessed the characteristics and inherent risks associated with those components. In the absence of any significant issues or risks, what the auditor planned to perform is to be expected. In general, the audit approach and response is consistent year on year.
152. The way the auditor documented the basis for their planning considerations, and when and how they exercised their professional judgment – for example, when bringing forward planning matters from one audit to the next – varied significantly over the review period, to the point that I cannot determine with sufficient certainty whether all key planning issues and audit risks were identified. Until 2007, the documentation of key planning meetings also varied.
153. Of particular concern is the lack of documentation to demonstrate the auditor's understanding of the wastewater project and their professional judgment when assessing its likely impact on the Council's annual report. For example, between 2006 and 2009 – when the project could be expected to have had an increasingly significant impact on the Council's annual report – the auditor indicated that they were generally aware of project delays, changes to the scope of the project and cost escalations. However, the project was not identified as a significant planning consideration or area of focus. How the auditor

came to this decision, why no significant audit risks were identified and no audit test procedures developed are all insufficiently documented.

154. Audit New Zealand states that the documentation on the audit files is consistent with practice at the time, and also that evidence of planning decisions was effectively documented in the audit planning memorandum. Unfortunately, the insufficiency of the documentation makes it difficult to determine whether the auditor has sufficiently and appropriately taken into account all key planning considerations and risks. In particular, I found that there is insufficient documentation during the 2006 - 2009 period to indicate why the auditor did not consider the wastewater project to be a significant audit or planning risk, or area of audit focus. Contrary to the position taken by the auditor, Audit New Zealand agrees the wastewater project should have been a significant area of focus between 2006 and 2009 but acknowledges that it clearly was not.
155. These deficiencies in documentation are evident in other areas. For example, there is insufficient documentation to show the extent to which the auditor relied on matters considered in previous audits, why the auditor did not connect such matters from one audit to the next, or why the auditor considered such a matter was no longer a significant risk.
156. Auditors are entitled to rely on the results of work performed in previous audits, to the extent they remain relevant. Determining their relevance involves exercising professional judgement. Similarly, it is reasonable to expect issues identified in previous annual report audits, or during the audit of Council's planning documents, to be considered if they are also relevant to the current audit. Documentation provides evidence that the auditor has exercised professional judgment and scepticism.
157. Two matters stand out as particularly concerning. First, between 2003 and 2005, the wastewater project was recognised as a general planning consideration. In each of these audits the auditor completed a high level review of the project management. Given the current stage of the project, the work performed by the auditor is appropriate in order to sufficiently understand the impact of the wastewater project on the annual report at that time. However, my concern is that between 2006 and 2009, the wastewater project was not identified as a key planning consideration or audit risk, even though Audit New Zealand now concedes that it should have been. Discussions with the auditor suggest that they continued to rely on the project management assessment carried out in 2005 and on discussions with management. Unfortunately, the nature and extent of that reliance is insufficiently documented. Nor is there any documented evidence as to whether the auditor updated the original assessment to take account of new or changed circumstances and information.
158. The auditor's failure to consider the changing nature and impact of the wastewater project between 2006 and 2009 is in itself a significant deficiency in the planning and performance of the audit engagement. But the failure to sufficiently document the professional judgment exercised at the time further compounds it.
159. The second area of major concern relates to how the auditor connected, or failed to connect, issues identified in Council's planning document audits of 2006 and 2009 with the annual report audits.
160. As part of their audit work, the auditor reviewed the minutes from Council meetings (there was no specific Council audit committee) and has noted significant issues, discussions and decisions. The auditor identified several occasions when these Council

meetings considered aspects of the wastewater project. Matters that were relevant to the auditor's understanding of the Council's operations, or that may have had an impact on the Council's annual report audit, were documented on the audit file. The auditor's notes build up a picture of the changing nature of the wastewater project over time, and confirm that the Council was regularly updated on significant issues (including those affecting the funding of the project).

161. All this documentation and evidence on file suggests the auditor was, or should have been, fully aware of the changing potential audit risks relating to the project. However, there is insufficient documentation to show how the auditor took account of the changing nature of the project, its risk or impact on the annual report or the other matters identified in the course of planning and performing the audit. For example, it would be reasonable to expect that information given to the Council about the increasing cost of the project between 2006 and 2009 would prompt the auditor to consider whether this was a significant audit risk or potential area of audit focus. Yet while the audit files indicate the auditor did consider and take into account in the audit important matters like this when they were raised in the Council minutes, there is a lack of documentation showing *how* such matters were taken into account.
162. By 2010, the methodology and approach to planning the Council audit had been further enhanced, resulting in a more comprehensive and integrated approach to identifying audit risk and areas of audit focus. These enhancements took account of changes to the auditing standards that applied to the audit.
163. From 2011, the irregularities relating to the wastewater project and the setting and assessment of rates were beginning to be known. The auditor was aware of them when planning the 2011 and 2012 audits, and took account of them in the risk assessment. There is also evidence that Audit New Zealand was working with the OAG to respond to the irregularities. Now that the asset is operational, concerns about the management of the project are largely historical from an audit perspective. However, the auditor continues to consider and assess the risk associated with the capitalised value of the asset.

*What audit work was planned and performed on the Mangawhai Community Wastewater Project?*

164. From my discussions with the auditors and examination of the audit files, I have sought answers to the following questions:
  - What evidence or documentation is available on the audit file to demonstrate the auditor's understanding of the wastewater project, its impact on the Council and community and how the progress and development of the project impacted the Council's annual report?
  - How did the auditor's understanding of the project develop and change over time?
  - What assessment did the auditor make of the Council's overall project management?
  - What significant audit risks or areas of audit focus did the auditor identify and how were they addressed in the planning and performance of the audit?
  - What assessment did the auditor make of the project's impact on the Council's management control environment and on the preparation of the annual report?

- What specific audit work, or audit test procedures, did the auditor plan and perform during the development/construction period of and on the capitalization of the infrastructure asset in the Council's financial statements?
  - What issues, deficiencies or irregularities did the auditor identify and how were they communicated to the Council, intended users of the annual report and to the OAG?
165. As I have previously noted, by any measure the wastewater project was a significant undertaking for the Council. Its funding and financial implications were of significant public interest for the community. My discussions with the auditors, and examinations of the documentation and evidence available on the audit files, demonstrate that the auditor was generally aware of the project's progress and development.
166. In the context of this review, the most important aspects of the wastewater project include:
- 166.1. The project was of strategic long-term importance: it was a critical element of the Council's strategy for managing and sustaining future population/development growth in the region, and the resulting demands on the Council's core infrastructure assets.
  - 166.2. The project's scope, size and scale meant it had a significant impact on both the community and the Council's operations (including its obligations to engage and consult with the community, and the financial impact of the development cost on current and future ratepayers);
  - 166.3. The project's overall management and governance, including the method of procurement and funding, made it a significant and unique undertaking for the Council. It was not a normal 'business as usual' activity.
  - 166.4. The project significantly impacted the Council's funding and financial strategy in many ways – rates, development contributions and borrowings, the projected operating and capital expenditure requirements, and the Council's assets and liabilities.
  - 166.5. The impact of the funding and financial decisions associated with the project on the Council's overall financial strategy was significant. Those decisions would continue to constrain the Council's financial flexibility in the short to medium term. So significant were the funding implications that the Council needed to introduce a debt segmentation policy to allow the project to be funded within prudential borrowing limits. Moreover, the Council entered into highly complex financial instruments to manage the risk of fluctuating interest rates and development costs.
  - 166.6. Council decisions regarding the scope and financial implications of wastewater project were reliant on robust growth and planning assumptions. These assumptions underpin the financial forecasts and revenue projections. They also directly influence any assessment of the prudence of Council's financial strategy.
  - 166.7. The Council did not possess all of the necessary skills and experience to manage the wastewater project internally. It was therefore heavily reliant on external advice, project management and consultants. Effectively, utilising the skills and expertise of external advisors and consultants while maintaining appropriate governance oversight and control was a significant challenge for the Council.

- 166.8. The outsourcing of the development, project management and funding of the wastewater project was considered to be essential in order to effectively manage the Council's exposure to financial risk arising from cost and time overruns. Outsourcing the management of the project would also influence or affect the way that the project was accounted for in the Council's financial statements.
- 166.9. Between 2006 and 2009, multiple issues and developments arose that changed the project's impact on the Council. The auditor was, or should have been, aware of these emerging issues and the consequent changes in the project and financial risk – including the impact of updated forecasts, projections, timelines and financial planning assumptions that affected the project's overall cost and funding implications.
167. In my view, the auditor's understanding of the project was insufficient given its significance and scale, which should have alerted the auditor to matters of performance, waste, probity and authority. However, the extent to which this deficiency impacts the overall objective of the annual report audit – to obtain *reasonable assurance* – needs careful analysis. What is reasonable for the auditor to have addressed when planning and performing the audit must be considered relative to the potential impact or risk that the wastewater project would have for the annual report. It is accepted that the auditor did not need to completely understand every detailed aspect of the project. But they needed to have a sufficient understanding to recognize its impact on the annual report and respond appropriately – such as understanding the appropriate accounting treatment during and after construction or understanding the impact of funding decisions on the Council's financial statements.
168. From the available evidence and documentation, I consider that the auditor did not have a sufficient and complete understanding of the wastewater project in order to effectively plan and perform the audit engagement. For example, I have found that in 2006-2009, the auditor did not identify any key audit risks associated with the project. Nor did the auditor adequately consider whether the accounting treatment of the project was correct or whether the impact of changes to the size and scope of the project posed any significant issues for the funding of the project or on Council's overall financial strategy.
169. The following summarises my key findings and observations for each cluster of audits:
- 2003 – 2005*
- 169.1. Discussions with the auditor(s) suggest that the auditor(s) had a reasonable background understanding of the needs and drivers behind the wastewater project, and was also aware of issues with contract negotiations, potential contractors etc. Unfortunately, the audit files do not sufficiently document much of this understanding, nor the professional judgment exercised by the auditor(s) at the time. This means that it is not possible to fully assess the extent to which their background knowledge informed the planning of each audit engagement. However, given the project's stage of development, it was unlikely to have significantly impacted the annual report at that time. In my view, the general understanding developed/obtained by the auditor(s) at that time was considered sufficient to assess the impact of the wastewater project on the annual report and therefore to effectively plan and perform the audit engagement.
- 169.2. Planning documentation identifies the wastewater project as an area of emphasis, reflecting the significance of the project for the Council.



- 169.3. Between 2003 - 2005, the auditor performed an annual review and assessment of the overall management of the wastewater project. The work was undertaken as part of the auditor's consideration of the Council's management control environment, and with the aim of forming a high-level understanding of the Council's structures, systems and processes around the project. The assessment involved enquiry and discussion with key management (the Council's asset manager and finance manager). Insufficient documentation means I cannot determine how far the auditor's assessment extended or whether the matters discussed with the Council were explored further.
- 169.4. In the course of this work, the auditor appears to have identified the critical background reports used when the project was being set up, the nature and extent of community consultation to that point, risk management and the role of the project manager. These reports are not contained on the audit file but referred to by the auditor where appropriate.
- 169.5. The auditor considered that the Council had in place appropriate structures, systems and processes to manage the project.
- 169.6. In my view, the auditor's assessment was not sufficient to support the specific conclusion reached in terms of the overall project management of the wastewater project. Further, it was too narrow to allow the auditor to assess the overall control and management of the project or to consider its impact on the Council's operations.
- 169.7. Notwithstanding my view on this matter, the work completed was sufficient for the auditor to plan and perform the 2003 – 2005 audits, as the project was not then considered to have a material or significant impact on the annual report. However the review seems to have been intended as a broad assessment of the project management, and was not tightly focused on the annual report implications. The auditor's conclusion appears to support this.
- 169.8. In response, Audit New Zealand asserts that the review was undertaken so that an audit opinion could be expressed. It was not intended to be a comprehensive review of the project's management. It is correct that the review was planned as part of the 2003 – 2005 annual report audits. However, the work completed does not appear to be directly connected with assertions in the annual report. The auditor makes general conclusions or observations that the Council's decision to outsource the project is indicative of the Council's strategy to effectively manage risk. In general, it is difficult to determine from the documentation how the conclusions reached connect with the auditor's planning of the audit or the identification of audit risks.
- 169.9. It is noticeable that the auditor's annual review of the project between 2003 - 2005 was narrowly focused and did not specifically consider a range of matters that would be relevant to a complete understanding of the impact of the wastewater project on the Council's annual report:
- The effectiveness of the Council's overall governance and control of the wastewater project;
  - The effectiveness of the external developer's project management;

- Council's overall risk management strategy, framework and risk identification. The auditor's consideration of whether it was appropriate for the Council to outsource the project to manage its financial risk was too narrow;
- The project's funding and financial implications;
- The robustness or quality of project budgets and financial projections;
- The project's impact on the Council's funding and financial policies and financial strategy; and
- The appropriate accounting treatment for the project given the nature of the project management contract or approach.

I have queried this with Audit New Zealand who advise that any work completed at the time of the 2005 audit would only ever have been a preliminary assessment, given the early stages of the project and as a new contract was signed post-balance date, and was therefore still subject to change at the time of the audit. Audit New Zealand suggests that much of the information required to undertake a comprehensive assessment of the matters identified above did not exist at the time of the 2003 – 2005 audits – as the contract was not signed until October 2005.

Between 2006 – 2009, Audit New Zealand agrees that the assessment should have been updated subsequently to reflect the different stages of the wastewater project once the final contract had been signed. I concur with Audit New Zealand's general position on this matter. However, I remain concerned over the sufficiency of documentation on the file to support this. In my view, there is insufficient documentation on the file to indicate whether the work performed by the auditor was a preliminary assessment only. Second, in the context of the work performed, if in the auditor's professional judgement the matters identified above were not matters that needed to be acted upon until after the contract was signed then it is reasonable to expect that this judgement would be documented. Third, with respect to the auditor's consideration of the governance and oversight arrangements that the Council had in place, in my view, these are equally relevant to both the Council's planning and set up of the project (pre-contract signing) and during the period of development or construction (post-contract signing) and therefore were matters that should have been considered by the auditor and documented on the file. Notwithstanding these limitations, I accept Audit New Zealand's assertion that, based on the current stage of development, this would not have influenced the auditor's planning and performance of the audit.

### 2006 - 2009

169.10. The documentation available on the audit files for this period is deficient in *multiple ways*. It provides insufficient evidence that the auditor:

- identified any audit risks associated with the project or carried out any specific audit test procedures to assess the project and its impact on the Council's annual report;

- was aware of the significant changes in the project's nature, scope and financial implications that occurred over this period – nor that the auditor properly considered how these changes would affect the Council's annual report;
  - updated the 2005 (preliminary) assessment of the project at any point. As I have noted, the auditor acknowledges relying on that assessment during the 2006-2009 audits, but this too is insufficiently documented.
  - integrated their assessments and conclusions from the 2006 and 2009 planning document audits into the planning and performance of the 2006-2009 annual report audits.
- 169.11. In this review, I have specifically considered irregularities in the setting and assessment of rates, including those used to fund the wastewater project. A separate analysis of these findings is set out in section 4.5.
- 169.12. In this period, the auditor did not identify any significant audit risks associated with the wastewater project. Thus, no detailed audit work or test procedures were ever performed on the project at this time, despite its implications for the annual report. If the project's financial/transactional impact was considered during a particular audit, it was as part of the general audit test procedures performed on key components of the annual report (eg ongoing expenditure).
- 169.13. The auditor continued to rely on the 2005 preliminary project management assessment during the planning and performance of the 2006-2009 audits. Audit New Zealand suggests the 2003 - 2005 reviews were a preliminary assessment only and were appropriate in the context of the stage of development at that time. Given the significance of the wastewater project, the auditor should have reviewed, updated and reassessed that preliminary assessment (including consideration of the matters set out in paragraph 169.9) during 2006-2009, as the project progressed and once the final contract position had been established. There is no evidence that the auditor ever did so.
- 169.14. Financial projections show that the cost of the project significantly increased over the 2006 – 2009 period. While the auditor appears aware of the escalating cost there is no evidence or documentation to indicate that the auditor was concerned or saw this as a risk to the Council, its financial strategy or sufficiently understood the impact on the Council's annual report. In 2006 the project cost increased from \$17.5m to \$26m when the new contract was entered into and then to \$35m in the LTCCP – (the final construction payment to Mangawhai Development Holdings Ltd (MDHL) in July 2009 was \$45.756m and the carrying value of the entire asset at 30 June 2010 was \$51.418m). As the method of procurement, funding implications and accounting treatment would have had major impact on the annual report, the wastewater project should have been a significant area of focus for the auditor in 2006- 2009. This was confirmed in the 2012 OAG quality assurance review, which found the risks associated with the project were not understood, adversely affecting the testing and resulting judgments made in the 2009 LTCCP, 2009 and 2010 annual audits. Audit New Zealand concurred with the OAG's finding.
- 169.15. Because of the deficiencies in the planning and performance of the audit that I have outlined, the auditor failed to plan for, detect or appropriately consider



numerous potentially material deficiencies in the Council's 2006 – 2009 annual reports, including:

- accounting and disclosure of the Council's contractual capital commitments related to the wastewater project were not adequately shown in the financial statements;
- accounting treatment of the asset during construction and development, and related disclosures, were not consistent with generally accepted accounting practice;
- on completion, the wastewater project was not capitalised in accordance with generally accepted accounting practice; and
- the basis on which the Council set and assessed the targeted rates for the wastewater project did not comply with the provisions of the LGRA.

169.16. In several of these areas, the Council amended the financial statements, or included additional disclosure about adjustments to comparative information to correct the original errors/omissions in previous financial statements. But every error or omission the Council made in preparing the annual report raises questions about whether the auditor issued the correct audit opinion.

#### *2010– 2012*

169.17. By 2010, the wastewater project was complete and fully operational. Between 2010 and 2012, the auditor became aware of deficiencies in the way the annual report and planning documents recognised or accounted for the project and the resulting asset. The auditor adequately considered these matters when planning and performing the audit of the 2010-2012 annual reports and planning documents. The auditor's assessment of the impact of deficiencies, now identified on the auditor's opinion, are supported by the documentation on file.

169.18. Initial planning for the 2010 audit identified certain business or audit risks associated with the project, concurrent with the handover of responsibilities from the previous auditor. No significant risks or planning issues were identified, although it is recognised that this initial assessment was based on the transfer/handover of information from the previous auditor. The incoming auditor updated their initial assessment as the audit progressed and irregularities relating to the project, and to the setting and assessment of rates, started to emerge.

169.19. Documentation on the 2011 and 2012 audit files shows the auditor was aware of the emerging issues related to the accounting treatment and funding of the wastewater project. The evidence indicates the auditor addressed and responded to these issues appropriately. For both audits, the audit report issued is unqualified but provides additional disclosure of issues related to the wastewater project, the setting of rates and the future financial viability of the Council. The audit report draws users' attention to management's disclosure of these issues in the annual report.

169.20. Deficiencies in the accounting for the wastewater project in 2009 had a carry-over impact into 2010. In particular, the wastewater asset balances had not been correctly capitalised in accordance with generally accepted accounting practice.

- 169.21. Between 2010 and 2012 there is evidence of increasing communication between Audit New Zealand and the OAG over the emerging issues and irregularities. The opinion the auditor needed to issue was the subject of detailed consideration and discussion.

