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Summary:
Inquiry into the
Mangawhai
community
wastewater
scheme





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This report is a summary of our full report, *Inquiry into the Mangawhai community wastewater scheme*. The full report is 420 pages long. The cost of printing such a lengthy document is considerable, so we have printed limited copies of the full report.

The full report, and this summary, are both available in HTML and in PDF format at the Auditor-General's website, www.oag.govt.nz.

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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 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)¹ has had to consider wastewater disposal for Mangawhai.
- 1.2 Since 1996, the need to construct a community wastewater scheme for Mangawhai has been a significant issue for KDC. It has also caused significant community concern. A wastewater scheme was eventually built between 2007 and 2010, using a public private partnership (PPP) approach.
- 1.3 By the end of 2011, KDC was carrying out several reviews of the wastewater scheme, including legal and financial reviews. 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.
- 1.4 We have looked at all 16 years of the project – 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 wastewater scheme; and
 - the overall suitability and cost-effectiveness of the scheme that has been constructed.
- 1.5 The problems with the wastewater project raised other questions, so the inquiry also considered the roles played by KDC's auditor and by other relevant agencies.
- 1.6 The inquiry has not considered questions of legality in any detail. One of the reasons KDC asked us to inquire was its recognition 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.
- 1.7 During our work, two other processes began to assess legal questions:
 - KDC has initiated a Local Bill seeking to validate a wide range of its decisions and actions. This Bill would put an end to debates about the status of those decisions and actions.

¹ 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.

- 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.

1.8 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 is not appropriate for us to comment on legal questions that these other processes are examining.

Part 2

How the wastewater project began (1996 to 2002)

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. We looked at what studies showed about water quality in the Mangawhai area and how KDC considered options for improving water quality. With the assistance of an engineer, we also reviewed whether septic tanks were a suitable solution for Mangawhai.
- 2.3 We found 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.

How Kaipara District Council set up the wastewater project

- 2.4 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.
- 2.5 We considered the initial advice KDC received on how to deliver the wastewater scheme and its funding constraints. We considered how this advice affected the decision to use a PPP approach that the Council made later. We also looked at the Council’s initial decisions to select a project manager and about project governance arrangements. We also looked at how KDC decided to proceed with a PPP approach.

2.6 We found 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 for 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.

Tender process to choose a construction partner

2.7 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.

2.8 We reviewed the tender process KDC used and the preliminary work that KDC carried out on how it would fund the project.

2.9 We found that:

- The basic process and steps that KDC took to tender for a partner to build and operate the scheme 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.

2.10 Our assessment is that KDC was out of its depth in embarking on a PPP and relied heavily on its project managers for guidance.

Discussions with the community when the wastewater project began

2.11 KDC had discussions with the community before the project began. We found that the consultation was good when the Council initially decided that a reticulated scheme was necessary. KDC also took other steps to communicate with the community, including establishing a Community Liaison Group in 2000 as part of the project's governance arrangements and the use of a community forum and public meeting during the tender process.

2.12 We also looked at how the Council communicated with the community, and how it took into account the community's concerns, when the project began. We found that KDC's work to communicate with the community and understand its views during this initial phase of work was reasonably good.

Our overall comments on how the wastewater project began

2.13 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.

2.14 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.

2.15 Although the Request for Proposal (RFP) for tenders to construct the scheme did not rule out disposal to water, it made it clear that stakeholders did not prefer this and that the risk of gaining consent for disposal to water 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.

- 2.16 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.² It was risky for KDC to carry on with the tender process without resolving this issue. The disposal site for the scheme was not identified or secured until quite late in the project and added significant costs.
- 2.17 We do not consider that the decision to use a PPP was well founded. Although there was reasonably well-developed Australian guidance about PPPs available by 2001 and the Beca consortium³ 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 decision was largely driven by financial considerations and the perception that a PPP would keep the debt off KDC's balance sheet so KDC could get around its borrowing restrictions. In our view, KDC should have done more work to consider the full range of options available to it.
- 2.18 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.
- 2.19 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.
- 2.20 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.
- 2.21 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

2 The benchmark is a figure used for deciding whether a PPP would offer better value for money than KDC building and operating the wastewater scheme itself.