*The auditor's consideration and assessment of the management control environment*

170. In planning the audit engagement the auditor is required to consider and assess the Council's control environment. The overall objectives of the control environment assessment are to assist the auditor in:
- Identifying key audit risks or areas of audit focus that need to be addressed during the audit; and
  - Effectively planning the approach to the audit to ensure that the overall objectives of the audit are satisfied.
171. In assessing the effectiveness of key aspects of the control environment, the auditor is not aiming to provide separate assurance over the entire Council-wide control environment. However, the auditor's assessment directly contributes to the identification of audit risks and areas to be focused on during the audit. It also influences the design of audit test procedures. Carrying out a control environment assessment involves exercising a high degree of professional judgment. It also requires the auditor to have a sound understanding of the Council's operations and activities. An incorrect or inappropriate assessment may result in the auditor failing to identify key audit risks or failing to plan an audit approach to something that should be a key area of focus.
172. In reviewing the auditor's work in this area, I was interested in both the breadth and depth of the auditor's understanding and assessment. I also wanted to understand the auditor's assessment of those aspects of the control environment that would have subsequently been considered when the auditor planned their audit approach to the wastewater project – for example, the auditor's consideration of the Council's planning and budgeting, risk management, performance monitoring etc. All these are matters which the auditor would consider when determining the appropriate audit approach.
173. The audit files demonstrate that the auditor assessed the Council's control environment at an overall entity level and at the "significant underlying system level". At an overall entity level the auditor considered the following components of the control environment:
- Control culture and values
  - Organisation and governance structures
  - Planning and budgeting
  - Performance monitoring
  - Compliance with laws and regulation
  - Impact of external influences
  - Other matters of relevance
174. Between 2003 and 2005, the auditor supplemented their assessment by looking at and considering the following additional control environment components – contract

tendering and management, capital project management, reporting and communications and HR policies and practices.

175. In general, I am satisfied that these aspects were considered in a way that supported the planning of the annual report audit and the identification of key audit risk/areas of audit focus. However, as I go on to discuss, I question whether the auditor's consideration of the planning, budgeting and performance monitoring aspects was sufficiently broad to allow a proper assessment of the Council's financial management and governance.
176. The following summarises my key findings and observations for each cluster of audits:

*2003 – 2005*

- 176.1. Between 2003 and 2005, the auditor assessed the control environment as good or effective. This assessment is captured in the planning memorandum and the auditor's approach/response is outlined in the risk analysis form.
- 176.2. The auditor completed a separate assessment of the Council's project management control environment by specifically considering the wastewater project. This assessment found that, in the auditor's assessment, the Council had appropriate structures, systems and processes to manage the wastewater project.

An assessment was made every year between 2003 and 2005. It remained largely unchanged from year to year, even though the auditor noted that it had been updated/discussed with management. The documentation indicates high level consideration only of aspects of the project management, largely by way of enquiry or discussion. In the context of forming a view on the overall control environment this high level approach is not unreasonable. However, the auditor did not perform a comprehensive assessment, or try to validate whether the processes, systems and structures were in fact operating effectively as described. Nonetheless, the auditor formed a conclusion that they were in fact effective. Audit New Zealand has indicated that this did not affect the planning of the audit, given the current state of the project and the fact that it would not have significantly impacted the annual report at that time. I am inclined to concur with this assessment, while still noting my concerns about documentation – especially the auditor's documentation of their overall conclusion or assessment.

- 176.3. There are aspects of the completed assessment where the auditor drew conclusions about aspects of the control environment. In doing so, the auditor exercised professional judgment. However, there is insufficient documentation to demonstrate how certain conclusions were reached. For example, the auditor comments that no instances of management override have been noted, but provides no further documentation to support this conclusion nor how it was reached. Similarly, it is difficult to determine how broadly the auditor considered key aspects of the control environment – for example, the auditor cites the Council's decision to outsource the wastewater project to support their view that the Council is risk averse.
- 176.4. I have separately considered and addressed the issue of documentation on the audit files between 2003 and 2005. I have accepted Audit New Zealand's position that the sufficiency of the documentation was reasonable in respect of practice at that time. However, the fact remains that, as an independent reviewer, I have found it difficult to ascertain from the documentation on the audit file the

completeness and sufficiency of the auditor's understanding of key aspects of the control environment that resulted in an overall assessment of 'good/effective'. What is documented on the checklist indicates a narrow assessment was made in a number of areas.

- 176.5. In general, audit files demonstrate an integration between the control environment assessment, the identification of audit risks or areas of audit focus, and the planned audit response. The auditor's assessment of the control environment supports the planning and performance of audit test procedures that were reasonable for an annual report audit during this period.

#### *2006 – 2009*

- 176.6. Between 2006 and 2009, the auditor also assessed the control environment as good or effective. This was captured in the planning memorandum, along with the auditor's planned audit approach to further testing or assessing the Council's control systems. The auditor generally completed their assessment following discussions with Council management.
- 176.7. From 2006, the auditor's assessment was narrower than in the previous cluster of audits. There was no separate or detailed assessment of the Council's project management. There is no documentation or evidence on file indicating that the auditor specifically looked at the wastewater project in the context of the Council's overall control environment at any stage between 2006 and 2009. This is in contrast to each of the previous three years' assessments.
- 176.8. In discussions with the auditor, I was told that they continued to place reliance on the previous 2005 assessment. However there is no documentation on the audit file showing the nature and extent of their reliance, nor why an assessment made in 2005 continued to be relevant in each subsequent audit. It would also be reasonable to question whether the assessment made in 2005 was relevant and appropriate for the 2006-2009 period given the project's changing nature, scope and risk management over this period. It is noteworthy that the 2006 risk assessment form refers to completing a project management assessment, yet there is no documentation on file to indicate that this was completed. Similarly, the 2006 planning memorandum notes the wastewater project as a significant project but says in the auditor's judgment that there are no concerns about how the Council is handling it. But when I reviewed the audit files, I could find no documentation showing how the auditor exercised their judgment in forming this conclusion.
- 176.9. In the design of the audit approach, the control environment assessment was integrated and linked with other planning considerations. This is detailed in the planning memorandum.
- 176.10. The auditor's assessment of the management control environment includes a number of qualitative assessments. They relate particularly to the robustness of Council's budgeting and reporting, and to the competence, attitude and experience of staff. In 2008 the auditor completed an 'entities at risk' assessment, including qualitative assessments of the competency and knowledge of management. Again, due to an absence of sufficient documentation on file, it is not possible for me to assess the sufficiency and appropriateness of the matters the auditor took into account in reaching such conclusions.

- 176.11. In reviewing the assessments completed between 2006-2009, I found little change year-to-year in the auditor's assessment. Nor did the matters documented when forming this judgment change significantly in nature or extent.
- 176.12. Between 2008 and 2009, the documentation shows planning meetings took place involving the Council and the auditor, and the audit team. There is no indication that the wastewater project was identified as a matter of concern or an area of audit risk/focus at these meetings.
- 176.13. Also between 2008 and 2009, the auditor noted that their assessment of the Council's budgeting process relied on work performed as part of the LTCCP audit (which, in the case of the 2008 audit, was performed in 2006). This assessment was integral to the auditor deciding whether meaningful analytical review of budget-actual could be conducted. However, there is insufficient documentation to demonstrate that the auditor had sufficiently considered whether the 2008 budgeting processes continued to operate as effectively as had been assessed in the 2006 LTCCP audit. Further, there is insufficient documentation to demonstrate how the auditor determined the relevance of the budgeting process for the 2009-2019 LTCCP to the budgets set for the 2009 audit.
- 176.14. The auditor's 2009 assessment of the management control environment noted that instances of fraud had been detected during the 2008 period. However, the documentation detailing the auditor's discussions with the Chief Executive indicates no frauds. I found these conflicting statements difficult to reconcile. The documentation on file indicates that the auditor considered the nature of the frauds committed, and the quality of the control systems, before determining that those systems could continue to be relied upon.

#### *2010 - 2012*

- 176.15. Between 2010 and 2012, the auditor's assessment of the Council's control environment was significantly more far-reaching than in 2006-2009. The nature and extent of the documentation supporting the auditor's assessment is also significantly greater, and the auditor has more thoroughly recorded the basis on which they exercised their judgment.
- 176.16. In 2010, the auditor assessed the management control environment as effective. The reasons and rationale for this assessment are more extensively documented than in any of the previous audits. The auditor has relied on the work completed on budgeting and monitoring as part of the 2009 LTCCP audit, integrating this into the assessment. Acceptance and continuance assessments start to identify the emergence of issues and risks within the Council, and the documentation shows the auditor is considering how best to respond to these. The auditor identifies the wastewater project as needing consideration, given the significant debt that the Council has taken on. Other planning documents point to the emergence of financial and funding issues – a slow-down of development contribution revenues, treatment of Ministry of Health subsidies etc. Overall, I found that the linkages between the entity- and activity-level assessments were sufficient for the auditor to effectively plan the audit, and to identify areas of audit risk and focus.
- 176.17. In approaching the 2011 audit, the auditor initially assumed that the entity-level control environment would be effective. The auditor subsequently decided to undertake a comprehensive reassessment of the management control

environment, on the basis of significant issues and concerns emerging around the Council's management, governance and financial management practices: this is extensively documented. Based on this work, the auditor concluded that the Council's control environment was now ineffective, citing poor financial management as the primary reason.

176.18. Towards the end of the 2011 audit, the auditor updated this assessment. More features of the control environment were now considered to be ineffective: risk management, planning and budgeting, performance monitoring and legislative compliance. It is clear from the documentation that the auditor had not, and would not, rely on the control environment in determining their audit approach. Significant planning issues and risks were identified, including the impact of the wastewater project on the Council's financial strategy. Significantly, in September 2011, the auditor sought to revalidate the audit approach given the emergence of major financial and management concern. In particular, the auditor appeared troubled by findings from an independent financial health check, concerns about valuation of the wastewater asset, and the emergence of rating issues. The auditor considered it was appropriate to keep relying on certain controls at a system level, but overall, the auditor's approach was to conduct a substantive-based audit.

176.19. It is clear that the auditor chose not to rely on the management control environment in 2011, and that they revised their assessment of key components they now judged ineffective. However, I am uncertain from the documentation on file whether this was because certain aspects of the control environment had deteriorated or because the auditor had received additional, or new, information to indicate the possible existence of significant deficiencies. The independent assessment and health check of the Council's financial management practices identified many issues which were not in fact new, and raised concerns about the Council's budget management practices. The auditor's updated assessment draws on the findings from this independent assessment, and it is clear that they influenced the auditor's conclusion that the Council's budget management and planning practices were ineffective. Discussions with the auditor suggest that while many of the issues that forced the reassessment of the control environment assessment arose in 2011, they were probably there in previous audits.

176.20. In 2012, the auditor's assessment of the management control environment was that it remained ineffective. This was based on similar findings and observations as in the prior 2011 audit. In making their assessment, the auditor reviewed the Council's progress in implementing the recommendations from the 2011 independent financial health check, particularly what steps the Council had taken in terms of its management of debt and borrowings. (The independent report had noted significant financial issues arising from the increased level of debt to fund the wastewater project, and the need for a clear strategy to deal with this).

Overall, the auditor's judgment about components of the control environment is extensively analysed and documented. The auditor notes significant concerns with the integrity of the control environment, and with potential management override in previous periods. The auditor does not rely on the entity level controls, and has designed the audit approach on the basis that these controls are ineffective. The planning documentation highlights a number of key risks and the auditor's response to them. The auditor's assessment of the control environment, the assessment of risk and the auditor's response are clearly integrated.



### *The auditor's assessment of the Council's financial management control environment*

177. Here, the auditor considered matters relating to the integration of planning and budgeting within the Council, and to the regularity of performance monitoring. Between 2003 and 2005, the auditor also considered contract tendering and management, as well as capital project management: each of these encompass matters relevant to the financial management control environment.
178. In considering the auditor's entity level assessment of the Council's financial management environment, direction and control, I am concerned that it focused on matters that were too narrowly defined or scoped. I also question whether the assessment sufficiently considered some matters that are highly relevant to the Council's financial management. Documentation on the audit files indicates that only limited attention was given to the Council's overall financial management practices and financial strategy, to understanding the implications of significant funding and financial decisions, and to the Council's management and adherence to its funding and financial policies.
179. In 2011, the Council sought an independent financial health and sustainability review, different in scope from the audit of the Council's annual report by the auditor. The independent review's findings highlighted weaknesses and deficiencies in the Council's financial management practices and financial sustainability. It also identified weaknesses in the Council's budgeting and performance reporting, and raised concerns about the Council's financial sustainability due to the completion of the wastewater project.
180. The auditor considered this independent review as part of the 2011 and 2012 audit, and took into account some of its findings when assessing the Council's control environment during each of these audits. Importantly, the independent review identified deficiencies that existed both at the time it was completed and in earlier periods. However, I have found that the documentation supporting the auditor's assessment of the management control environment fails to identify, or highlight, any of the matters that had been identified as an area of concern as part of the independent review.
181. In examining the audit files for evidence of the nature and extent of the matters considered by the auditor, I have found that:
- 181.1. Between 2003 and 2010, the auditor judged the Council's budget-setting process to be effective. Whether this assessment included consideration of budget-setting at an entity and project level is insufficiently documented. There is no documentation to indicate that the auditor ever specifically considered the sufficiency and appropriateness of the budget-setting process for the wastewater project during their 2003-2005 project management assessment. Nor could I find any 2006-2009 documentation to indicate if, or how, the auditor considered the project's escalating construction and development costs in relation to the Council's budgeting processes.
- 181.2. The funding of the wastewater project placed pressure on the Council's funding and financial strategy, and therefore directly impacted current and future ratepayers. As part of its project funding decisions, Council expanded its Treasury policies and practices to allow it to enter into complex financial derivatives such as interest rates swaps. But the auditor made no assessment of the wastewater project's impact on the Council's overall financial health and management. There is no documentation showing that the auditor considered whether the Council had the financial management competencies, processes and controls necessary to

manage these complex financial instruments and its current and future financial challenges.

- 181.3. Between 2005 and 2009, the audit files document the emergence of systemic concerns about accounting for asset development, capital and maintenance costs, as well as the capitalization and expensing of these costs. It appears that the auditor responded to this specific risk when planning the audit approach to property, plant and equipment. However, there appears to have been no overall analysis of whether the ongoing emergence of such issues indicated a more systemic deficiency in the overall financial management control environment – or whether they pointed to deficiencies in the underlying financial systems and processes, or in the skills, competencies and knowledge of key management and staff.
- 181.4. By 2010, the auditor was alert to significant funding and financial issues – for example, the slowing of revenue from development contributions. The potential audit risk associated with these planning considerations was assessed, and appropriate audit test procedures were designed. But between 2006 and 2009, there is no documentation to indicate that the auditor was aware of any such funding and financial issues when they assessed the Council’s entity level control environment.
182. My review of the audit files reveals that numerous issues, deficiencies and complexities associated with the financial management of the Council’s operations emerged over time. In my view, if the auditor had considered them, they would have directly influenced the auditor’s assessment of risk and therefore the audit test procedures that were designed. Asked to respond to this proposition, Audit New Zealand queries whether the audit approach or the design of test procedures would have been affected if in fact the auditor had identified these issues/deficiencies. Audit New Zealand suggests that the auditor’s work on controls at a system level, together with the substantive approach adopted, enabled them to obtain the *reasonable assurance* required to satisfy the objectives of the audit.
183. I have taken account of this argument when considering whether the objectives of the audit were satisfied. Notwithstanding its potential validity, I can find no reason why the auditor should not also have considered the issues, deficiencies and complexities when assessing the management control environment throughout the entire period under review. I have found that the auditor increasingly did so between 2010 and 2012, including by taking account of the results of the independent financial health check. In my view, the need to consider these matters applied equally in the 2006-2009 period.



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## 4.2 KEY FINDINGS AND OBSERVATIONS – AUDITOR’S APPROACH TO ASSESSING THE COUNCIL’S COMPLIANCE WITH LEGISLATIVE REQUIREMENTS

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### Introduction

184. The terms of reference require me to consider whether Audit New Zealand sufficiently and appropriately:

- planned the audits so that they addressed the required legislative matters; and
- performed the audits to ensure that these matters were sufficiently and appropriately addressed.

### Responsibilities for ensuring compliance with applicable laws and regulations

185. Within the overall accountability framework for public entities, responsibility for ensuring compliance with applicable legislation rests with the Council. Within the Council itself, primary responsibility rests with management. The Council’s governing body provides oversight and governance.

186. As already stated, the auditor’s responsibility is to plan and perform each audit to ensure that the overall audit objective is met – that is, to obtain *reasonable assurance* that the annual report or planning document is free from any material misstatement, whether caused by fraud or error. The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

187. In planning an audit engagement, the auditor must take account of the legal and regulatory framework within which the Council operates. They must consider the potential impact of applicable laws and regulations on the Council’s annual report, planning document or any other matter the auditor is required to report on.

188. The extent to which individual laws and regulations can affect the annual report or planning documents varies considerably. Some may have a direct material impact on the Council’s annual report – for example, the Local Government Rating Act 2002 (LGRA) or the Goods and Services Tax Act 1985. Compliance with other laws (for example, the Building Act or Resource Management Act) may be required because of the specific nature of Council’s activities and operations, or because they relate generally to the conduct of business in New Zealand (for example, laws and regulation relating to employment, health and safety). Legislation or regulation of this kind may not have a direct material impact on the recognition and disclosure of matters in the annual report or planning documents, but the Council must comply with them if it is to avoid material penalties or liabilities.

189. The auditor’s specific responsibilities in respect of legislative compliance include:

- obtaining sufficient evidence of the Council’s compliance with whatever laws and regulations are generally recognised as directly impacting on the determination of amounts or disclosures in an annual report or planning document;
- performing audit test procedures to help identify instances of non-compliance that may have a material effect on the annual report or planning document; and
- responding appropriately to any non-compliance or suspected non-compliance.

190. The OAG's auditing standards prescribe the requirements against which the auditor must plan and perform the audit, and clarify the scope of the auditor's responsibilities. Those standards reiterate that the auditor is not responsible for preventing or detecting non-compliance. They stress the important distinction between the auditor's work and the advice provided by Council's independent legal advisors. The auditor's responsibility to consider the laws and regulations applicable to the audit engagement must not be misconstrued: it does not mean that the auditor provides a legal opinion on the Council's compliance with relevant laws and regulations. Auditors must not provide opinions (in a legal sense) on a public entity's compliance with laws and regulations, other than the general assurance provided as a result of the audit.
191. In discharging their obligations, auditors are required to remain alert to the possibility that any of the audit test procedures used to form an opinion on an annual report or planning document may reveal actual or suspected non-compliance. It is therefore important to maintain professional scepticism throughout the audit, given the nature and extent of the laws and regulations that may affect a Council.
192. There is an inherent risk that intended users of an annual report or planning document may misconstrue the obligations that the auditor is operating under: in other words, an expectation gap may arise. In particular, users may mistakenly expect that the auditor will detect all instances of non-compliance with all laws and regulations, regardless of their potential impact on the annual report or planning document. Similarly, management may incorrectly assume the auditor's opinion removes the need for Council to obtain independent legal advice on its legislative compliance. The auditor needs to be aware of the risk of such expectation gaps, and take steps to manage or mitigate them.