3 The project managers for the scheme were a consortium led by Beca.

being made, and the reasons for them. Good records provide the foundation for that accountability. 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.

- 2.22 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.
- 2.23 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 3

Difficulties getting the wastewater project under way (2003 to 2007)

Changing to a different kind of project

- 3.1 In September 2002, the Council had selected a preferred provider, Simon Engineering (Australia) Pty Ltd (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 (Build, Own, Operate, Transfer) 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.
- 3.2 With the enactment of the Local Government Act 2002, KDC could no longer use a BOOT scheme and needed to change the way it was to deliver the wastewater scheme. We looked at how the Council made the decision to change to a DBFO (Design, Build, Finance, Operate) type of PPP and what that meant for its negotiations with Simon Engineering and the proposed contract.
- 3.3 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, for example, whether a PPP was still the best option, what models were now available and their relative merits, and what options were available for funding the purchase. 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.

Funding the wastewater project

- 3.4 With the change from a BOOT to a DBFO, 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.
- 3.5 We looked at the work that KDC did on the funding mechanisms that it proposed to use to fund the project, including development contributions and a subsidy from the Ministry of Health. We also looked at the work KDC carried out on its borrowing and financing policies between 2003 and 2007.

3.6 We found 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.

Changing the contractor

3.7 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 early 2005, the parent company of Simon Engineering went into voluntary administration. The Council withdrew from negotiating with Simon Engineering and engaged with the two bidders that had participated in the earlier tender. One bidder was not interested, so KDC decided to contract with the other bidder, EarthTech.

3.8 We found 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 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.

Finding a disposal site for the effluent

- 3.9 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.
- 3.10 We reviewed the work KDC did to secure a disposal site and identified the consequences of that decision.
- 3.11 We found 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.

Increasing the scope of the wastewater project

- 3.12 In February 2006, KDC adopted a Statement of Proposal to consult the community on the wastewater scheme. This set out the estimated capital costs of the project, \$35.6 million, and KDC's preferred funding of the scheme using a mix of rates and development contributions. Later in 2006, the Council decided to purchase land for the disposal site (a farm). Because of the costs of the additional infrastructure required for the disposal site, and the costs of purchasing the farm, the estimated capital costs of the scheme increased. The Council needed to consider how it was going to fund these increased costs. 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).
- 3.13 We looked at the work KDC did on the assumptions about population growth. These assumptions were used as the basis for the contract with EarthTech and to determine the level of rates and development contributions included in the Statement of Proposal. We also considered the Council's decision in October 2006 to change the growth assumptions for the scheme and increase the scope of the scheme.

- 3.14 We concluded 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. 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.
- 3.15 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.

Other changes to the wastewater project

- 3.16 As well as the major changes and challenges that the Council had to deal with between 2003 and 2007, there were many other changes during this period. KDC needed to give effect to its earlier decision to increase the scope of the scheme. This meant that it needed to amend the contracts it had agreed with EarthTech and ABN Amro. We looked at the reasons that the contracts were amended and the changes that were made. We also looked at the oversight that Council had of this process. The contracts that had been signed in October 2005 included financing costs that would need to be paid by KDC if construction was delayed. The delays in getting started meant that KDC was continuing to incur these costs.
- 3.17 KDC also decided to extend the project management contract with the Beca consortium. When it signed the amended project documents, KDC also decided that it would use swaps to hedge its interest rate risk during construction.
- 3.18 We concluded 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 stage of the project, the Council was no longer in control of the project or its costs.
- KDC's record-keeping was poor.

How the community was kept informed

- 3.19 From 2003 to 2007, KDC and its contractors were communicating regularly with Mangawhai and Kaipara ratepayers about what was happening. We looked at the formal consultation that KDC carried out in this period, as well as KDC's communication with the community on important decisions during this period.
- 3.20 We concluded 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.
- 3.21 We have not commented on whether KDC's consultation with the community complies with the Local Government Act 2002, as this matter is currently before the High Court.

Our overall comments on how the Council dealt with difficulties

- 3.22 Between 2003 and 2007, the weaknesses in the way the project had been set up started to show. 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.

- 3.23 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.
- 3.24 We are concerned that the Council lost control of the size and cost of the project. It is not satisfactory that we could not find clear and consistent figures for the project's costs and funding.
- 3.25 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, we found when considering the work to find a disposal site, 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 funding and borrowing options, and the value for money of the proposed financing arrangements.
- 3.26 By the time construction was ready to begin in late 2007, the Council had 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.
- 3.27 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.
- 3.28 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.

- 3.29 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 4

Building and implementing the wastewater scheme (2007 to 2012)

How construction was to be managed

- 4.1 We looked at what the contract documents set out for how the construction process was to be managed, including the tools that were available to KDC to oversee the construction work. We then considered how KDC ensured that the tools that it had were used on its behalf.
- 4.2 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).
- 4.3 We also found that the contract documents did not cover all the works to be carried out, which was to have financial consequences for KDC. We discuss this further below.

Events during construction

- 4.4 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.
- 4.5 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.
- 4.6 We considered how the work carried out during the construction was managed, including how well KDC controlled what was being built, and whether EarthTech built what it was contracted to build. We looked at the process that was used for making modifications to what was agreed to be built under the contract documents, and how information on those modifications and their cost effects were provided to Council. We also looked at how the work to connect residences

to the scheme was carried out and the quality of the community liaison during the construction period.

4.7 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.

Funding and financing changes during construction

4.8 During this period Council made further changes to the level of rates and developments contributions it proposed to use to fund the project. KDC also decided to use interest rate swaps to manage its interest rate risk during construction. Because of the changes that were made to what was to be built after the contract documents had been signed in December 2007, the timetable for construction could not be met. This meant that the financing arrangements, which were dependent on that timetable also needed to change. In addition, a swap that had been used to manage Council's interest rate risk during the period up until the end of construction needed to be broken.

4.9 We reviewed the changes to the funding for the project that Council agreed to make, and the changes that were made to the financing for the project during the construction period.

4.10 In summary, we concluded 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 funding for the project, including the debt financing.

4.11 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.

The Council takes possession of the assets

- 4.12 KDC took possession of the wastewater scheme after construction. The Project Deed set out a process that was to take place before Council took possession. This process was to check that the scheme had been constructed in accordance with the Project Deed and was capable of being operated for its purpose and in accordance with all consents. We refer to this process as the “commercial acceptance process”. The commercial acceptance process was an important mechanism that KDC had to ensure that when it paid for the scheme, the scheme had been built as intended by the parties and was fit for purpose. We looked at what the Project Deed required for the commercial acceptance process, and then compared this to what happened.
- 4.13 The Project Deed provided that commercial acceptance was to occur in two stages. That is, KDC would take ownership of part of the scheme once construction of that part was completed. It would then take ownership of the other part of the scheme at a later date, once construction of that part had been completed. KDC had agreed to this because it had been told that it would save money on the financing costs. Because of the delays to the construction timetable caused by the additional work on the modifications, commercial acceptance did not occur in two stages. Instead, it occurred on a single date.
- 4.14 We found that:
- Commercial acceptance was given by the Project Director on KDC’s behalf 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.

How the wastewater scheme is operating now

- 4.15 We looked at how the wastewater scheme is operating now, and received assistance from two engineers, including a wastewater engineer to carry out this part of the work. We looked at what the Project Deed says about how the scheme is to be operated, and how KDC is managing the contract. We also considered what the monitoring by NRC showed about how the scheme is operating. One of the issues we considered was the operation of the disposal site and whether it would have capacity to take all projected flows of wastewater.

- 4.16 We found 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.

Our overall comments on construction and implementation

- 4.17 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.
- 4.18 Northland Regional Council has not been able to provide us with any data to show whether the water quality in the Mangawhai Harbour is improving yet. It may take some time for water quality to improve. KDC needs to work with Northland Regional Council to ensure that this monitoring is done, so that the community gets information about whether the scheme has achieved its purpose.
- 4.19 However, it is clear that KDC did not monitor and manage the construction process adequately.
- 4.20 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.
- 4.21 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.
- 4.22 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.

- 4.23 Given the level of community concern about the project and its affordability, the need 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 so. 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. In our view, the information held by KDC was totally inadequate.