### **Considering legislative compliance in the annual report audit**

193. The standards applicable to the audit of the annual report required the auditor to obtain:
- A general understanding of the legal and regulatory framework applicable to the Council, and the local government sector as a whole. The auditor then assessed the Council's compliance with that framework.
  - Sufficient evidence of the Council's compliance with whatever laws and regulations are generally recognised as directly impacting on the determination of amounts or disclosures in an annual report or planning document.
194. I have reviewed the audit files to assess whether the auditor has met these standards in the annual report audit, and found that:
- 194.1. The laws and regulations directly affecting the Council were outlined in the audit planning memorandum and/or other planning documentation. Auditors were also given guidance, including OAG sector briefs, setting out the legislation affecting the local government sector and the overall legislative framework within which the Council undertakes its operations and activities. The auditor has further categorised those laws and regulations into three separate groups as a way of showing their potential impact on the annual report, and therefore provide a basis from which to determine the nature and extent of audit testing to be performed. Overall, the auditor's schedule of legislative and regulatory requirements appears sufficient and appropriate, as does the categorization.

194.2. Throughout the period of the review the primary focus of the auditor's work on legislative compliance involved considering the following key laws and regulations, identified as category 1 legislation:

- Local Government Act 2002;
- Local Government Rating Act 2002;
- Local Authorities (Members' Interest) Act 1968; and
- Local Government Elected Members Determinations.

There is evidence on each audit file to show that the auditor considered and assessed these legislative requirements, including (where appropriate) their impact on the Council's annual report. I address separately the sufficiency and appropriateness of this work.

194.3. The auditor's approach to category 2 legislation (legislation that is considered to have a fundamental effect on Council operations) and category 3 legislation (legislation which may result in significant financial, operational or political exposure) is set out in the audit planning documentation. Legislation in these categories includes the Resource Management Act 1991, Building Act 1991, Goods and Services Tax Act 1985 and more. The auditor considers that while laws and regulations in these categories are unlikely to have a material impact on the annual report, a further risk assessment would be appropriate – potentially on a periodic or cyclical basis. A planned response for each category was identified.

194.4. However, except for 2006, I found no evidence that the auditor in fact assessed any of the category 2 and 3 legislative requirements, nor did they consider or assess the possible impact of non-compliance on the annual report. As part of the 2006 audit, there is evidence of a general risk assessment performed on the "Other Legislation": it addressed matters required under the auditing standards applicable at the time. The auditor considered the risk of non-compliance was not high and no further testing was required.

194.5. Audit New Zealand states that the auditor's primary focus was on category 1 legislative requirements. The sector briefs, audit engagement letters and audit arrangement letters all confirm this. I accept that this emphasis was reasonable, and was clearly communicated to the Council.

194.6. However, the auditor's planned audit approach clearly indicates that an assessment of category 2 and 3 legislative requirements was also appropriate – regardless of their potential impact on the annual report – and would be carried out. I consider that this planned approach was reasonable and appropriate.

194.7. Yet, as I have noted, apart from in 2006, there is no documentation showing the auditor ever assessed the potential impact on the annual report of non-compliance with category 2 and 3 legislation. I can only conclude that this assessment did not happen. Without it, at least on a cyclical basis, the auditor could not reasonably assess the potential for non-compliance by Council or demonstrate their own compliance with the auditing standards or planned audit approach.

194.8. The general audit approach required the auditor to understand the Council's overall legislative control environment – how the Council ensured it maintained

compliance with legislative requirements. Based on my review of the audit files, the auditor's planned approach was, first, to review Council's minutes to determine whether any instances of non-compliance were reported to the governing body. They then carried out separate substantive tests and assessments (usually by completing checklists) to determine Council compliance with legislative requirements. Principally, the focus was on category 1 legislation. Finally, the auditor obtained representations from management and the Council about its compliance. I am broadly satisfied that this general approach was consistent with the requirements set out in the auditing standards.

194.9. In each audit, the auditor sought to understand and assess the Council's overall legislative control environment – usually through discussions with management. The auditor noted the key features of that environment, and how those features contributed to an overall assessment of the control environment's effectiveness. At an overall entity level, the auditor was not expected to test or corroborate the key features of the Council's overarching legislative compliance systems and framework. However, it is reasonable to expect the auditor to be able to demonstrate, by means of documentation on the audit file, how they assessed the effectiveness of the Council's control environment and satisfied themselves that the Council was compliant with legislative requirements. As I have already stated, documentation of the auditor's professional judgement forms part of the evidence required to support their conclusions.

194.10. In support of their overall assessment the auditor has noted that the Council's primary control was a six-monthly legislative compliance confirmation completed by senior management. In some audits, the Council also used independent legal advice. From this, the auditor assessed that the control environment was effective. However, there was insufficient documentation to indicate how this assessment was reached. For example, the documentation does not tell us whether the auditor:

- considered the sufficiency and appropriateness of the confirmations;
- considered whether management's six-monthly sign-off addressed those legislative requirements identified by the auditor as category 1, 2 or 3, or whether there was sufficient confirmation of management's assessment of the impact these legislative requirements would have on the annual report;
- discussed with management whether instances of non-compliance had been noted; or
- understood how Council management completed and signed off the six monthly confirmation.

I consider that this lack of documentation was a weakness in the auditor's planning and performance of the audit.

194.11. Audit New Zealand asserts that in forming a view on the overall effectiveness of the Council's legislative compliance framework there is no requirement for the auditor to test the underlying legislative compliance systems. They also contend that the auditor's subsequent testing and assessment of Council's compliance with category 1 legislation was largely independent of their assessment of the overall legislative control environment or framework. Any deficiencies in this latter work

would not have influenced the nature and extent of any substantive testing, as these test procedures were largely prescribed through the legislative compliance checklists.

- 194.12. While I accept this general view, it raises two important issues. First, assessing the overall control environment contributes to an understanding of the risk of non-compliance with all legislation, not just category 1 legislation. Any weaknesses found in the general control environment would influence the auditor's view of whether more regular or detailed testing should be performed in respect of category 2 and 3 legislation. Second, regardless of whether substantive testing was already prescribed, the auditor performed an assessment of the control environment and assessed it as effective. It is therefore reasonable to expect that auditor has carried out sufficient appropriate work, and exercised appropriate professional judgement, to support the conclusion reached. In my view, the deficiencies noted in the auditor's assessment remain valid observations, in spite of the position advanced by Audit New Zealand.
- 194.13. In each audit, the auditor carried out substantive testing to assess the Council's compliance with the requirements of category 1 legislation. Such testing generally involves completing checklists that highlight key legislative requirements and requires the auditor to assess whether the Council has complied with them.
- 194.14. Usually, the auditor completes the checklist by answering 'yes' or 'no' ('no' answers generally require follow-up or additional explanation). I found no, or only limited, documentation of how the auditor applied their professional judgment to form a conclusion on compliance on the basis of these responses. Sometimes, the auditor can determine with reasonable certainty whether a requirement has been complied with – for example, the requirement for the annual report to recognise or disclose a matter set out in Schedule 10 of the Local Government Act. In such cases, a checklist approach has minimal risk as a way of making an assessment. However, the checklist may require the auditor to confirm other matters or provisions that require a higher level of professional judgment – for example, whether the Council has complied with the LGRA in determining the basis of a targeted rate. In these instances, a completed checklist cannot reveal how the auditor exercised their professional judgment or arrived at a conclusion. This observation echoes observations I have made elsewhere about the sufficiency, appropriateness and quality of documentation.
- 194.15. Audit New Zealand acknowledges that the standard of documentation provided by the checklists could be better, particularly for 2007. However, it argues that documentation standards improved through the 2010-2012 period. Audit New Zealand also says it now expects auditors to document the judgments they have made in reaching conclusions.
- 194.16. I acknowledge that documentation standards did improve over this period, consistent with the general shift in accepted practice underway in the audit industry since 2003. However, I continue to have reservations about the quality of documentation supporting the responses in the checklists. I accept that using checklists to carry out substantive testing may be an efficient way to plan and perform audit test procedures, and that the use of checklists is a reasonable practice within the audit industry. But there are inherent limitations in responding 'yes' or 'no' to questions about which the auditor must exercise

professional judgment. Accordingly, the auditor needs to take great care about how their professional judgment is documented when completing checklists (even if a response is in the affirmative). In the course of this review, I have seen checklists where the auditor's response is confusing as to what audit testing was carried out to support the conclusion reached. This is shown, for example, in the auditor's use of such phrases as *nothing has come to our attention to suggest that information in the annual report does not comply with the requirements of the Act*. Such wording is generally considered to be at odds with the purpose or objective of the audit. It is unclear from the documentation what work was undertaken by the auditor to support this conclusion or why the auditor expressed/documentated the conclusion in the form of negative assurance. Where an auditor is required to summarise their judgment using a prescriptive, narrow checklist, the result can be inappropriate or insufficient documentation being left on file.

194.17. Another risk is that a 'yes' response could be interpreted as the auditor having determined with certainty that the Council has complied with a legislative requirement. I have already noted the inherent limitations of any audit and the fact that performing audit test procedures cannot be construed as the auditor having formed an opinion, in a legal sense, about the Council's compliance. Documenting the auditor's professional judgement is an important way of managing the audit expectation gap and of ensuring no misunderstandings of the nature and extent of assurance the auditor has obtained.

194.18. To evaluate the merits of using checklists, I sought comment from Audit New Zealand about how it manages their use and inherent limitations. Audit New Zealand advised me that its "*checklists have been designed such that affirmative answers to all questions on the checklist provide sufficient assurance to the auditor to issue an unmodified opinion*". Audit New Zealand also indicates that "*for many of the questions, a 'Yes/No/NA' response is appropriate. However, Audit New Zealand's expectation is that where judgements have been exercised in forming conclusions those judgements should be documented. This has been a key part of our professional development training since 2007*".

### *The auditor's assessment of the Council's compliance with the LGRA in setting and assessing rates*

194.19. I have considered in detail the auditor's work on Council rates, including its assessment of Council's compliance with key provisions of the LGRA. My findings and observations are detailed in section 4.5. Several of them inform my view of the auditor's assessment of the Council's compliance with category 1 legislation, namely:

- Responsibility for the setting and assessment of rates, and therefore ensuring compliance with the provisions of the LGRA rests with the Council. The auditor is primarily concerned with obtaining *reasonable assurance* that the recognition and disclosure of rates revenue, assets and liabilities in the annual report are free from any material misstatement.
- Overall, based on the objectives for the audit of the Council's annual report, I determined that the general methodology, approach and test procedures (including test procedures to assess the Council's compliance with the LGRA) were a reasonable, and appropriate, basis from which to plan and perform the audit engagement.



- The auditor has obtained a general understanding of how the Council ensures compliance with the LGRA and has completed the legislative compliance checklist applicable to the LGRA. Between 2003 and 2010 the auditor's completion of this checklist and the performance of substantive audit test procedures did not identify any instances of non-compliance with the LGRA. This is despite the Bill currently before Parliament identifying a number of instances of non-compliance between 2006 and 2012.
- It is reasonable to expect that on the basis of the audit test procedures performed by the auditor to assess the Council's compliance with the LGRA over the period covered by the Bill, that the issues and irregularities identified in the Bill, as outlined in section 4.5, should have been within the focus of the auditor and, in most cases, those irregularities should have been detected by the auditor.
- The issues and deficiencies in the work performed by the auditor on rates constitute non-compliance with the auditing and professional standards that the auditor is required to adhere to. These issues will contribute to an overall assessment as to whether the objectives of the audit have been met. Notwithstanding these deficiencies I am satisfied that the auditor's failure to identify the instances of non-compliance would have been *unlikely* to have affected the issuing of an unqualified opinion on the Council's financial statements. However, had those irregularities been identified it is *likely* that both the annual report and auditor's report would have set out additional disclosures in respect of those matters.

#### *Other general findings and observations*

194.20. The auditor obtained representations from the Council that it accepted responsibility for ensuring compliance with all applicable legislative and regulatory requirements, and that – to the best of the Council's knowledge – it had complied with those requirements. Between 2003 and 2009, these representations were *unqualified*. From 2010, the Council's representations acknowledged potential irregularities in the setting and assessment of rates, and in its compliance with the Act. The 2006 - 2009 representations made no reference to non-compliance, despite the Bill now identifying there were instances of non-compliance during this period.

194.21. Although such written representations form part of the necessary evidence for the audit engagement, and are required under the auditing standards, they do not on their own provide sufficient evidence about any matters they mention. I am satisfied that the auditor did not rely solely on the Council's written representations, but had put in place other audit test procedures to obtain the reasonable assurance required.

194.22. My discussions with the auditors highlighted the highly subjective nature of the auditor's work in this area – especially the assessments they must make to reach a conclusion about the Council's legislative compliance, the nature and extent of work required to achieve a reasonable level of assurance, and how to evaluate the impact of non-compliance on the audit objective or opinion issued. Each auditor indicated that while auditing standards may clearly outline the auditor's responsibilities and obligations, the auditor considered that they had little guidance to help them determine whether they have achieved the necessary

qualitative threshold or whether further testing may be required. I queried this matter with Audit New Zealand. Its response was that the guidance in the Audit Manual is clear, fully complies with the professional requirements set out in the OAG's auditing standards (AG-208 and AG ISA (NZ) 250) and that it provides training on this aspect of the Audit Manual as part of its professional development programme. Audit New Zealand acknowledges that the matter does warrant further attention and it intends to look at what improvements can be made. Given the objectives of the audit, and the potential for an expectation gap to arise in this area of the auditor's work, this matter needs further attention from Audit New Zealand.

### **Considering legislative compliance in the audit of the Council's planning documents**

195. The audit of the Council's planning documents differs in scope from the audit of the annual report. The Local Government Act explicitly requires the auditor to report on the Council's compliance with the Act's requirements for preparing and presenting the planning documents.
196. The nature and extent of the auditor's responsibilities also differs from those applicable to an audit of the Council's annual report. Most information set out in the planning document is *forecast* or *prospective* in nature. Clearly, the auditor cannot assess the Council's prospective compliance with laws and regulations in future periods, as the actions which the legislative requirement would affect are yet to happen.
197. Thus, the auditor's responsibilities are primarily limited to assessing whether the Council has complied with the Act in preparing the planning document. This would also encompass, where appropriate, an assessment of Council's compliance with the relevant provisions of the LGRA (insofar as the setting of Council's rates affect material amounts and disclosures in the planning document). However, the audit of the planning document does not review the Council's assessment of the rates in respect of each property, as this is carried out after the planning document has been adopted.
198. In general terms, the auditor is required to obtain:
  - a general understanding of the legal and regulatory framework applicable to the preparation of the planning document, and then assess how the Council has complied with that framework;
  - sufficient appropriate evidence of the Council's compliance with the Act (and, where appropriate, the LGRA) insofar as compliance may have a direct material impact on the determination of matters and disclosures set out in the planning document.

### ***Significant findings and observations***

199. I have reviewed the audit files in order to assess whether the auditor has met the requirements of the auditing standards applicable to the Council's planning documents, and found that:
  - 199.1. The methodology, audit approach and audit modules were structured to clearly demonstrate that the audit encompassed all relevant legislative requirements affecting the development of the planning document. Audit work was planned and organized so that the auditor could express an opinion on the draft Statement of Proposal (accompanying the draft LTCCP or LTP) prepared for community consultation.



- 199.2. The audit files clearly show that the auditor assessed whether each planning document included the content required in the Act, and addressed the necessary matters of presentation. The auditor completed a contents and integration review for each audit of Council planning documents or Statements of Proposal. No significant instances of non-compliance were identified.
- 199.3. The auditor then made a separate qualitative assessment of the matters and disclosures set out in the planning document (for example, the auditor assessed whether the assumptions underlying the forecasts were reasonable and appropriate).
- 199.4. From reviewing the audit files, and my discussions with each of the auditors, it is clear that the auditor was aware the Council had obtained independent legal advice on key matters relevant to the preparation of planning documents and the wastewater project. It also appears that the auditor relied on this independent legal advice, which in the context of the objectives of the auditor would be reasonable and acceptable. Whether this advice is sufficient on its own or should be considered in connection with other audit evidence is a matter of professional judgment for the auditor. Despite the auditor's reliance on the independent legal advice, however, there was insufficient documentation to demonstrate the nature and extent of the auditor's reliance on this advice, including whether the advice is sufficient for the auditor's purposes. Without this, there was a risk of the auditor becoming over-dependent on the advice of independent legal advisors.
- 199.5. For each planning document audit, a detailed assessment of how the Council intended to develop its planning document was made, and whether the underlying systems, processes and information supporting the disclosures in the planning document were in place. Audit New Zealand has noted that the assessment serves two purposes. First, it serves as a reminder to the Council of the focus areas and a prompt for action in preparing the planning document. Second, it provides an information source and is one basis for the risk assessment for the audit (along with other factors such as the environmental scan, knowledge of the Council, assessment of controls and preliminary analytical procedures). Audit New Zealand notes that the Council's self-assessment is generally an expression of intent from which we can take little comfort – especially with respect to legislative compliance, which is fundamentally assessed by the auditor based on a LTCCP document that is produced and the audit work is to test that document itself, not what the Council plans to do.
- 199.6. While I generally accept Audit New Zealand's position on this matter I would note that, particularly in respect of the 2006 audit, the self-assessment checklist was used by the auditor to identify areas of audit focus and to effectively plan the work to be performed during the audit – the auditor used the responses in the self-assessment checklist to focus on particular matters likely to be a focus or issue in preparing the LTCCP. In my view, it is directly relevant to the matters the Act requires to be included in the LTCCP and therefore assisting the auditor to identify potential areas of legislative non-compliance.
- 199.7. As noted, I have separately considered the auditor's work on Council rates, including their assessment of Council's compliance with key provisions of the LGRA. The findings and observations relating to this work are detailed separately in section 4.5; those that are directly relevant to this discussion are, in summary:

- The Council is responsible for setting and forecasting its rates for the period covered by the planning document, and therefore for ensuring compliance with the provisions of the LGRA. The auditor is primarily concerned with obtaining *reasonable assurance* that the rates outlined for the period of the planning document have been set in accordance with the applicable legislative requirements.
- Overall, based on the objectives for the audit of the Council's planning document, I determined that the general methodology, approach and test procedures (including test procedures to assess the Council's compliance with the LGRA) were a reasonable, and appropriate, basis from which to plan and perform the audit engagement. In particular, in 2009 and 2012, the auditor was required to confirm the rates resolution had been appropriately set and the cap on uniform charges and fixed dollar targeted rates had not been exceeded.
- In 2006, there was no evidence or documentation on file to indicate whether the auditor considered or tested whether the matters set out in the Council's rates resolution were consistent with the matters set out in the Council's funding impact statement. However, the auditor has considered whether the funding impact statement has been set in accordance with the LGRA. Despite the Council's subsequent acknowledgement of irregularities in the setting of rates for 2006/2007 the auditor has identified no errors, omissions or issues in the setting of the rates. The same deficiency is noted in the performance of audit work related to the 2009 planning document.
- In the case of the 2012 audit there is evidence and documentation on file to indicate that the auditor has considered the use and basis of general, differential and targeted rates. The auditor has placed reliance on the work performed by the Council's independent legal advisor in determining whether the Council has complied with the requirements set out in the LGRA. While accepting that such reliance is reasonable in appropriate circumstances, there is insufficient documentation to demonstrate the extent of reliance the auditor placed on the independent advice or how the auditor exercised their professional judgement in determining whether the advice was sufficient and appropriate in the context of the objectives of the audit or the conclusions being reached by the auditor. Without such documentation it is difficult for me to assess how the auditor managed the potential risk of over-reliance or over-dependency on the advice of independent legal advisors, neither of which is desirable.