Part 5

The accountability system for local authorities

- 5.1 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.
- 5.2 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. The main agencies are:
- **The Auditor-General:** 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. Audit New Zealand is the business unit that carries out annual audits. The Office of the Auditor-General (OAG) is the business unit that, among other things, deals with correspondence requesting inquiries.
 - **The Ombudsman:** 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. 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.
 - **The Minister of Local Government and the Department of Internal Affairs:** 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.
 - **The Police and Serious Fraud Office:** 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.
 - **The courts:** 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.

Independent review of the work of Audit New Zealand

- 5.3 The terms of reference for the inquiry set out that the Auditor-General would appoint an independent person to review the audit work carried out by Audit New Zealand relating to Kaipara District Council.
- 5.4 We commissioned Mr Neil Cherry for this work, who is chairman of the New Zealand Auditing and Assurance Standards Board.⁴ 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, a former Auditor-General of Victoria, Australia, to act as a peer reviewer for Mr Cherry.
- 5.5 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 long-term plans (LTPs).

What the review found

- 5.6 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.
- 5.7 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.
- 5.8 The review concluded that the audits carried out between 2003 and 2005 satisfied the audit objective: the auditor had obtained reasonable assurance that the audited information met the required standards. However, the review criticises the sufficiency of documentation in the audit files for these years. 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.

⁴ 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 at the Australian Auditing and Assurance Standards Board. He carried out this review in his personal capacity.

- 5.9 The independent review found that, between 2006 and 2009:
- problems continued with the adequacy of documentation in the audit files and the assessment of the management control environment within KDC;
 - the auditor did not update their understanding of the wastewater project in these years, did not adequately assess the project's potential effect on KDC or the audit engagement, and did not give any independent consideration to the accounting treatment for the project;
 - the auditor inappropriately relied on KDC's management as a primary source of audit evidence and did not independently corroborate the information management provided;
 - the planning and assessment of risk that was done did not provide a sound basis for planning and performing the audits during this period and some audit test procedures were performed incompletely or inadequately; and
 - there were significant deficiencies in the auditor's work on rates during these years and the auditor should have detected many of the irregularities covered by the Validation Bill through normal test procedures.
- 5.10 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. 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.
- 5.11 The independent 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.
- 5.12 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

- 5.13 Some steps have already been taken, including:
- Audit New Zealand was removed from the KDC audit in late 2012;
 - the OAG's quality assurance programme 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; and
 - 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 local government 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.
- 5.14 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. She 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.
- 5.15 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. However, the concerns raised by this independent review do not suggest widespread or systemic problems that would justify removing audits from Audit New Zealand.

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

- 5.16 The inquiry also considered 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.

- 5.17 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, Ms Smith had no significant involvement in matters relating to KDC before this inquiry started in March 2012.
- 5.18 The OAG received five complaints about KDC between 2002 and 2005. Ms Smith considered that the OAG's responses to them were adequate.
- 5.19 There were no further complaints to the OAG until early 2010, by which time the wastewater scheme was completed and operating. By May 2010, three correspondents had written either to the OAG, Ombudsman or the Department expressing concern about a targeted rate for the scheme. One of these correspondents also raised a range of wider concerns about the Council and the wastewater scheme.
- 5.20 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. Given the information available to the OAG at the time, the inquiry concluded that the decision not to inquire was reasonable, although it is now clear that the correspondents were right about many issues.
- 5.21 The OAG's decision was appropriately 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. 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. In this situation, it was also reasonable that the OAG did not review the legal questions about the rate in depth. However, the OAG's decision was based on inadequate information.
- 5.22 The inquiry found that the OAG did not acknowledge in its letters to the correspondents 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. This is not advice that the OAG would now give.
- 5.23 The OAG began to suspect that there might be more issues about KDC and the scheme than the wastewater targeted rate only when KDC provided the OAG 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.

- 5.24 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, given 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.
- 5.25 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 a first-principles review of the rate.
- 5.26 Ms Smith found that the Office of the Ombudsman was acting reasonably when it declined to investigate the wider concerns raised with it. Like the OAG, the Ombudsman will usually decline to investigate complaints that the complainant has not first tried to resolve with the public entity concerned.
- 5.27 The inquiry identified shortcomings in the way that the three main accountability agencies communicated with each other and in the communication with the correspondents. There were no issues with the actions of the Police or the Serious Fraud Office.