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### 4.3 KEY FINDINGS AND OBSERVATIONS – AUDIT OF THE COUNCIL’S KEY PLANNING DOCUMENTS, *LONG-TERM COUNCIL COMMUNITY PLAN (LTCCP)* AND *LONG-TERM PLAN (LTP)*

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#### Introduction

200. The terms of reference require me to assess Audit New Zealand’s audits of the Council’s principal planning documents – the 2006 and 2009 long-term council community plans (LTCCP) and the 2012 long-term plan (LTP).

201. For each planning document, the audit objective and scope was slightly different. When the Act was amended in 2010, the scope and content of the LTCCP was reorganized into what is now referred to as the LTP; there were also changes in the nature and extent of the auditor’s responsibilities to form an opinion on the planning document. For clarity, those responsibilities throughout the whole period were:

*2006 and 2009 long-term council community plans* – in accordance with sections 84(4) and 94(1) of the Act, which applied at the time, the auditor was required to report on:

- the extent to which the Council complied with the requirements of the Act in respect of the LTCCP;
- the quality of the information and assumptions underlying the forecast information in the LTCCP; and
- the extent to which the forecast information and proposed performance measures in the LTCCP provided an appropriate framework for meaningful assessment of the actual levels of service provision.

*2012 long-term plan* – following the 2010 amendment to the Act, the responsibilities of the auditor were limited to reporting on:

- the extent to which the Council complied with the requirements of the Act in respect of the LTP; and
- the quality of the information and assumptions underlying the forecast information in the LTP.

202. The Act makes it clear that the auditor shall not comment on the merits of any policy content in the planning documents. Responsibility for the policy content rests with the Council, in consultation with the wider community. The purpose of any audit is to enhance the degree of confidence that intended users can have in the information set out in the planning document, which is a basis for consultation, engagement and decision-making between the Council and the community. The auditor’s objective is to obtain *reasonable assurance* that the planning document is free from any material misstatement and that the objectives of the audit, as set above, are met.

203. Any assessment of the adequacy of Audit New Zealand’s audit planning, performance and reporting must therefore take account of the scope and objective of the audit.

204. Where possible, this section draws together the findings and observations from each audit into one overall set of conclusions. Findings that are specific to one particular audit engagement are separately identified.

### **Development of the audit methodology and audit approach**

205. The OAG developed the following methodologies for auditing the Council's planning documents:

#### ***2006 LTCCP Audit***

206. This was the first time this planning document was required to be audited. It was recognized across the sector that local authorities would take time to develop their systems, processes and procedures to the point that the information they included in their LTCCPs was of the standard expected by the Act. There was also considerable concern over the current state of asset management planning across the sector. From an audit perspective, one of the key risks was whether asset management plans adequately supported Council's specification of services, and the quality and robustness of the Council's long-term financial forecasts.
207. The methodology developed by the OAG appears to have adequately addressed this evolving state of affairs. It strongly emphasised:
- the Council completing a self-assessment checklist to ensure that the LTCCP adequately covered all matters required to be included in the planning document under the Act – covering community outcomes, decision-making and consultation, the quality of underlying performance management systems and other matters;
  - the assessment and testing of the control systems that produced information for inclusion in the LTCCP. Given the objectives of the audit and the nature, extent and source of information required to compile the LTCCP, the 2006 methodology acknowledged the limitations of a substantive approach to the auditing of these control systems at the time of the audit. There was a strong focus on ensuring adequate systems were in place to produce the information required for the LTCCP; and
  - ensuring forecasts were based on the best possible estimates and best available knowledge, and were consistent with the Council's policies.
208. Significantly, the methodology suggested that the decision to perform substantive tests would depend on the auditor's preliminary planning and assessment of risk, and the results of any controls testing.
209. Compared to subsequent audits in 2009 and 2012, the 2006 methodology focused less on the need for the auditor to consider the financial prudence and affordability of the plans and forecasts set out in the LTCCP. However, it emphasised the need for the auditor to have a strong background understanding of the Council and its operations when planning and performing the audit.
210. There is clear evidence that the OAG liaised with Audit New Zealand and auditors in developing and rolling out the audit methodology. A number of checklists were developed to guide the auditor.

### *2009 LTCCP Audit*

211. The methodology for this audit refined and updated that used for the 2006 audit. It recognised sector-wide improvements had been made to the systems, processes and information supporting the information and content of the 2009 LTCCP.
212. Based on the lessons drawn from the 2006 audit, the 2009 methodology now placed more focus on:
- how individual Councils were implementing the principle of sustainable development;
  - ensuring that the LTCCP provided clear information about the choices that the community had in regards the services and activities being provided;
  - enhancing the information set out in the LTCCP regarding the Council's financial management practice and financial prudence;
  - performance frameworks and measures to assess the Council's ongoing performance; and
  - ensuring that the Council had adequate information to support the matters and disclosures set out in the LTCCP.
213. There was a greater focus on the need for the auditor to perform substantive audit test procedures, substantive analytical procedures and audit test procedures to confirm supporting information, forecasts and computations used by the Council. This methodology and approach was comprehensively documented and delivered to auditors.
214. In my view, these were significant enhancements that strengthened the link between the work expected of the auditor and that required to satisfy the objectives of the audit objectives. Compared with the 2006 methodology, the new audit test procedures required the auditor to apply greater focus and more effort to obtain reasonable assurance on the matters they needed to report on.

### *2012 LTP Audit*

215. The methodology integrated all key aspects of the 2009 methodology, but was updated to reflect the 2010 amendment to the Act (see paragraph 2.2 above).
216. It continued to emphasise the need for the auditor to consider matters of financial prudence, affordability and the Council's overall financial strategy when forming an opinion on the LTP and other matters. It also clearly directed auditors that Councils needed to ensure the LTP engaged the community in the *right debate* – that is, that the LTP needed to outline matters that were relevant and significant to the activities and challenges facing the Council.

### **Key Findings and observations**

217. Clearly, the methodology developed by the OAG evolved considerably since the 2006 audit. In my view:
- 217.1. For each audit, the planned audit approach was consistent in all material respects with the audit methodology. The audit approach recognised the key areas of audit

emphasis identified by the OAG and integrated them within the planning modules developed as part of the methodology.

- 217.2. Audit New Zealand and each auditor agreed that the methodology adopted for each of the three audits provided a reasonable basis from which to plan and perform the audit. It was also generally agreed that the auditor would be able to obtain reasonable assurance about the matters on which they were required to report if they carried out the audit in accordance with the methodology.
- 217.3. The methodology and approach developed for the 2009 audit, and subsequently updated for the 2012 audit, was more comprehensive and integrated than the 2006 methodology. Enhancements were made consistent with the sector-wide evolution of the planning documents and their changing areas of focus since they were first audited in 2006. In particular, the enhancements acknowledged the evolving state of Council planning systems and the information required to support the preparation of the planning document. In 2006 there was a greater focus on ensuring legislative compliance and comparatively less on matters where there is now greater focus or emphasis – financial prudence, ensuring the right debate is outlined in the LTP from which to effectively engage the community etc. It was generally recognised at the time that the 2006 methodology appropriately reflected the fact that many Councils were struggling to develop the information and systems required to support the information required to be outlined in the LTCCP. In particular, during the 2006 audit, Audit New Zealand had a number of concerns regarding the quality of the Council's asset management plans. Notwithstanding the evolving or changing nature of the audit methodology, the methodology developed in respect of each of the 3 planning document audits was reasonable and appropriate in respect of the objectives of the audit at that time.
- 217.4. In the 2006 audit, the auditor placed significant emphasis on the Council's completion of the self-assessment checklist. It served two main purposes. First, it reminded the *Council* of the audit's likely key areas of focus so it could attend to them when preparing the LTCCP. Second, the checklist provided a basis for the *auditor's* risk assessment by highlighting areas where more focus was required during testing. It supported other areas of the auditor's work in planning audit test procedures – including assessing controls and the control environment, environmental scanning, and the preliminary performance of analytical review procedures.
- 217.5. The auditor and the OAG both reviewed the self-assessment checklists. But when I examined the documentation on the audit file, I found it difficult to clearly see the linkages between (a) the Council's responses to the matters set out in the checklist, (b) the auditor's assessment of whether these responses were reasonable, (c) the auditor's broader understanding of the Council's operations, activities and management control environment, (d) the auditor's resulting risk assessment, and therefore (e) the nature and extent of audit test procedures that would otherwise need to be performed by the auditor to satisfy the objectives of the audit.
- 217.6. Audit New Zealand asserts that, after the OAG and the auditor had reviewed the self-assessment checklists, the risks they identified were recorded in the audit planning memorandum. It also suggests that the self-assessment would not have resulted in reduced testing of the LTCCP, as the balance of the LTCCP audit



contained minimum mandatory procedures. It says that the only area where the self-assessment solely appears to be used for audit evidence was around the component of the LTCCP where the Council identified the community outcomes and decision-making processes. In these areas, Audit New Zealand says that the self-assessment was consistent with the expectations of the audit. Moreover, it notes that community outcomes were in fact outside the scope of the audit opinion, other than from a legislative compliance perspective.

217.7. In my view, there seems little doubt that the self-assessment checklist effectively served the first of its intended objectives – to focus the Council on key aspects of the LTCCP and subsequent audit. The OAG’s review helped improve the consistency with which LTCCPs were prepared across the sector, and also enabled it to give direct and timely feedback to the Council.

217.8. However, I am concerned about the second of the two objectives – there is insufficient documentation on the audit file to show whether the Council’s self-assessments were a reasonable basis for this risk assessment: did the auditor consider the Council’s responses consistent with their own understanding and, if so, how did they exercise their professional judgment? There was an inherent risk that the Council’s responses to matters identified in the checklist might be more positive than was reasonable (and of course this risk applies to all audits across the sector, not just the Council’s LTCCP audit). Other than the fact that the self-assessment was reviewed by the OAG and the auditor, there is insufficient documentation as to whether, in the auditor’s professional judgement, the matters identified by the Council were sufficient, complete and appropriate in the context of the matters being commented on. If so, Audit New Zealand argues, the self-assessment checklist did not lead to a reduction in subsequent audit testing (see paragraph 217.6 above), then this would go some way to mitigating that risk. However, I would note that the auditing standards require auditors to assess the adequacy of information produced by the Council, or any independent third party, if they intend to rely on or use that information as part of their audit. The auditor asserts that the self-assessment checklists were reviewed, and I accept this. However, I remain concerned about the insufficiency of the documentation. The audit files do not reveal the extent to which the auditor used the information to assist them in determining their risk assessment and, if they did, how, in the auditor’s professional judgment, the information the Council supplied was considered to be complete, sufficient and appropriate to use when identifying the audit risks associated with the 2006 LTCCP – and therefore the auditor’s subsequent areas of focus or testing.

217.9. In subsequent audits, the self-assessment checklist was completed by the auditor, not the Council. In doing so, the auditor would have used their professional judgment about the matters identified and documented it on the checklist itself, thereby creating evidence of that judgment being exercised. But I have concerns about the quality of the 2006 audit, because there it was the *Council* who identified the matters reported in the checklist. However, I accept Audit New Zealand’s proposition that the issue was unlikely to have any consequential impact on the auditor’s work towards satisfying the audit objectives.

217.10. Finally, in assessing the methodology, I have considered its application to the wastewater project. Given the significance of the project to the community and the Council, did the methodology require the auditor to apply sufficient focus and

effort to this project? I am satisfied it did, in the event that the wastewater project was found to have a significant impact on the planning document's disclosures – even if that focus and effort was limited to the auditor documenting their judgment as to why the project did or did not form part of their testing.

### **The LTCCP audit – audit planning and risk assessments**

218. At the time the 2006 LTCCP was developed, scoping and planning of the wastewater project had already commenced. By the time of the 2009 LTCCP, it was nearing completion, although its scope, funding and financial implications had changed significantly from that set out in the 2006 LTCCP. In 2007 the Council amended the 2006 LTCCP to reflect these changes, and to update the project's cost and funding projections. By the time of the 2012 LTP audit, the wastewater project was finished and the resulting infrastructure asset had been commissioned. The plant and infrastructure asset were fully operational. However, between the 2009 LTCCP and the 2012 LTP, a number of irregularities relating to the wastewater project had been identified.
219. The terms of reference require me to consider whether, in planning and performing the audits, the auditor was sufficiently focused on significant material risks or financial matters, including those directly relevant to the wastewater project.

### *Audit Documentation – Knowledge and Understanding of the Wastewater Project*

220. Each of the auditors responsible for the respective LTCCP audits told me they were generally aware of the project's background, history and progress at the time the audits were underway.
221. In planning a LTCCP audit, the auditor draws on information obtained from the Council's annual report and previous LTCCP audits. Similarly, the auditor is informed by professional judgment exercised in relevant previous audits. This is reasonable and appropriate, and consistent with Audit New Zealand's philosophy of *auditing the entity*.
222. However, auditing standards require the auditor to document how they have used any earlier information, and why they consider it remains relevant to the current audit. Each audit file must contain sufficient appropriate audit evidence to stand on its own in support of the opinion issued.
223. I have no doubt that each auditor had some awareness and understanding of the wastewater project, much of it accumulated over the course of previous audits. However, I have identified deficiencies in how the auditor used this knowledge in planning and performing the 2006 and 2009 LTCCP audits. These include:
- Insufficient documentation on the audit files to show what information the auditor used, and/or the professional judgments they relied on from those previous audits when carrying out the current audit;
  - Insufficient documentation of why the auditor considered it appropriate to rely on this previous information. During interviews and discussions with the auditor, they clearly considered a number of important matters had been dealt with in previous LTCCPs or amendments and therefore required no further work or update. There is insufficient documentation of whether and how the auditor exercised their professional judgment.



(As a general observation, it has been a constant challenge throughout this review to establish the basis for the auditor's judgment and work at a particular point in time, and to then effectively manage the risk of hindsight. Examining the documentation on the audit files has been an important means of managing this risk. However, on several occasions my discussions with the auditor revealed an understanding of the wastewater project that was not adequately reflected in the documentation.)

- An inherent risk that the auditor relied on an incomplete base level of knowledge and information about the wastewater project when planning subsequent audits.

*The auditor's identification of key planning/audit risks associated with the wastewater project, and their impact on the audit*

224. The auditor did not identify the wastewater project as a key audit risk or area for focus in either the 2006 or 2009 LTCCP audits. No matters of concern were documented in the auditor's consideration of the overall control environment. Further, I found no evidence that the LTCCP planning modules project included any specific consideration or testing of the project, or of its impact on the LTCCP.
225. Based on the significance of the wastewater project at the time of the LTCCP audit, the project – especially its future funding and financial impact – should have been a significant area of audit focus. This has been acknowledged by Audit New Zealand: they say that while the planning approach was consistent with the expectations of other audits, it is unclear why the sewerage activity was not selected for testing. Audit New Zealand also note that *"In the financial year to 30 June 2006 the MEWS project increased from \$17.5m to \$26m when the contract was entered into, to \$35m in the LTP. MEWS should have been an area of focus, but was not"*.
226. Given the requirements for the preparing the LTCCP, and therefore the matters on which the auditor was required to report, it is reasonable to suggest that the wastewater project should have been considered significant. Factors that support this assertion include:
  - the scope, size and scale of the project and its impact on both the Council's operations and the wider community (including the obligations on the Council to engage and consult);
  - the project's strategic importance in managing future population and development growth within the region;
  - the project's funding and financial implications (including the impact on funding from rates, development contributions and borrowings, the projected operating and capital expenditure requirements, the impact of the project on the assets and liabilities of the Council, the impact on Council's financial policies and, finally, the project's significance within the Council's overall funding and financial strategy);
  - the significance of the Council's planning assumptions in ensuring that future financial forecasts were robust, and that the Council would be able to keep assessing the affordability and financial impact on ratepayers;
  - the auditor's awareness of early problems with the contracting and awarding of the project, which would have prompted a wider interest in the project's progress;
  - the impact of updated forecasts, projections, timelines and financial planning assumptions that started to affect the overall cost and funding implications of the

wastewater project before 2006, and then between 2006 – 2009. The auditor should have focused on the size and impact of these updated financial projections. The difference between the contracted value and the budgets forecast in the LTCCP should have been carefully examined to determine if the budget information was reasonable and appropriate; and

- the significance of the approach to project management and construction adopted by the Council.
227. In relation to this last factor, all the auditors agree that the Council's decision to outsource the management and funding of the wastewater project was appropriate. The Council believed that it lacked sufficient capability, capacity and the technical expertise needed to appropriately manage the wastewater project. The auditor also noted that the Council had adopted a low-risk strategy and wanted to avoid any significant exposure to financial overrun or cost blow-out on the project.
228. I am not required to form a view about whether the Council's risk and project management strategy was reasonable or appropriate. However, it is clear that the auditor believed it was, and this professional judgment is significant. Unfortunately, the audit files provide insufficient documentation of the basis for that judgment and how it influenced subsequent audit planning and the identification of audit risks.
229. Any decision by Council to outsource the project would never absolve it from its ultimate responsibility to maintain appropriate project oversight and control. Such a decision would change, rather than eliminate, the auditor's need to assess the impact on audit risk and testing. I was unable to find any documentation showing how the auditor assessed this risk and its possible impact on the overall management control environment, or what testing may have been helped the auditor evaluate the Council's project management strategy. There is insufficient evidence to indicate whether the auditor developed a sufficient understanding of the governance and management arrangements by which the Council maintained appropriate oversight and ensured the right information was disclosed in the LTCCP.
230. Overall, the risks and implications of the wastewater project for the LTCCP were not clearly documented on the audit file. The extent of the auditor's understanding of the wastewater project at the time the audit was carried out is thus unclear. Further, significant audit risks were not identified in respect of the wastewater project, nor their impact on the LTCCP. The documentation also shows little, if any, testing and consideration of the wastewater project. Yet the wastewater project should have been a significant part of the work the auditor was required to perform as part of the planning modules.
231. As revealed in subsequent financial periods, there were numerous problems associated with the management of the wastewater project. Some affected the way the project was disclosed and treated in the Council's planning documents (for example, the accounting treatment of the asset, the robustness of the growth and funding forecasts etc.). The fact that the auditor gave insufficient consideration and focus to the wastewater project in the performance of audit test procedures meant that these financial and funding issues were not sufficiently and appropriately considered during the planning and performance of the audit.

*The auditor's understanding of the management control environment and how it determined the planning approach and areas of audit focus*

232. The completion of the self-assessment checklists, together with the auditor's knowledge of the Council and its operations and activities, were the main ways the auditor built an understanding of the management control environment and its influence on the LTCCP.
233. As we have seen, in the 2006 audit, the self-assessment checklist was completed by the Council, then considered by the auditor and the OAG (through a hot review process). In 2009, the self-assessment questions were completed by the Council and returned to the auditor. The auditor then used this information to complete the template to assess the Council's self-assessment document. I discuss this in paragraphs 217.4-217.9, including my view on the auditor's subsequent reliance on the checklists in planning and performing the audit.
234. The documentation on the audit file indicates that the auditor's analysis of the management control environment was reasonably high-level and generic. The extent to which the auditor was drawing on previous knowledge of the client's management control environment was not clear from the documentation. Similarly, it was not clear from the checklist how the auditor exercised their judgment to support the conclusions drawn. Consideration of the methodology and planning modules developed for both audits appears to envisage that the auditor would undertake a more comprehensive assessment and focus on key audit risks. It is reasonable to suggest that the auditor would follow-up, verify or validate key matters before determining the approach and testing to be applied.
235. The self-assessment and contextual risk review were key inputs into the auditor's identification of planning issues and risks. In the case of the 2009 audit, they were also factors that influenced the decision on whether to adopt a controls- or substantive-based audit approach. In general, I found it difficult to understand how the auditor established linkages between each of the audit planning modules. The auditor duly completed each module, but how they exercised their judgment when drawing on previously completed modules (such as the self-assessment) was not always clear.

*Audit work on the wastewater project as part of key LTCCP planning modules*

236. The LTCCP planning modules guide the auditor on performing and conducting the audit. The auditor exercises professional judgment to determine the key audit risks or areas of focus, and the nature and extent of audit testing to be performed.
237. As noted previously, the auditor did not identify the wastewater project as a risk or a significant area of focus for testing in either the 2006 or 2009 audits. This is borne out by the lack of documentation, apart from minimal reference to the wastewater project, throughout the planning modules. There is no documentation showing that the auditor considered the financial forecasts, funding implications or assumptions underpinning either of these projections and forecasts. There is insufficient documentation to indicate how the auditor satisfied themselves that the LTCCP appropriately reflected the wastewater project, including its financial and funding implications – despite the strong likelihood that the project, underlying assets, service levels and implications on the financial strategy would significantly impact on the disclosures in the LTCCP.
238. In the 2009 audit, when the wastewater project was nearing completion, it was likely there would have been a significant focus on the project in the following planning modules:

- Asset and activity management
  - Linkages to other documents
  - Assumptions
  - Financial prudence
239. In the 2009 audit, the auditor adopted a substantive approach to planning and performing audit test procedures. Based on the documentation available on the audit file, there is no evidence that the auditor identified or considered the wastewater project as an area of audit risk or focus. As a consequence, there is no evidence or documentation to indicate whether the auditor considered the impact of the wastewater project on the waste water activity or that there was any consideration or assessment of the basis of the financial projections and forecasts or the impact/implications of the project and resulting asset on the Council's financial strategy (including consideration of the financial prudence).
240. Given the nature of my review, I need to carefully manage the risk of hindsight and speculation. As a consequence, I am not in position to conclude what would have been identified, and what conclusions the auditor would have reached, had testing of the project's implications – a significant matter in the overall LTCCP – been carried out under the above modules.
241. Despite the auditor failing to consider the audit risks in the specific context of the 2009 LTCCP, there is evidence on other audit files that the auditor should have been on alert to risks associated with the planning assumptions and financial forecasts etc. Discussions and interviews with the auditors, and my review of the audit files, reveal the auditor performed analytical procedures that highlighted variances in funding and revenue streams related to the project: these should have alerted the auditor to potential problems. Why the auditor did not perceive this as an area of audit risk or focus, and why no consideration was given to further substantive testing of the robustness of these forecasts and planning assumptions in the 2009 LTCCP, is not documented. As a consequence, there is no evidence to demonstrate that the auditor sufficiently considered the implications of these forecasts on the Council's financial strategy, or the general affordability and prudence of the wastewater project for the Council or community.

### ***Other matters***

#### ***Asset and Activity Management***

242. In both the 2006 and 2009 audits, the OAG had identified the quality and robustness of AMPs as a key concern across the local government sector. Audit work was carried out during these audits to enable the auditor to consider and assess the sufficiency and quality of the Council's AMPs.
243. Audit New Zealand considered the waste water AMP in 2006. However, the work it undertook was generic, dealing with the overall risk rather than specifically detailing the risk resulting from the Council's management of the project. Audit New Zealand has indicated that the wastewater project was not contained within the five sections that made up the waste water AMP. I found no evidence that the auditor considered the impact of the wastewater project on the waste water AMP or the asset service levels over the period of the LTCCP. There is insufficient documentation to determine whether the auditor was satisfied that the financial projections set out in the LTCCP were

appropriately supported by the service levels and financial forecasts set out in the AMP or other similar Council planning documents in respect of the wastewater project.

244. The auditor for the 2006 audit indicated that they were comfortable with the level of disclosure about the project throughout the draft LTCCP. They seemed to have no particular concerns about the project's overall management. This level of comfort appears to derive from work previously performed as part of the Council's annual report
245. On this basis, and given that the community had been given an opportunity to comment on the LTCCP, the auditor did not believe that specific testing or consideration was necessary. Instead, they focused much of their effort on roading, planning and policy activities in 2006 and roading, water and refuse in 2009.
246. I accept that roading constituted a significant activity in terms of the Council's overall planning. It was therefore reasonable to expect that this activity would be a particular focus for the auditor, although – as I have repeatedly observed throughout this report – the potential audit risks associated with this activity were insufficiently documented when the audit was in the planning stages.
247. Notwithstanding, I find there were significant deficiencies in the planning and performance of the audit due to the lack of documentation of (a) how the auditor assessed the risks of the wastewater project in relation to the LTCCP, (b) what knowledge or information the auditor drew on from other audits or sources and (c) the view that no specific testing of the project was considered necessary. In my view, a review of the methodology clearly shows that the project would significantly impact many aspects of the LTCCP planning approach and modules.

#### *Linkages to other documents*

248. Funding the project was a significant consideration for the Council. The Council relied on targeted rates (including the one-off targeted rate) and development contributions as the primary sources of income to fund the project. The receipt of development contributions is inextricably linked to current and future growth projections. The Council's segmented debt policy was established, in part, to allow the Council to fund significant infrastructure by debt but to have this debt segmented away from the Council's core debt. Without this segmentation, the Council would most likely breach its prudential borrowing limits.
249. Each of these policies formed a significant part of the LTCCP. The revenue and funding implications were material. Yet these policies were not subject to detailed testing or consideration by the auditor. Significantly, the Council's development contributions policy was not correctly adopted as part of the adoption of the 2009 LTCCP: this was not identified by the auditor.

#### *Assumptions and financial prudence*

250. The 2009 methodology and audit approach required the auditors to focus to a greater extent on the Council's forecasts and projections, the quality of the underlying assumptions and the financial prudence of the overall plan.
251. Based on my review of the audit file, I find:
- There was insufficient consideration, corroboration and/or challenging of the planning assumptions and the robustness of the information underpinning the financial forecasts;

- The auditor had reason to consider whether key growth assumptions remained valid and therefore their likely impact on the overall funding decisions for the project;
- Financial forecasts and projections are inherently sensitive to the underlying assumptions. As the wastewater project did not form part of the approach and testing performed by the auditor, subjecting the development contribution projections to any sensitivity analysis was not considered;
- There was no evidence or documentation to demonstrate how the auditor linked the AMPs, levels of service, key planning assumptions and financial forecasts;
- The auditor relied heavily on the external financial modelling of the project funding. There was little, if any, evidence to indicate how the auditor assessed the modelling output as adequate to support the LTCCP forecasts. As it was, the modelling needed to be significantly updated for the 2012 LTP audit.
- The financial prudence module was not properly completed because it failed to sufficiently integrate key matters from other planning modules so that the auditor could form an overall judgment of the LTCCP's financial prudence.

### *Observations and Findings from a Review of the 2012 LTP Audit File*

252. By contrast with the 2006 and 2009 audits, the key audit risks and issues affecting the Council were extensively documented and considered in the planning of this audit. There was a more comprehensive assessment of the risks associated with the operation of the asset and the overall financial situation that the Council now found itself in.
253. The audit file also demonstrates a more extensive analysis of the planning issues and risks relevant to the 2012 LTP and how these affected the planning and performance of test procedures. The audit file shows evidence of reasonable linkages and logic between the planning issues and the compliance, controls and substantive test procedures to be performed.
254. There is also evidence to indicate the auditor was alert to the significant issues that had emerged about the Council's management and governance of the project, and had taken them into account in planning and performing the audit.
255. Significantly, the quality of the audit file and particularly the documentation indicates that many of the concerns identified in a review of the 2006 and 2009 audit files were rectified in 2012. Planning modules were sufficiently and appropriately completed.
256. Clearly, there was a significant increase in the level of effort and resources applied to the audit. Significantly more actual hours were spent on the audit than had been budgeted or spent in the previous two audits.
257. Audit New Zealand consider that the magnitude of the problems identified with the Council's governance and financial management, and with the wastewater project generally, meant the audit team had to perform whatever work was necessary to ensure that the information set out in the LTP was robust, sufficient and appropriate.
258. From a public interest perspective, this is understandable. But it raises some important questions about the level of effort and resource required to satisfy the objectives for auditing an LTP. In the 2012 audit, the additional audit test procedures allowed the auditor to obtain reasonable assurance over the matters on which they were required to



report, and to issue an unqualified audit opinion. Thus, the objectives of the audit were met. However, I note that the level of resource and work effort was significantly higher than that budgeted. The questions I have therefore are, first, whether the original budget was a reasonable basis for the planning and performance of the audit and, second, what can be regarded as the reasonable, or minimum, level of resourcing and effort required for the auditor to satisfy the objectives of the audit. In my view, these are important public interest considerations – ensuring that reasonable cost of auditor obtaining the required level of assurance is transparent and understood and ensuring that the auditor has sufficient appropriate resources to satisfy the objective of the audit.

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#### 4.4 KEY FINDINGS AND OBSERVATIONS – QUALITY CONTROLS SYSTEMS, PROCESSES AND PROCEDURES

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259. The terms of reference require me to consider whether the auditors applied adequate quality control mechanisms, processes and procedures in planning and performing the audits.
260. The OAG's standard on quality control requires Audit New Zealand to:
- Maintain a system of quality control at an organisational level that is designed to provide reasonable assurance that the organisation and staff comply with relevant professional and ethical standards, legal and regulatory requirements and ensure that reports issued by Audit New Zealand are appropriate; and
  - Implement appropriate quality control procedures at an audit engagement level to ensure that the engagement complies with relevant professional and ethical standards, legal and regulatory requirements and that the audit report issued is appropriate in the circumstances
261. The OAG standard also sets out the requirements for quality control reviews of audit engagements. Engagement quality control reviews (EQCRs) are required for all audits over 500 hours or where the audit is considered *high risk*. In all but the 2009 annual report audit, and the 2006 and 2009 audit of the Council's planning documents, the budgeted hours for the Council's audit exceeded this 500 hour threshold.
262. I have reviewed the quality control mechanisms applied to each Council audit against these requirements and expectations, and make the following findings:

##### **Overall system of quality control**

263. The evidence shows that Audit New Zealand developed and maintained a system of quality control at an organisational level throughout the review period. Elements of this system include assigning leadership responsibilities, ensuring adherence with relevant ethical and professional requirements, accepting and maintaining relationships with clients, managing human resources within the organisation, maintaining engagement performance, and monitoring processes.
264. Over the period covered by this review Audit New Zealand also sought three independent reviews of its quality control system and its engagement performance. One review was conducted by the Australasian Council of Auditors-General (ACAG) on invitation by the then Auditor-General. There were also two independent reviews conducted by the New Zealand Institute of Chartered Accountants (NZICA). These reviews were similar in scope to those performed on other chartered accounting practices. In all three cases, the independent reviewers issued reports. No adverse findings were made.

##### **Engagement Quality Control Review (EQCR)**

265. Where an audit is less than 500 hours, Audit New Zealand's system of quality control requires an auditor to assess, for the purpose of determining whether an EQCR<sup>13</sup> is

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<sup>13</sup> EQCR (Engagement Quality Control Review) is the term used to describe Audit New Zealand's independent peer review activity. The term was introduced in 2007. Prior to 2007, this peer review activity was referred to as Professional Standards Review (PSR). For the purposes of this report I use the term EQCR to apply to the independent peer review activity before and after 2007.



required, whether the client may be considered a *high risk*. This risk assessment is made against a broad set of risk-based criteria. Auditors advise the General Manager, Professional Practices of their assessments annually, and it is decided whether to assign an EQCR to the particular client and/or auditor.

266. As it stands, the General Manager, Professional Practices relies on the fact that a detailed assessment has been appropriately made by the auditor. The observations and judgments that have informed those assessments are not immediately obvious to the General Manager, Professional Practices when making a final decision. The focus and scope of the matters brought to the attention of the decision-maker, and the fact that the auditor does not necessarily outline the judgment exercised in making an individual assessment, together pose an inherent risk to the decision-making process.
267. For the audit of the Council's 2009 annual report, the budgeted hours were below the 500 threshold set by the OAG. A separate assessment of whether the Council was *high risk* was therefore required. The auditor prepared an EQCR assessment (by way of a summary question and answer checklist) and forwarded it to the General Manager, Professional Practices. The auditor's assessment was that the Council was not considered a high risk and therefore a request for dispensation from an EQCR review was sought. The request was granted by the General Manager, Professional Practices. The process adopted by the auditor raises two concerns:
  - 267.1. The auditor's assessment noted that there were no weaknesses in the Council's management control environment and that there were no significant issues noted in prior years. This reflected the auditor's view at that time, and may in fact be consistent with the evidence available on file. However, as I have noted throughout this report, there are significant reasons to question whether that underlying assessment was reasonable and appropriate.
  - 267.2. Audit New Zealand was contractually obliged to provide an EQCR reviewer for the 2009 audit. This was set out in the Council's Letter of Undertaking, and provided for in the audit fees for this engagement. Yet this contractual obligation was either overlooked or was not given sufficient weighting in the auditor's assessment of whether to request dispensation from an EQCR review. The contractual obligation to provide an EQCR review was not brought to the attention of the General Manager, Professional Practices at the time that the request for dispensation was being considered.
268. Regardless of any difference of opinion about the appropriateness of the auditor's assessment (see 10.1 above), the EQCR dispensation should not have been granted. Audit New Zealand was obliged to perform an EQCR review for the entire 2009 audit.
269. In terms of timing, I note that the decision to grant a dispensation was made after the audit had been planned. During the planning process, the EQCR reviewer did review the planning document. However, once the dispensation was granted, there is no evidence of any further EQCR involvement. Importantly, the obligations outlined in the Letter of Undertaking covered the audit as a whole, not just the planning stages.
270. Of the audit files reviewed, EQCR reviews were performed in all but three audits. For one other audit, EQCR was completed over the audit's planning component but not on the fieldwork and finalisation components. Evidence on file shows the EQCR reviews were completed.

271. No EQCR review was performed on either the 2006 or 2009 LTCCP audits. Audit New Zealand has advised that this was because the hours budgeted for these audits did not exceed the OAG threshold of 500 hours which automatically required the assignment of an EQCR. However, both Audit New Zealand and the auditors have noted that these audits were subject to the OAG's *Hot Review* processes. There is evidence that matters relating to the wastewater project were considered as part of the *Hot Review* of the 2009 audit. However, it is important to note that the objective of a *Hot Review* differs from that performed as part of an EQCR review. The *Hot Review* does not examine the audit fieldwork or files prepared by the auditor. Accordingly, it is not intended to ensure compliance with relevant professional and ethical standards.
272. In considering the nature and extent of the OAG's *Hot Review* process, it is important to note that this was introduced as part of the methodology and approach to the audit of the Council's planning documents. There is no OAG *Hot Review* performed as part of the audit of the Council's annual report. The *Hot Review* process was introduced in order to improve the quality and consistency of both the preparation of planning documents across the local government sector, and of the audits of those documents. There is evidence of the *Hot Review* process being performed in respect of each audit of the Council's planning document.
273. In the case of each audit where an EQCR review was performed there is evidence that the EQCR reviewer considered and confirmed those matters that were relevant and appropriate to the planning and performance of the audit engagement. The EQCR reviewer has signed-off the planning memorandum to this effect. The OAG's standard outlines the matters that an EQCR/PSR reviewer would be expected to consider in completing their review. While the reviewer relies on the work performed by the auditor and the assessments of risk etc. that are made, they have satisfied themselves that all relevant matters have been appropriately considered in order for the auditor to effectively plan and perform the audit engagement.

### **Quality control/review of audit fieldwork at an engagement level**

274. The evidence on file indicates that fieldwork was reviewed by senior audit staff. Generally, such reviews would be performed by the audit supervisor, manager or director.
275. It is impossible to know what matters were identified during these reviews as there is no remaining documentation of the review process: it is general practice that documentation of matters arising from a file review is not retained. However, matters identified during the file review must be addressed and actioned by the auditor before the audit is finalised. On this basis there should be no residual review matters outstanding: any necessary follow-up action will have been completed, meaning the audit file can *stand on its own* in support of the opinion issued.
276. As this report has identified significant deficiencies in planning and performing the audits, it follows that the reviews of the fieldwork were also deficient by failing to detect or address these problems.

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## 4.5 KEY FINDINGS AND OBSERVATIONS – THE AUDITING OF COUNCIL’S RATES

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### Introduction

277. While this review was underway, a local bill<sup>14</sup> was introduced into Parliament to address irregularities in the setting and assessment of the Council’s rates. These irregularities relate to the way the Council purported to comply with certain provisions of the Local Government (Rating) Act 2002 (the LGRA) and the broader Local Government Act 2002.
278. The Council acknowledges irregularities in the setting and assessment of certain rates for the financial years 2006/2007 to 2011/2012 (inclusive). These irregularities raise questions about the validity of those rates, and are therefore of considerable concern to the local community. There is a strong public interest in understanding why the irregularities were not identified by the auditor
279. Accordingly, I have examined the sufficiency and appropriateness of the auditor’s work on rates, focusing primarily on the period covered by the Bill.
280. Throughout, I have attempted to clarify how the audit’s scope and objectives affected the auditor’s role, responsibilities and obligations to consider and audit particular components of the annual report or planning document. As already noted, the scope and objective of the audit of the Council’s planning documents were different from those of the Council’s annual financial statements audit. Consequently, the design and performance of audit test procedures for the audit of the planning document differed from those for the annual report audit.
281. My examination of the auditor’s work on the Council’s rates has focused on two issues. First, I have sought to determine whether the test procedures performed by the auditor were reasonable and appropriate for the scope and objectives of the engagement – and particularly whether they adequately addressed the risk that the annual report or planning document was not compliant with the LGRA. Second, I have considered whether those test procedures would have (or should have) given a reasonable level of assurance that irregularities – such as those subsequently identified in the Bill – would have been detected.

### Responsibility for setting and assessing rates

282. The Council is responsible for setting and assessing rates, and for ensuring compliance with appropriate legislative requirements. The auditor is responsible for planning and performing the audit to ensure that the overall audit objectives are satisfied.
283. In the case of the Council’s annual report, the auditor is primarily seeking *reasonable assurance* that the recognition and disclosure of rates revenue, assets and liabilities are free from any material misstatement. In planning and performing the audit, the auditor is required to ensure the Council’s compliance with those provisions of the LGRA generally recognised as having a material impact on the determination of amounts and disclosures in the annual report.
284. In the case of the Council’s planning documents, the auditor is primarily seeking *reasonable assurance* that the Council has complied with those provisions of the LGRA that

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<sup>14</sup> The Kaipara District Council (Validation of Rates and Other Matters) Bill (the Bill), introduced to Parliament in June 2013.

affect (a) the preparation of the long-term plan and (b) the quality of the information and assumptions underlying the forecast information, including rates.