Part 6

Our overall conclusions

Summary of what we found

- 6.1 KDC was correct when it decided that Mangawhai needed a reticulated sewerage system and its process for assessing the need and making that decision were sound.
- 6.2 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 Mangawhai Harbour.
- 6.3 The rest of the story is one 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.
- 6.4 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 entity 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.
- 6.5 The project took a long time to complete, the costs increased significantly, and many people lost confidence in KDC.
- 6.6 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.
- 6.7 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.

- 6.8 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.

Underlying causes

- 6.9 This report has identified numerous failings in the way KDC planned and managed the wastewater project. The common theme, throughout all of the particular issues, is the question of capability. We identify particular capacity and capability concerns in relation to:
- governance;
 - management;
 - project management;
 - specialist resources; and
 - procurement.
- 6.10 The other main deficiency was KDC's inadequate focus on its public sector obligations and accountability. Particular concerns included:
- 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.
- 6.11 There is a tendency to discount such points as bureaucratic, but they are 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 for decisions 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.⁵*

⁵ Auditor-General's overview (March 2013), *Inquiry into decision by Hon Shane Jones to grant citizenship to Mr Yang Liu*, page 10.

- 6.12 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. 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.
- 6.13 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.
- 6.14 Although the wastewater project has provided Mangawhai with a reticulated sewerage system, it 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.

What we can learn from the wastewater project

- 6.15 In summary, the main lessons from our inquiry are:

Accountability

- Public entities should be meticulous about legality.
- Good record-keeping is the foundation of effective accountability.
- Workshops can supplement formal council meetings, but not replace them.
- Contractors need to be tied into public sector accountability mechanisms.

Governance

- Understand the role and stick to it.
- Common sense is a legitimate governance tool.
- Understand what assurance is needed and where it will be obtained.
- Audit committees can provide useful support.

Management

- There are limits to contracting out.
- It is important for public entities to maintain appropriate financial management capacity and capability and to stick to their sphere of competence.
- Project governance and management is important.

PPP arrangements

- Do not underestimate what is involved in a PPP arrangement.
- Accounting should not drive the decision to enter into a PPP.
- Transfer of risk is not an end in itself.
- PPPs are unlikely to succeed fully if the contract is not for “the complete package”.

Lessons for auditors

- Understand the entity as a whole.
- Assessing the strength of the management control environment is fundamental.
- Good and open communication between auditor and entity is vital.

Lessons for accountability agencies

- Agencies need to talk to one another.
- It is important to keep an eye on the bigger picture.
- Do not assume that people are familiar with an agency’s role and how it works.

What needs to change

6.16 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 that:

- KDC has changed. It has been restructured and has new senior management, the elected members have been replaced by Commissioners, it has a new auditor, and it has instituted many internal reviews and implemented new systems.
- There is much more guidance available for any public entity considering embarking on a PPP arrangement.
- Reporting requirements for financial and service performance information have developed significantly in the last decade, along with the associated auditing standards.
- The Minister’s powers to intervene in local authorities have been reformed and a more graduated set of responses is now available.

- 6.17 There are a number of matters that will always be difficult for public entities. These need on-going recognition and management, so far as possible. They include:
- maintaining capacity and capability, particularly for scarce specialist expertise and in remote or rural settings;
 - dealing with the community response when councils make controversial decisions that have attracted strong supporters and opponents;
 - misunderstanding of the assurance provided by an audit meaning that entities do not take appropriate steps to manage their own risks;
 - recognition that the responsible entity always needs to have an opportunity to solve its own problems first, before other agencies can or should get involved.
- 6.18 Finally, our inquiry has raised two questions that we consider warrant further debate in the sector. They are:
- Do current public sector structures and allocation of responsibilities support effective development and maintenance of infrastructure?
 - Does New Zealand need more effective remedies for holding local authorities to account?
- 6.19 These are policy questions, and they are not new. It is not the role of the Auditor-General to attempt to solve them. However, we suggest that they warrant consideration and debate.

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. Most of them can also be obtained in hard copy on request – reports@oag.govt.nz.

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