285. Because of the clearly defined objectives of the audit the auditor's work on rates cannot be relied upon as a legal review of the Council's compliance with the applicable legislative requirements. In circumstances where the Council requires some form of legal sign-off or assurance, then it is reasonable to expect it to seek such assurance directly from appropriate independent legal counsel. Evidence on the audit files indicates that, during the period of this review, the Council did seek and obtain independent legal advice on its setting of rates.

### **Audit of the Council's annual report**

286. In broad terms, the auditing of rates involves test procedures that allow the auditor to:

- consider and assess the management control environment within which the Council sets and assesses rates;
- determine whether key controls are in place for the Council's rating system, whether these controls are operating effectively, and whether they can be relied upon;
- have a reasonable level of assurance that rates revenue, rates debtors and other disclosures relating to rates are fairly reflected in the financial statements; and
- assess whether the Council has complied with applicable legislative requirements in setting and assessing rates for the financial period.

### **Assessment of legislative compliance**

287. Overall, based on the audit objectives for the Council's annual report, I consider that the auditor's general methodology, approach and test procedures provided a reasonable and appropriate basis from which to plan and perform the audit engagement. In particular, the auditor's work in assessing the Council's compliance with the LGRA was sufficient to allow them to form a conclusion on whether rates revenue is fairly reflected in the financial statements of the Council. In addition, the methodology and test procedures were consistent with the auditing standards set by the OAG.

288. From examining the files relating to annual report audits, I found that:

- 288.1. The auditor's focus on and attention to potential risks associated with the audit of rates significantly increased over the periods covered by my review, as did the guidance to the auditor, as set out in the audit methodology and approach, on these risks.
- 288.2. The audit test procedures that the auditor was required to perform were designed to ensure that the auditor could effectively satisfy the objectives of the audit engagement. Audit work is not intended to detect or prevent every instance of non-compliance but to obtain reasonable assurance that the annual report is not materially misstated. For example, the audit approach requires the auditor to test a sample of the Council's targeted rates and assess whether these rates have been set in accordance with the LGRA. There is no expectation that the auditor would review and test all targeted rates in all audits, unless the auditor considered it reasonable and appropriate to do so. However, it would be reasonable to expect

that the auditor would outline the basis and judgment used to determine which targeted rates would be tested.

- 288.3. Throughout the audit engagement, the auditor has made clear that responsibility for ensuring compliance with legislative requirements remains with management. The auditor must communicate carefully the extent to which their work can be relied on, and the limitations on the audit opinion they provide. If these points are not fully understood, there is a risk that the auditor's work and opinion may be wrongly assumed to provide a level of assurance on legislative compliance, and management may consider it unnecessary to seek appropriate independent legal advice. In fact, it is not the role and function of the auditor to provide such advice.
- 288.4. Overall, I consider that the auditor satisfactorily discharged their obligations to communicate the respective responsibilities of the Council and the auditor. The auditor did so in a way consistent with the auditing standards, audit methodology and general industry practice in place at the time the audit engagement was performed.
- 288.5. As I have already commented, the Council obtained extensive legal advice about potential irregularities identified in the setting and assessment of Council's rates during 2010-2012. The auditor was entitled to rely on that legal advice, but only after considering its sufficiency and appropriateness. In some cases, the auditor considered that the legal advice might be at odds with previous legal advice given to the Council. Despite the ex-post nature of the legal advice obtained by the Council, the evidence shows the auditor did review and consider that advice in considering the impact of the irregularities on the conclusions and audit opinions the auditor provided during 2010-2012.
- 288.6. Usually, the auditor plans and performs legislative compliance test procedures after the Council has set and assessed the rates for the financial year covered by the annual report. This means that if any issues or irregularities are identified, they can only ever be reported to management for corrective action in the next (or later) financial period. This is in contrast to the work performed by the auditor on the Council's planning document where any irregularities identified during test procedures can be addressed on an ex-ante basis before the Council sets and assesses rates for the first year of the long-term plan.
- 288.7. In my view, the timing of the test procedures during audits of the annual reports and planning documents was reasonable and appropriate, given the objective for each audit engagement.

### **Assessment of the management control environment**

289. The auditor is required to consider and assess the Council's management control environment, including its system for ensuring compliance with legislative requirements when setting and assessing rates.
290. I found deficiencies in the auditor's consideration of these issues. In general, the auditor relied heavily on discussions with management to understand how the Council was complying with the requirements of the LGRA. These discussions were, at times, narrow in focus. The auditor also appeared to rely heavily on the fact that finance and rates staff had knowledge and experience, in part because of their length of service. At an entity level, the auditor's assessment of the Council's systems for ensuring legislative

compliance are limited by the fact that the auditor does not ordinarily test or corroborate what they have been advised by management. The auditor will generally rely on subsequent testing of control systems, or the performance of substantive audit test procedures on rates, to ensure that systems and procedures are operating effectively and that the Council has complied with applicable legislative requirements. Despite the limitations of their approach, the auditor nonetheless concluded that the management control environment was effective.

291. Any deficiencies in this area can have significant consequences. The auditor may become over-reliant on the Council's control environment and systems. The auditor may fail to design and carry out audit test procedures that would allow any instances of material fraud, error or non-compliance on the Council's annual report or planning document to be identified.
292. Audit New Zealand asserts there is no evidence to suggest that deficiencies in the auditor's consideration of the management control environment or systems of internal control affected the subsequent testing carried out by the auditor on rates. Audit New Zealand considers there was limited opportunity for discretion in the design of test procedures. Apart from the auditor determining which targeted rates to select for testing, all other test procedures were largely defined or prescribed.
293. I have carefully considered Audit New Zealand's position. I agree that the auditor was asked to carry out several test procedures that would be performed regardless of their assessment of the management control environment or system of internal control: for example, the auditor must consider whether the rates assessment notice contains all of the matters required by the LGRA. However, it is equally clear that the auditor must perform test procedures to determine whether the Council has complied with other legislative requirements where substantive testing alone would be insufficient. For example, the auditor needs to ensure that the Council's rating database is up to date and complete. As a result, the auditor's consideration of the management control environment remains an important consideration in the identification of any areas of audit risk or focus or in the nature and extent of test procedures to be performed. I am therefore of the view that the narrow consideration of matters relevant to the auditor's assessment of the control environment are of concern. I accept that at the time that the auditor performed their assessment or the performance of audit test procedures there had been no instances of non-compliance that would have, or should have, placed the auditor on alert. I deal separately with whether the performance of the audit test procedures themselves should have identified instances of non-compliance.

## **Documentation**

294. Throughout my review of the annual report audits, I have been concerned about the lack of sufficient appropriateness documentation on the audit file – to demonstrate performance of the audit test procedure or the exercise of the auditor's professional judgement on a particular matter. This concern extends to the audit of Council's rates. While I acknowledge a noticeable improvement in documentation during later audits (from 2009 onwards), the lack of sufficient appropriate documentation throughout the review period is still of concern as identified in the following areas:
  - The auditor's documentation of their professional judgment, particularly in determining which matters were, or were not, selected for testing. For example, it is unclear how the auditor selected which targeted rates would be tested. Nor is it



clear why, during the 2009 audit, the auditor did not select and sample the wastewater scheme targeted rate that had been introduced in that financial period.

- The documentation of audit test procedures performed to support the auditor's conclusions. For example, during the 2008 audit, the auditor indicated that the targeted rates were tested. However, there is no documentation showing whether all the rates were tested and, if not, which were tested. The nature and extent of test procedures carried out to support the auditor's conclusions is not documented either.
  - The performance of audit test procedures designed to assess the Council's compliance with the provisions of the LGRA. In many instances, the auditor simply noted that the Council has complied with a particular provision of the LGRA without sufficiently demonstrating the nature and extent of work performed or the results of the audit test procedures.
295. I have noted that the Council obtained independent legal advice on various rating matters during the review period. These include potential irregularities in the setting of rates for the wastewater scheme, which the Council became aware of during the 2010 audit. The evidence indicates that the auditor appropriately considered the nature and extent of this advice, discussed the issues with the Council, and assessed the consequences for their opinion on the Council's financial statements. However, the auditor's documentation of the results of their audit test procedures and the conclusions they formed were at odds with the matters identified in the Council's independent legal advice. Once the auditor had considered the independent legal advice given to the Council, they did not go back and review the work they had performed.
296. Once aware of the potential irregularities, the auditor brought the matter to the attention of the OAG in a reasonable and timely manner. The evidence also shows that the auditor and the OAG considered how the irregularities might affect the audit report. The auditor advised the Council to disclose the irregularities in its financial statements, which it did by way of a note to the financial statements that formed part of the annual report. This disclosure appears consistent with the auditor's advice. The nature and extent of Council's disclosures was sufficient to enable the auditor to issue an unqualified audit opinion in respect of the 2010 annual report.
297. In both the 2011 and 2012 audits, the auditor had access to more evidence. This helped them better understand and assess the nature, extent and impact of the irregularities on the annual report. The audit reports for these years explicitly draw attention to the Council's disclosures.
298. Throughout all audits of 2010-2012, I found that the auditor exercised reasonable judgment in determining the impact of the irregularities (in so far as they were known or understood at the time) on the audit opinion, and whether it was necessary to include additional information or disclosure in the audit report.
299. For each audit performed during these periods, the auditor's work on rates was reviewed by the supervisor or manager.

### **Irregularities in the setting and assessment of rates, as identified in the Bill**

300. The irregularities identified in the Kaipara District Council (Validation of Rates and Other Matters) Bill include the Council's failure to:

- set specified rates on a basis authorised by the LGRA;
  - assess specified rates in accordance with the LGRA;
  - set specified rates in accordance with the provisions of the applicable Funding Impact Statement (FIS), as required by the LGRA; and
  - include certain information required by the LGRA in the rates assessments issued to rate-payers.
301. The irregularities occurred from 2006/2007 to 2012/2013 (inclusive). The audit files show the auditor first became aware of some of these irregularities during the 2010 audit of the Council's annual report. The files also show the auditor considered the impact of those irregularities when carrying out audit test procedures and forming an opinion on the financial statements at that time. However, the audit files do not show that the auditor was aware of, or had identified, any of the irregularities before the 2010 audit.
302. In my review, I have sought to understand why this was the case. First, I looked at what rates-related work was planned and performed by the auditor between 2006 and 2010. Second, I examined whether the auditor was aware at the time that they performed each of these audits, or ought to have been aware, of the irregularities subsequently identified in the Bill.
303. In considering these questions, I carefully examined the matters outlined in the Bill and also the irregularities disclosed by the Council itself. To effectively mitigate any risk of hindsight, I focused on the work the auditor was required to perform *at the time* the audit was conducted. Likewise, I referred only to those auditing standards that were applicable then.
304. At a high level, it is clear that the approach developed by Audit New Zealand to auditing rates – in particular, the design of audit test procedures to assess compliance with the LGRA – required the auditor to consider those areas of the Council's rates setting and assessment process where irregularities were subsequently identified.
305. Having examined the auditor's work in those areas between 2006 and 2010 in more detail, I found the following significant issues and deficiencies:

*Assessing the basis of the differential and targeted rates*

- 305.1. The audit approach required the auditor to sample selected differential and targeted rates, and to determine if the basis on which those rates were set was consistent with the LGRA. The auditor was not required to test all differential and targeted rates, unless they had reason to believe that this was necessary. However, in my view, it would be reasonable for the auditor to consider and document the basis on which particular differential or targeted rates were selected for testing. Thus, taking into account the scope and overall objective of the audit engagement, I consider the audit approach to be reasonable.
- 305.2. During the 2007 and 2008 audits, the auditor tested the basis of "key" differential and targeted rates. No issues of non-compliance were identified. However, the audit file does not show which rates were selected and whether they included the specified rates subsequently identified in the Bill. Nor is there evidence or documentation showing how this test procedure was performed.



- 305.3. In relation to the sewerage rates which the Bill is seeking to validate, the auditor selected those rates for testing in at least two years (2008 and 2009). No instances of non-compliance were identified.
- 305.4. In 2009, the Council introduced a new targeted rate to fund the wastewater scheme. However, the auditor did not select this targeted rate as part of the sample of rates to be tested. This decision must be questioned, given the significance of the project and its associated funding to the community and the Council, and given that the rate had been introduced for the first time in 2009: the auditor could reasonably have been expected to take these factors into account when deciding the sampling approach. There is no documentation on file showing *how* the auditor exercised their judgment in selecting the rates that were tested. When questioned on this matter, Audit New Zealand responded that “The contention that Mangawhai targeted rate should have been tested can be supported given the significance of the rate both financially and in the context of the Council’s environment”.
- 305.5. As for other irregularities identified in the Bill, the extent to which they should have been identified by the auditor depends on whether:
- the differential or targeted rate was selected for testing;
  - there is sufficient reason to believe that the differential or targeted rate should have been sampled; or
  - the results from audit test procedures carried out on other differential or targeted rates indicated a broader systemic level of non-compliance that would warrant the auditor extending their sample selection.

I accept Audit New Zealand’s statement that: “Given a sample basis is applied, it is not a reasonable expectation that all targeted rates would have been tested”. However, had the auditor identified irregularities in the differential and targeted rates that were selected for testing, they might have been alert to the possibility and extent of additional non-compliance in the setting of other differential or targeted rates.

- 305.6. As noted, the auditor became aware of doubts about the setting and assessment of certain rates during the 2010 audit. The evidence confirms that the auditor reviewed and considered the legal advice obtained by the Council at that time. The financial statements disclosed the issues identified, although the audit opinion does not refer to the disclosures made by management. The value of the problematic rates collected by the Council was also disclosed. As the amounts involved were material to the financial statements, the auditor was therefore required to consider whether the audit opinion should be qualified, or whether the opinion should refer to the disclosures by management in the financial statements.
- 305.7. The auditor decided not to issue a qualified opinion, apparently because they considered the Council had appropriately disclosed these irregularities in the annual report. While these disclosures were considered sufficient in 2010, in 2011 and 2012 the auditor included additional disclosure in their audit report. A decision was made in conjunction with the OAG that an unqualified audit report was appropriate.

### *Reconciling the rates resolution to the Funding Impact Statement (FIS)*

- 305.8. The auditor was required to ensure that all rates in the rates resolution were as set out in the FIS to the planning document. All rates in the FIS must be included in the rates resolution.
- 305.9. Between the 2006/2007 to 2009/2010 financial periods, the auditor carried out the test procedure and confirmed that the Council's rates resolution were correctly set on the basis of the rates set out in the FIS. No issues of non-compliance, and no differences, were identified by the auditor.
- 305.10. On each audit file, the auditor recorded that the test procedure had been performed. But in at least three of the four audits, there is insufficient documentation and evidence on file to indicate how the audit test procedure was performed and how the auditor's conclusion was reached. It is therefore impossible to determine with sufficient certainty what the auditor completed and why the irregularities were not identified.
- 305.11. In the 2009/2010 audit, there is evidence and documentation on file to show how the auditor performed the audit test procedure. The auditor did not identify any inconsistency between the rates resolution and FIS. The documentation also suggests that certain elements of the rates resolution were not specifically confirmed, despite the test procedure requiring all rates to be consistent across the two documents. Towards the end of the 2010 audit the auditor became aware of a number of irregularities in the setting and assessment of rates. There is no evidence to suggest that the auditor went back to the original work performed to review or consider their conclusions in light of the new evidence. The work performed by the auditor, and the conclusions reached, were therefore at odds with the subsequent information considered by the auditor. This discrepancy should have been addressed by the auditor.

### *Ensuring that rates assessment notices contain all matters the LGRA requires to be disclosed*

- 305.12. The auditor was required to ensure that the rates assessment notice contained all the elements and requirements set out in the LGRA.
- 305.13. For each financial period, the auditor recorded that they had compared the information set out in the rates assessment with the disclosure requirements set out in the LGRA. No instances of non-compliance were identified in any financial period.
- 305.14. However, in three out of the five audits performed between 2006 - 2010, there is insufficient documentation on file to indicate how the audit test procedure was performed and how the auditor's conclusion was reached. It is therefore not possible to determine with sufficient certainty what work the auditor completed or why the irregularities were not identified.
- 305.15. For 2009/2010, there is sufficient evidence and documentation on file to support the performance of this test procedure. Notwithstanding, the auditor did not identify any of the irregularities referred to in the Bill.
- 305.16. By 2010/2011, the Council had obtained independent legal advice on the irregularities relating to the setting and assessing of rates – including

irregularities in the rates assessment notices. Even though this legal advice was on file, the test procedure performed by the auditor did not identify any issues of non-compliance.

***Root Cause Analysis: understanding the reasons for the deficiencies identified in the auditor's work***

306. Based on the audit test procedures the auditor was required to perform, it is reasonable to expect the auditor to have detected the following rates-related irregularities subsequently identified in the Bill:
- differences between the FIS and the Council's rates resolution;
  - uncertainties over whether the rates assessment notice correctly contained all matters required by the LGRA;
  - uncertainties over the basis for "key" targeted rates selected by the auditor during the 2006/2007 and 2007/2008 audits;
  - uncertainties over the basis for the targeted sewerage rates selected by the auditor for testing in the 2007/2008 and 2008/2009 financial periods; and
  - uncertainties over the basis for the targeted rate to fund the wastewater scheme in 2009 (on the basis that the auditor could have been reasonably expected to select this particular rate as part of their sample testing).
307. In the case of all other targeted rates, the auditor was required to exercise professional judgment to determine which differential or targeted rates would be sampled. It does not necessarily follow that the auditor should have detected those irregularities identified in the Bill that relate specifically to other targeted rates.
308. The irregularities identified in the Bill raise questions about the legality of the rates levied by the Council. In turn, this has prompted the Council to reconsider the collectability of rates revenue from 2007 – 2009 in preparing the 2010 financial statements. The deficiencies noted in the auditor's work are therefore significant. They create doubts about whether the auditor correctly performed the work required, and complied with the auditing standards and audit methodology developed by Audit New Zealand. The deficiencies also raise questions about whether the objective of the audit was met, and what impact the irregularities would have had on the auditor's opinion had they been identified.
309. I have talked to both the auditor and Audit New Zealand about possible reasons for the audit deficiencies I have identified. Unfortunately, neither these discussions nor a root cause analysis clearly show why the audit test procedures failed to identify the irregularities. This is despite the auditor, at the time that the work was performed, having access to sufficient evidence from which to identify the irregularities.
310. Following discussions with the auditor, I have concluded that the primary reasons for the deficiencies outlined above were:
- a lack of understanding of the requirements of the LGRA
  - a lack of understanding of the objective or purpose of the audit test procedures

- a failure to adequately identify the risks and significance of non-compliance.

These lapses meant the auditor was not in a position to apply sufficient appropriate professional judgement when performing the audit test procedures, or to identify potential material non-compliance, or irregularities, should they be present. The deficiencies noted in the auditor's work were not identified or addressed through the engagement quality review processes.

Cumulatively, these deficiencies mean the rates-related test procedures performed by the auditor did not comply with the auditing and professional standards applicable to the audit engagement, or to the audit of Council's rates.

311. The auditor acknowledges that the auditing standards require them to prepare documentation that provides a sufficient record of the basis for the audit report. The auditor must also provide evidence that the audit was planned and performed in accordance with the auditing standards and audit approach applicable to the engagement. According to Audit New Zealand, some audit test procedures require 100 per cent substantive testing of the Council's document(s).
312. I have closely examined the wording of the audit test procedure on the audit file. I consider that additional information about the context of the test, and more clarity about its objective, are needed. Such additional information would help the auditor better understand the risk of non-compliance, the extent of the work required and the implications for the legality of the rates should irregularities in the Council's compliance with the LGRA be identified – regardless of how small or insignificant those differences may appear.
313. From my enquiries, it seems that more senior, experienced auditors were more aware of the significance of legislative compliance requirements associated with the LGRA. Should the work have been performed by these more experienced auditors, it is possible that they would have been alert to the implications of any differences and therefore that the irregularities may have been identified. However, it is incumbent on the auditor and senior audit staff to direct and supervise all staff employed on the audit. They must ensure all staff are clear about what is expected from the test procedures they perform, make them aware of the risks associated with non-compliance, and highlight the significance of the test procedures' objective.
314. Audit New Zealand has accepted that certain work and test procedures were not completed correctly. The organisation has learned several lessons from the review which it continues to address. They include the need to:
  - regularly train staff about auditing rates, in particular the legislative compliance aspects and the significance of relevant tests for assessing audit and assertion risks;
  - clarify the importance of documenting the results of the audit test procedures, the standard of documentation expected, and the significance of the judgements that must be made;
  - constantly review the assignment of staff to particular audit work, and the supervision of their work.

## Overall conclusions

315. The auditor plans and performs test procedures to assess whether the Council has set and assessed its rates in accordance with the LGRA. However, the auditor does so with the broader purpose of forming an overall opinion of the Council's financial statements. The auditor's work is not intended to detect or prevent every instance of non-compliance.
316. In planning and performing the audit, the auditor must make it clear that it is management's responsibility to ensure compliance with all legislative requirements. Here, there is evidence on file showing that the Council exercised this responsibility by seeking independent legal advice on a range of rating matters throughout the period under review. But the auditor must take the greatest care to accurately communicate the extent to which the Council can rely on the auditor's work. Otherwise, there is a risk that the auditor's work and opinion is seen to provide such a level of assurance on legislative compliance that management may choose not to seek independent legal advice. It is not the role and function of the auditor to provide such advice.
317. Notwithstanding this caution, given the test procedures the auditor was required to perform, it is reasonable to expect the auditor to have identified most of the irregularities subsequently identified in the Bill.
318. I acknowledge that the timing of the audit test procedures may not have prevented non-compliance from occurring in a particular financial year. However, if the auditor had reported any non-compliance and irregularities to the Council, management could have taken appropriate corrective action in future financial periods.
319. It is therefore reasonable for users of the Council's financial statements to expect the auditor to have not only carried out the specified audit test procedures, but also to have identified many of the irregularities outlined in the Bill.
320. Based on the analysis of irregularities found during the 2010-2012 audits and their potential impact on the audit opinion, it is highly unlikely that the auditor would have issued a qualified opinion in previous financial periods even if the auditor had identified those irregularities. Where the auditor should reasonably have detected an irregularity, it would *most likely* have resulted in them including an Emphasis of Matter paragraph in the audit opinion, and requesting the Council to include additional disclosure in the financial statements. In all cases, the nature and extent of the irregularities would have been significant enough for the auditor to communicate the matter to the Council and to the OAG.
321. The Council's compliance with the LGRA in setting and assessing rates is fundamental to its statutory power to rate. Compliance with the LGRA is therefore fundamental to management's assertions about its rates revenue in the Council's financial statements. Overall, I therefore consider the deficiencies I have identified in the auditor's work are significant. They directly influence whether the auditor has complied with the auditing and professional standards applicable to the audit engagement, and whether the auditor has satisfied the overall objectives of the audit.

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## 4.6 KEY FINDINGS AND OBSERVATIONS – AUDIT REPORTING, CONCLUSIONS AND COMMUNICATIONS

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### Introduction

322. Having completed my review of the audit files and assessed the sufficiency and appropriateness of the auditor's work, I am now in a position to consider and assess the impact of my key findings and observations on whether:
- the auditor has satisfied the overall objective of the audit;
  - there is sufficient appropriate audit evidence to support the conclusions reached by the auditor; and
  - the audit report and opinion issued by the auditor were appropriate
323. In the background section, I noted that the purpose of an audit is to enhance the confidence that intended users can have in a Council's annual report or long-term planning document. In planning and performing the audit, the auditor's overall objective is to obtain *reasonable assurance* that these documents are:
- free from any material misstatement; and
  - where appropriate or required, presented in a manner consistent with a recognised or prescribed reporting framework, or in accordance with applicable legislative requirements.
- Importantly, the concept of *reasonable assurance* does not mean that the auditor has obtained absolute assurance or that they have tested every transaction or disclosure in the annual report or long-term planning document. Nor does it mean that the auditor has looked at and assessed whether every aspect of the Council's operations and activities complies with applicable laws and regulations. It is recognised that most of the audit evidence from which the auditor draws conclusions, and bases their opinion on, is persuasive rather than conclusive
324. Throughout my review, I have remained aware of the *scope* of the audit engagement – the nature and extent of the matters on which the auditor is required to express an opinion, and also what matters the auditor's opinion does *not* address. The scope of the audit engagement is determined by the requirements and provisions of the Local Government Act 2002 (the Act).
325. Other matters that I have taken into account when reaching my overall conclusions include:
- 325.1. The limitations on the extent to which the audit engagement can, and should, be relied on. The concept of *reasonable assurance* does not mean that the auditor has obtained absolute assurance, or that they have tested every transaction or disclosure in the annual report/long-term planning document. Nor does it mean that the auditor has assessed whether every aspect of the Council's operations complies with applicable laws and regulations.



- 325.2. Whether the auditor has planned and performed the engagement in accordance with the professional and ethical standards applicable to each different type of audit engagement.
- 325.3. How the auditor took account of, or remained alert to, matters of direct interest or concern to the Auditor-General. In broad terms, these concern the Council's performance, authority, waste and probity.
326. At the conclusion of the audit, the auditor is required to form an opinion on the annual report or planning document. This opinion is based on the auditor's evaluation of the audit evidence collected during the audit. The auditor's report must clearly express that opinion and its basis. The auditor's opinion must encompass all those matters which they are required to report on.
327. To form their opinion, the auditor must conclude whether they have obtained *reasonable assurance* that the annual report or planning document is free from material misstatement (whether due to fraud or error), and that they are in a position to conclude on any other matter which the auditor is required to form an opinion on. The auditor's conclusion must take into account whether the audit evidence that has been obtained is sufficient and appropriate, and whether any uncorrected misstatements are material, individually or in aggregate.
328. Deciding whether errors or omissions may result in a material misstatement of the annual report or planning document is a matter of the auditor's professional judgment. To help make judgment, the auditor sets a level of materiality against which errors or omissions can be considered individually or collectively.
329. Here, even though the auditor's assessment of what is material may have been influenced by deficiencies I have noted in the audit planning and/or the identification of audit risks, I am nonetheless satisfied that the auditor's general approach to determining the level of materiality – as set out in their planning memorandum – was reasonable and appropriate.
330. When considering or determining whether a matter is material, the auditor's benchmark test is whether the misstatements would be expected to influence the economic decisions of users if those decisions were based on the annual report or planning document.
331. In this section, I have organised my analysis and findings as follows:
- First, I consider the impact that errors or omissions in the Council's annual reports/planning documents may have had on the auditor's reports;
  - Second, I set out my general observations and findings on whether the objectives of the audits were satisfied. By 'general', I mean those observations and findings that can be reasonably applied to *all* the audits performed throughout the review period (2003-2012);
  - Third, I present findings and observations that apply specifically to the following clusters of audits:
    - Audits performed 2003-2005
    - Audits performed 2006- 2009
    - Audits performed 2010-2012

### **Errors or omissions in the Council's annual report/planning documents: What impact did they have on the auditor's report?**

332. My terms of reference do not require me to form an opinion on whether an individual annual report or planning document was materially correct, or materially misstated. It would not be possible for me to form an opinion on this without performing an independent audit of these documents.
333. However, the possibility that an annual report or planning document contained errors or omissions is directly relevant to my assessment of whether the auditor satisfied the objectives of the audit. During the period under review, a number of significant irregularities and deficiencies were brought to light. In some cases, they directly call into question whether Council annual reports or planning documents were materially correct at the time that they were prepared.
334. I have sought to understand whether the auditor adequately addressed these irregularities and deficiencies in the audit, and also to understand their potential impact on the auditor's report. I acknowledge the need to avoid drawing conclusions with the benefit of hindsight, or on the basis of information and evidence that may not have been available to the auditor at the time that the audit was conducted. I have considered the risk of hindsight on a case by case basis.
335. Of the issues and irregularities brought to light recently, those that most significantly affect my overall conclusions and findings are:
- Whether the wastewater project was appropriately accounted for in the Council's financial statements; and
  - The irregularities identified in the *Kaipara District Council (Validation of Rates and Other Matters) Bill* introduced to Parliament in June 2013.
336. These recent disclosures have forced me to question whether the original assertions in the Council's annual reports/planning documents may have been deficient, and whether those documents would have been amended if the deficiencies had been identified at the time of the audit. I have formed this view based on how both the Council and auditor dealt with these irregularities once they were brought to light, and in considering whether it was reasonable that this action would also have been taken had the irregularities been identified in previous financial periods or audits. I have separately considered the impact of each of these issues or irregularities below.

### ***The Council's accounting treatment of the wastewater project***

337. In 2011 the Council reviewed the accounting treatment it had adopted during the period the wastewater scheme was under construction (2007-2009) and at the date of commercial acceptance (July 2009). This was the date when ownership of the asset was transferred to the Council, and also when the Council paid Mangawhai Development Holdings Ltd (MDHL) for the cost of construction. There is evidence on the audit file to indicate that the auditor, and Audit New Zealand more generally, helped the Council to consider what accounting treatment was appropriate.
338. In March 2012, the auditor wrote to the Council outlining the issues which it needed to consider or agree on to determine the most appropriate correct accounting treatment. That advice set out the auditor's views on:



- Whether it was appropriate for the Council to initially recognise the wastewater asset as property, plant and equipment at completion in July 2009, or whether the asset should have been recognised during the period of construction;
- Whether the arrangement between the Council, MDHL, ABN AMRO (ABN) and Earth Tec Engineering (ETE) constituted a service concession arrangement and, if so, how should that be properly accounted for; and
- Whether the Council had appropriately accounted for the following items in accordance with generally accepted accounting practice:
  - Costs associated with connecting houses to the wastewater network;
  - Interest costs accrued by MDHL during the period of construction; and
  - Loan transaction costs incurred by MDHL.

Importantly, the auditor's advice on this last matter (and on the accounting treatment of the three categories of cost identified) clearly indicated that several valid accounting options were available to the Council.

339. I have reviewed the auditor's advice, together with the Council's ultimate decision on the best course of action, to assess the potential impact these matters had on the Council's financial statements and the final audit report. My key observations are:

- 339.1. In relation to whether the Council should have recognised the wastewater asset as property, plant and equipment during the period of construction, the auditor's advice notes that *"Consideration of the factors of control and the risks and rewards of ownership provide conflicting indicators about whether KDC should have recognised the MEWS during construction or at the point it formally accepted the MEWS in July 2009"*. The auditor goes on to state that *"On balance, the substance of the arrangement was that KDC was constructing the MEWS during the 2008 and 2009 financial years, and in our view, it should have recognised the asset and the associated liability as it was being constructed"*.
- 339.2. This advice clearly indicates that the Council incorrectly accounted for the wastewater project during construction. The auditor says that the Council was incorrect to assume that as legal ownership did not transfer to the Council until commercial acceptance, then the wastewater project should not be recognised in the Council's financial statements until this occurred. That assumption – that the project should be managed and accounted for *off-balance sheet* – was incorrect. The auditor points out that this error affected the 2008 and 2009 annual reports and that, in each of those periods, the Council effectively understated its assets and liabilities. After commercial acceptance (July 2009), the resulting wastewater asset and borrowings to pay for its construction were recognised in the Council's 2010 financial statements as an asset and liability respectively.
- 339.3. In 2010 the Council completed a revaluation of its infrastructure assets. The scope of this revaluation included the recently capitalised wastewater scheme asset. The valuation of this asset was assessed at \$38.435million, \$12.983million lower than the carrying value of the asset (the value at which the assets had been capitalised at the time of commercial acceptance). The significant difference between the revaluation and carrying value related to the costs that the Council had capitalised

in July 2009. On commercial acceptance the Council reimbursed MDHL for the full cost of construction, which included the cost of connecting houses to the network as well as the interest and loan transaction costs incurred as part of the development. In reviewing the accounting treatment, the Council decided that these costs should not have been capitalised but expensed, as they were incurred through the period of construction. In respect of the treatment of borrowing costs, the Council's accounting policy was clear that these costs were to be expensed as they were incurred.

339.4. The 2011 annual report discloses, by way of a note to the financial statements, the Council's decision to restate prior period comparative financial information to reflect the accounting treatment that should have correctly applied in the 2008-2010 annual reports. I have set out below the overall effect that applying the correct accounting treatment would have had on the Council's financial statements in each period:

#### *2008*

- The assets and liabilities of the Council were respectively understated by \$6.431m and \$6.749m, the cost of construction by MDHL at that time;
- The Council's financing cost expenditure was understated by \$318k – this being the borrowing and financing costs that should have been expensed during this period.

#### *2009*

- The Council's property, plant and equipment and borrowings were understated by \$27.273m and \$36.120m respectively;
- Financing cost expenditure was understated by \$1.919m;
- Other expenditure was understated by \$10.493m –the cost of connecting houses to the network which the Council determined should not have been capitalised in July 2009 but expensed during the period of construction.

#### *2010*

- The Council's property, plant and equipment and borrowings were understated by \$375k and \$432k respectively;
- Financing cost expenditure were understated by \$704k;
- Depreciation expenditure was overstated by \$535k.

339.5. I have already observed that the auditor told the Council it had options for determining the most appropriate accounting treatment for costs incurred in connecting houses to the network, and separately for borrowing and finance costs incurred during construction. The Council's decision, as reflected in the 2011 annual report, was to expense these costs. The auditor's advice indicates that a valid argument could be made to either capitalise or expense these costs, but that it was a decision that Council needed to make.

340. Having found that the Council incorrectly accounted for the wastewater project, I have attempted to understand why the auditor did not identify this error during the audit engagement. As noted in various sections of this report, it is my view that the auditor lacked a complete understanding of the project necessary to effectively plan and perform the audit. This lack extends to the auditors' inadequate understanding of the appropriate accounting treatment. There is no evidence in the audit files to indicate that the auditor ever fully considered the appropriate accounting treatment for the wastewater project once the Council signed the final contract and scope in 2007, thus allowing the substance of the contract to be properly assessed.
341. My discussions with the auditor reveal their reliance on discussions with management. Council management understood that the nature of the contract was such that the construction of the asset would in effect be managed and accounted for off the Council's balance sheet. The auditor says all financial information and forecasts prepared during 2006-2009 support this understanding. I accept that auditor was aware that this was management's perception. However, I consider it unreasonable for the auditor to rely solely on management's advice or knowledge without independently considering whether it was consistent with the actual substance of the contract or arrangement.
342. There is no evidence from the 2006 -2009 files to suggest that the auditor ever independently reviewed and considered whether the accounting treatment was consistent with generally accepted accounting practice. No audit test procedures were ever completed during the construction period to determine the level of costs being incurred.
343. Overall, while I accept the auditor's view that Council management may not have sufficiently or appropriately understood the accounting treatment implications of the wastewater project, I consider it was unreasonable for the auditor to regard discussions with management as the primary source of audit evidence on which to base a conclusion on the appropriateness of the accounting treatment adopted by the Council. In my view, it is reasonable to suggest that, in accordance with the auditing standards that applied at the time of the 2006-2009 audits, the auditor should have independently reviewed or considered the substance of the contract and arrangement. Had they done so, the auditor would have been in a position to determine whether they agreed or disagreed with management's assertion that the wastewater project should not be accounted for in the financial statements of the Council during the period of construction. Should the auditor have performed this independent assessment, it is *highly likely* that the auditor would have challenged management's understanding. I consider this a serious deficiency in the planning and performance of the audit, and a failure to meet the applicable auditing standards. I am also concerned at whether sufficient professional scepticism has been applied to a matter that was likely to have had a significant or material impact on the Council's annual report and the auditor's own report, taking account of all of the information that was otherwise available to the auditor at the time of the audit – including contract documentation and arrangements, the auditor's understanding that the nature of the arrangement for the project had changed from that originally intended, the limitations of the audit assessment of the management of the project performed during 2003 – 2005..

*What impact do these errors have on the auditor's report?*

344. In answering this question, I have relied on the 2011 annual report disclosures about how the *adopted* accounting treatment would have impacted the 2008-2010 annual reports. I am satisfied that the auditor reviewed and considered these disclosures as part of their

audit of the 2011 annual report. I am also satisfied that the nature of the adjustments set out in the annual report disclosures is consistent with the auditor's advice to the Council in March 2012. I have also noted that while the Council may have had options about how to treat household connections, borrowing and financing costs, it had decided that all of these costs should have been expensed in the period in which they were incurred.

345. With respect to the cumulative effect of the errors and misstatements in the 2008 and 2010 annual reports – which the Council acknowledged occurred because of the accounting treatment applied in these periods – in my view, they would be unlikely to materially affect users' understanding or confidence in the overall financial statements. Had these errors been identified at the time of the audit it is *highly unlikely* that the auditor would have issued a qualified audit opinion on the Council's annual report. Nonetheless, it is a significant concern that the auditor failed to identify these errors and why they occurred. This directly affects my view of whether the auditor effectively satisfied the objectives of the audit.
346. In the case of the 2009 annual report, the errors and misstatements arising from the application of the incorrect accounting treatment meant that the Council's financial statements for that year were materially misstated. Thus, the individual and cumulative effect of the errors exceeded the materiality levels set by the auditor for the 2009 audit. As for whether it is reasonable to expect the auditor to have planned and performed the audit so that these material misstatements would have been revealed, I believe it is: the auditor should have identified the incorrect accounting treatment and the resulting material misstatements. As a consequence, I conclude that the auditor incorrectly issued an unqualified audit report in respect of the 2009 annual report.

### **The rating irregularities identified in the Kaipara District Council (Validation of Rates and Other Matters) Bill**

347. As I have noted elsewhere, this local Bill addresses irregularities in the way the Council purported to comply with certain provisions of the Local Government (Rating) Act 2002 (the LGRA) and the broader Local Government Act 2002. They are directly relevant to the recognition and disclosure of rates revenue, and related assets or liabilities, in the Council's financial statements in the year in which those rates had been set and assessed.
348. Section 4.5 details the work performed by the auditor on rates. There, I note significant deficiencies in the planning and performance of audit test procedures between 2006 and 2010, and conclude that it was reasonable to expect the auditor to have identified many of the irregularities addressed in the Bill.
349. The documentation in the audit files shows the Council became aware of irregularities in the setting and assessment of rates while the auditor was carrying out the 2010 audit. In its 2010 annual report, the Council included additional disclosures regarding the legality of the Mangawhai targeted rates. The disclosures clearly highlight potential irregularities in the setting and assessment of rates. The Council did not adjust the recognition and measurement of rates revenue in the annual report.
350. By the time of the 2011 and 2012 audits, the Council had undertaken further analysis of the nature, extent and impact of the irregularities. It made additional and more extensive disclosure of those irregularities, and their impact on the Council and the annual report. Again, no adjustment was considered necessary to the way rates revenue was recognised and measured. Both the Council and the auditor were satisfied that several courses of action were available to ensure the collectability of rates set and assessed.

351. The Council did take action between 2010-2012. Had the Council identified the irregularities earlier – it is *possible* that the Council may have included additional disclosure of the irregularities, similar to that made in the 2010- 2012 annual reports. I have not sought comment from the Council on this matter. In my view, the potential impact on the auditor’s report issued these earlier periods can be reasonably assessed without further considering how these irregularities may have affected the Council’s annual report or planning document.

*What impact do these irregularities have on the auditor’s report?*

352. In the case of the 2010 annual report audit, the evidence indicates that once the auditor became aware of irregularities in the setting and assessment of Council rates, they brought it to the attention of the OAG. The documentation available at the time was carefully considered, and it was decided that the auditor’s report would not be qualified and that no additional explanation or commentary in the audit report was needed. The auditor considered that the Council had appropriately disclosed the irregularities in the annual report.
353. As noted above, by the time the 2011 and 2012 annual reports were audited, the Council had carried out more detailed analysis of the nature, extent and impact of the irregularities on the collectability of rates, and of their possible effect on the Council’s financial statements: this led to additional disclosure in these annual reports.
354. Again, the audit file shows that the auditor and the OAG carefully considered the impact of the irregularities and the additional action taken by the Council. The auditor determined that an unqualified audit opinion remained appropriate, but that additional explanatory paragraphs in the audit report were now required. This additional text drew attention to issues raised by the Council’s disclosures in the annual report, and assessed the impact on the Council’s ability to continue as a going concern, possible risks to the Council’s financial viability, and legal issues associated with targeted rates. The auditor’s course of action, and the decision not to issue a qualified opinion, appear reasonable and appropriate – particularly in light of the Council’s disclosures in the 2011 and 2012 annual report.
355. The auditor’s approach in 2011 and 2012 is relevant when considering the possible implications for earlier auditor’s reports had the rating irregularities been identified before 2010 (as they should have been).
356. In the 2011 and 2012 audit reports, the auditor noted the Council’s proposed course of action to ensure collectability of current and prior period rates (the Bill currently before Parliament effectively validates these rates, despite the acknowledged irregularities). In preparing those audit reports, the auditor clearly saw the Council’s additional disclosures as important to determining whether the financial statements were materially misstated. In the auditor’s view, those disclosures provided a sufficient basis on which to form a conclusion on the annual report and issue an unqualified opinion. However, the auditor also decided that the irregularities were sufficiently serious to warrant additional disclosure in the audit report, effectively drawing users’ attention to the Council’s own disclosures in the annual report. In my view, it is likely that had the rating irregularities been identified earlier, the auditor would have adopted a similar approach to that outlined above: that is, they would have asked the Council to provide additional disclosure. The auditor would then have been in a position to issue an unqualified opinion but include additional disclosure referring to the impact of the rating irregularities, as they did in 2011 and 2012.

## Have the objectives of the audit been satisfied?

### *General findings and observations*

357. I turn now to consider the other general issues and deficiencies I have identified in the planning and performance of the audit engagement over the whole review period. These deficiencies have a significant bearing on my assessment of whether:

- there is sufficient appropriate audit evidence to support the conclusions reached by the auditor;
- the auditor met the standards and expectations required in the performance of the audit ;
- the auditor ultimately satisfied the overall objective of the audit.

358. In summary, the most significant deficiencies include:

- The auditor did not have a complete understanding of the wastewater project. In particular, the auditor's knowledge and understanding of the wastewater project were inadequate, and did not allow the audit engagement to be effectively planned and performed. The auditor's failure to identify the wastewater project as a significant area of audit risk or focus during 2006 – 2009 is a particularly egregious example. While the project's impact on the Council's annual reports/planning document varied during the review period, in my view, the project should have been a significant and increasing area of focus throughout the 2006 – 2009 audits. The auditor's inadequate understanding of the project prevented this from happening;
- The audit work performed by the auditor on Council's rates – principally during that period where significant irregularities in the setting and assessment of rates were identified in the *Kaipara District Council (Validation of Rates and Other Matters) Bill* – was inadequate;
- Whether the auditor applied sufficient professional judgement and scepticism when considering and assessing the impact of the wastewater project on the Council's financial statements during the period of construction (2008 – 2009);

359. I consider that these deficiencies were likely to have significantly impacted the auditor's ability to satisfy the overall objective of the audit, in the year(s) I have identified. They also significantly affect whether the auditor issued the correct audit opinion in those years. By their very nature, these deficiencies represent departures from the minimum professional standards and expectations required of the auditor.

360. More general areas of concern, affecting multiple audits, include:

- Whether the auditor appropriately considered all matters relevant to the planning of the audit engagement;
- The identification and assessment of significant audit risks and areas of audit focus;
- The sufficiency and appropriateness of audit documentation. I am principally concerned about the absence of documentation that would support the conclusions the auditor reached and provide evidence of the professional judgment they exercised – including when deciding the extent to which it was reasonable to rely on



advice from management and external advisors, and on work performed in previous audits. I have accepted Audit New Zealand's position that, over the review period, the industry had increasing expectations of what constituted sufficient appropriate documentation. However, the fact remains that the absence of sufficient documentation on the audit files makes it impossible to fully assess the nature and extent of the auditor's work, and to determine if it was sufficient to support the individual conclusions reached.

- The auditor's assessment of the Council's management control environment, and the extent they relied on it when deciding areas of audit focus and the test procedures needed to satisfy the audit conclusion; and
  - The auditor's assessment of the Council's compliance with laws and regulations.
361. The extent to which these deficiencies affect whether the audit objectives were met varies throughout the review period. I consider it *unlikely* that they directly impacted on whether the auditor has issued the appropriate audit report. But I am nonetheless concerned by them, as they call into question whether the auditor complied fully with the standards expected when planning and performing an audit.
362. In light of this general concern, it is instructive to examine the impact of these deficiencies on clusters of individual audits. My discussion incorporates observations I have made elsewhere in this report that shed light on the auditor's knowledge, understanding and testing of the wastewater project within each audit cluster.

*Specific findings and observations: audits performed 2003 – 2005*

363. In this period, the auditor viewed the wastewater project as a general area of audit focus when planning the audit. There is documentation and evidence showing the auditor reviewed the project management annually. While this assessment of the overall project management was overly narrow in scope and consideration of the most relevant aspects of the Council's governance and management of the project, it is unlikely to have influenced the auditor's planning and performance of the audit. I have made this assessment on the basis that during 2003-2005, the Council was still reviewing the scope of the wastewater project; the final contract documentation and structure of the project had yet to be determined. In my view the auditor's level of knowledge, understanding and testing was sufficient to enable them to understand the impact of the wastewater project on the Council's annual report or planning document, and thereby satisfy the objective of the audit.
364. My principal concern throughout this period is that the audit file does not always contain sufficient documentation for me to assess whether the auditor:
- had adequate audit evidence to support the conclusions they reached;
  - appropriately carried out the audit test procedures required; and
  - documented their professional judgement.
369. Audit New Zealand asserts that the nature and extent of documentation on the audit file was consistent with industry practice at that time. It is difficult for me to fully assess this now, although I accept that industry views on what constitutes sufficient appropriate audit documentation have increased since 2003.

370. I have noted other general deficiencies in the auditor's assessment of the Council's control environment. However, it is unlikely that these would have significantly impacted the identification of audit risks or areas of audit focus, or the auditor's approach to planning and performing the audit.
371. Notwithstanding these comments, in my view the audit files generally provide sufficient evidence to support the overall conclusions the auditor reached. There is no reason to think that the auditor had not satisfied the overall audit objective at the time that they issued their unqualified audit report.

*Specific findings and observations: audits performed 2006 - 2009*

372. During this period the project's scope and financial impact was reviewed, updated and finalised. Construction took place during 2008- 2009, and final commercial acceptance in July 2009 – after the 30 June 2009 balance date but before the 2009 audit was finalised. Over this time, changes in the project's scope and consequently the financial forecasts had a significant impact on the Council's annual reports and planning documents, the Council itself and the wider community. As I have already explained, it was found in 2011 that the Council incorrectly accounted for the wastewater project during construction. This error affected the 2008 and 2009 annual report; in the case of the latter, the effect was material (as the Council disclosed in 2011).
373. Based on my review of the audit files, I find that the auditor's understanding of the wastewater project – once its final scope and contract arrangement had been agreed – was insufficient to properly plan and perform the audit of the Council's annual reports/planning document. The potential impact of this failing is significant: it affected the auditor's overall conclusion and the audit report issued, and is therefore crucial to determining whether the objectives of these audits were satisfied.
374. As I have said, the wastewater project should have been a major focus for the auditor during this period. While the auditor was generally aware of the project's progress, I consider that level of awareness was not a sufficient basis on which to effectively plan and perform the audit. The auditor's understanding of the project's nature and scope did not allow a proper appreciation of its impact on the annual report. And, in contrast to 2003-2005, in this period the auditor identified no significant audit risks relating to the project.
375. I have heard from the auditor that they relied on the project management assessment performed by the previous auditor in 2005, and on management's general understanding of the project. I find the fact that the auditor regarded these sources as appropriate audit evidence during the 2006 – 2009 period a significant concern. In my view, the auditor should have been independently updating their understanding and assessment of the project as its scope was finalised, the construction contract was awarded, and construction got underway. The fact that the auditor identified no significant audit risks is also a concern, as it meant there was no assessment or testing of the contract arrangement and its impact on the Council's annual report during 2006 – 2009.
376. The auditor has noted that their understanding was influenced by the fact that the Council's understanding of the appropriate accounting treatment of the wastewater project during the period of construction was either incomplete or incorrect. The auditor has also suggested that nature of the public-private partnership arrangements, such as the arrangement put in place for the Council's wastewater project were new in the context of the local government audits. However, in my view the auditor's representations further illustrate my concern that the auditor has placed an inappropriate level of reliance on



management's understanding and has not independently performed sufficient appropriate audit test procedures to be satisfied that the accounting treatment was appropriate and that the Council's financial statements were materially correct. The fact that the auditor acknowledges the complexity of the arrangement suggests that it was reasonable to expect that the accounting and financial implications of the wastewater project would be a significant area of audit risk and focus. As has been explained, it was not. The nature and extent of the auditors reliance on management's understanding meant the auditor failed to adequately identify the potential impact on the Council's annual report if the incorrect accounting treatment was applied. In the event, its impact on the 2009 annual report was material.

377. I have already noted significant deficiencies in the auditor's work on rates, and pointed out that many of the irregularities since identified in the Bill before Parliament should have been detected by the auditor through their test procedures. While these shortcomings may not have changed the decision to issue an unqualified audit opinion, they are nonetheless significant concerns that mean the overall performance of the audit was sub-standard.
378. Finally, many of the general deficiencies noted in paragraphs 357-362 above were also apparent in this period. Again, they must be taken into account in my assessment of whether the auditor has met the standards expected and satisfied the overall audit objective.
379. Overall, after reviewing the 2006-2009 audit files and carefully considering the issues and deficiencies identified, I conclude that the auditor did not satisfy the overall audit objective in this period. The deficiencies noted in the auditor's work were not identified or addressed through the engagement quality review processes. As there is sufficient evidence to indicate that the Council's 2009 annual report was materially misstated, I also conclude that the auditor incorrectly issued an unqualified audit opinion on that annual report: it should have been qualified. This assessment is made on the assumption that the errors and omissions were left uncorrected.

*Specific findings and observations: audits performed 2010 - 2012*

380. After completion and commercial acceptance of the wastewater project in 2009, the infrastructure asset and related borrowings were brought into the Council's financial statements for the first time as part of the 2010 audit. As noted, the Council did not fully comply with generally accepted accounting practice in its accounting treatment of the project during construction. It addressed this issue as part of the 2011 annual report. The impact of the incorrect accounting treatment on the 2010 annual report was not material.
381. It was during 2010-2012 that significant irregularities in the management and funding of the project came to light, including irregularities in the setting and assessment of Council rates. From my review of audit files, I am satisfied that the auditor sufficiently and appropriately considered these matters when planning and performing audits in this period, and in forming an overall conclusion on the audit evidence available.
382. In general, the quality of audit planning and performance significant increased in this period. The sufficiency and appropriateness of audit documentation and evidence improved markedly, showing extra effort and resources were applied to auditing the Council's annual reports/planning document once the irregularities I have referred to came to light.

383. Apart from the initial planning of the 2010 audit, and the auditor's failure to identify significant audit risks associated with the wastewater project, I find only minor deficiencies in audit quality over this period. Those I have identified were unlikely to affect the auditor's conclusion or whether the auditor had satisfied the objective of the audit.

In my view, the audit files for this period generally provide sufficient evidence to support the auditor's overall conclusion. There is no reason to suggest that the auditor did not satisfy the overall audit objective at the time that they issued their unqualified audit report. Moreover, the auditor's 2011 and 2012 reports provide additional explanatory information that draws attention to the Council's disclosure of the irregularities, and their effect on the annual report.

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## APPENDIX 1: TERMS OF REFERENCE FOR THE REVIEW OF AUDIT WORK ON KAIPARA DISTRICT COUNCIL

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### **Background: the overall inquiry**

The Auditor-General is carrying out an inquiry into the Kaipara District Council's management of the Mangawhai community wastewater scheme. The inquiry is examining Kaipara District Council's development, implementation and oversight of the Mangawhai community wastewater scheme (and any related projects), from inception, including:

- the Council's planning and decision-making, including how well it complied with its policies and strategies, and the legal and other requirements for decision-making;
- the governance, management and contracting arrangements for the project;
- the Council's financial management, monitoring, and reporting;
- the funding for the scheme, including the use and setting of rates, borrowing and development contributions;
- the overall suitability and cost-effectiveness of the scheme that has been constructed.

The inquiry will also consider:

- the role played by the Council's auditor;
- the role played by other relevant agencies; and
- any other matters that the Auditor-General considers it desirable to report on.

The Auditor-General is the auditor of the Kaipara District Council, and appointed Audit New Zealand to provide audit services over the period being considered in the inquiry. As part of the inquiry work, the Auditor-General wishes to commission an independent expert to review and report on the sufficiency and appropriateness of the planning, performance and reporting of the audit work over this period.

### **Scope of the review of audit work**

The Reviewer will assess and report on the sufficiency and appropriateness of the planning, performance and reporting of the audits by Audit New Zealand of Kaipara District Council's:

- Long Term Community Council Plans ('LTCCPs') for 2006, 2009 and the Long Term Plan for 2012,
- Annual Reports for the years 2003 to 2012; and
- Annual Plans for the years 2003 to 2012.

The Reviewer will assess whether the work of Audit New Zealand was carried out in accordance with New Zealand auditing and assurance standards (including those issued by the Auditor-General), that applied at the time the audits were performed. In particular the Reviewer will assess and report on the following matters:

#### *Planning and performance of the audit engagement*

- Whether the auditors sufficiently and appropriately planned and performed the audits, including whether they had a sufficient and appropriate focus on significant material risks or financial matters, including in relation to the Mangawhai scheme;

- Whether the auditors planned the audits so that they identified the key legislative matters that needed to be addressed in the audit and whether they appropriately performed the audits to ensure that these matters were addressed;
- Whether the auditors planned the audits with due care, competence, independence and with sufficient professional judgement and scepticism;
- Whether the auditors had and applied sufficient and appropriate quality control mechanisms in planning and performing the audits;
- Whether the auditors in planning and performing the audits sufficiently and appropriately took into account key issues affecting the financial management of the Council;
- Whether the auditors sufficiently and appropriately communicated with Kaipara District Council staff in planning and performing the audits;
- Whether the auditors used adequate and appropriate resources in planning and performing the audits, including the use of appropriately skilled staff or experts;

#### *Audit reporting and conclusions*

- Whether the auditors' conclusions were supported by sufficient and appropriate evidence;
- Whether the auditors' conclusions were appropriately reported both in the audit report and management letters;

#### *Audit documentation*

- Whether the audit files contained sufficient and appropriate documentation of the audits;
- Whether the audit files contained evidence to show that the auditors had obtained sufficient and appropriate audit evidence to support their conclusions;

#### *Audit methodology*

- Whether the Audit New Zealand audit methodology adequately supported the planning and performance of the audits of Kaipara District Council;

#### *Audit communications*

- Whether the audit opinions in the audits were appropriate;
- Whether the management letters were appropriate.

### **Process for carrying out the review**

To carry out the review, the Reviewer will:

- review the information collected by the OAG that is relevant to his work;
- collect and review any other information that he considers relevant to his work;
- interview people with information that is relevant to work;
- prepare a written draft report of his findings;
- allow any person criticised in the draft report an opportunity to comment;
- revise the report as needed to address any comments received;
- finalise the report in a form that can be published alongside the overall inquiry report; and
- assist the OAG inquiry team to incorporate his findings into the overall inquiry report.

## **Support from OAG**

Although OAG staff will provide administrative support as needed, the Reviewer must carry out the review independently and make his own assessment of the audit work being reviewed.

OAG staff will provide the Reviewer with background information about issues that have been identified in recent reviews, including the other parts of the overall inquiry, which are relevant to the audit work. Where these reviews have reached conclusions on adequacy or defects in what has been done by Kaipara District Council or others, the Reviewer can rely on these conclusions for the purposes of this review.

The Reviewer will have full access to background information held by the OAG that is relevant to his work, and to all relevant information held by Audit New Zealand.

# Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Regional services planning in the health sector
- Effectiveness and efficiency of arrangements to repair pipes and roads in Christchurch Earthquake Commission: Managing the Canterbury Home Repair Programme
- Using the United Nations' Madrid indicators to better understand our ageing population
- Annual Report 2012/13
- Using development contributions and financial contributions to fund local authorities' growth-related assets
- Commentary on *Affording Our Future: Statement on New Zealand's Long-term Fiscal Position*
- Annual Plan 2013/14
- Learning from public entities' use of social media
- Inquiry into Mayor Aldo Miccio's management of his role as mayor and his private business interests
- Managing public assets
- Insuring public assets
- Evolving approach to combating child obesity
- Public sector financial sustainability
- Education for Māori: Implementing *Ka Hikitia – Managing for Success*
- Statement of Intent 2013–2016
- Central government: Results of the 2011/12 audits
- Health sector: Results of the 2011/12 audits

## Website

All these reports, and many of our earlier reports, are available in HTML and PDF format on our website – [www.oag.govt.nz](http://www.oag.govt.nz). Most of them can also be obtained in hard copy on request – [reports@oag.govt.nz](mailto:reports@oag.govt.nz).

## Notification of new reports

We offer facilities on our website for people to be notified when new reports and public statements are added to the website. The home page has links to our RSS feed, Twitter account, Facebook page, and email subscribers service.

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The Office of the Auditor-General has a policy of sustainable publishing practices. This report is printed on environmentally responsible paper stocks manufactured under the environmental management system standard AS/NZS ISO 14001:2004 using Elemental Chlorine Free (ECF) pulp sourced from sustainable well-managed forests. Processes for manufacture include use of vegetable-based inks and water-based sealants, with disposal and/or recycling of waste materials according to best business practices.



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