

The Highland Council: Caithness Heat and Power

Follow-up statutory report

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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Commission findings

1. The Commission accepts the Controller of Audit's report on The Highland Council: Caithness Heat and Power.
2. The Commission had previously considered reports in June 2010 and February 2011 from the Controller of Audit that highlighted wide-ranging deficiencies in the council's involvement in the Caithness Heat and Power project. These reports identified serious weaknesses in governance and accountability. This current report is in response to the Commission's request that the Controller of Audit provides a final report on the financial position.
3. We accept the Controller of Audit's conclusion that the final cost to the council is £11.5 million. This is a substantial and serious loss of public money caused by significant deficiencies in the governance of the project and, patently, it does not represent value for money for the council's taxpayers.
4. The council has learned an expensive lesson in this case. The commitment shown and the progress made by the council in addressing the situation and in minimising cost is recognised, as is its revised approach to dealing with arm's-length external organisations (ALEOs).
5. This case provides useful learning points for all councils, particularly the need for robust governance and accountability arrangements for an ALEO in which roles and responsibilities are clear, particularly those of councillors. We therefore take this opportunity to remind councils of our report published in June 2011 entitled *How councils work: an improvement series for councillors and officers - Arm's-length external organisations (ALEOs): are you getting it right?* which provides advice on how ALEOs should be set up and managed.
6. This case also highlights the need to ensure sound risk management; a full assessment of the skills required; and a rigorous option appraisal for initiatives that provide council services.
7. The Commission will therefore share these findings directly with all councils.

Introduction

1. The Controller of Audit reported to the Accounts Commission in June 2010¹ and February 2011² on The Highland Council's involvement in Caithness Heat and Power (CHaP), an innovative project aimed at providing heat and hot water to houses in Wick.
2. These reports considered events from the project's inception in 2002 through to 2008 when, faced with mounting financial and technical problems, the council decided to take control of the company it set up to deliver the project. The reports highlighted wide-ranging deficiencies in the council's involvement in the project, including serious weaknesses in governance and accountability.
3. When I reported in February 2011, the project was ongoing and I was not in a position to identify overall costs or to quantify any losses the council may have incurred. In its findings³, the Accounts Commission requested that I provide a final report at an appropriate point, identifying for the Commission and the public the financial consequences of the project.
4. During 2012/13, the council reassessed the risks and financial assumptions relating to the CHaP project. Its decisions are reflected in the council's accounts for that year, the audit of which was completed in September 2013. Also in 2012/13, a private company started to provide a district heating system to some of the houses previously connected to the CHaP system. In view of these developments, I have decided that this is an appropriate point at which to fulfil the Commission's request for a final report on the financial position.

The CHaP project

Background

5. In 2002, the council initiated a project to deliver an innovative heating system in Wick. This was consistent with its commitment to support renewable energy and tackle fuel poverty. In 2004, the council approved the CHaP project and the formation of an arm's-length company to deliver it.
6. Initially, the project was to involve a wood-fuelled system that would produce heat and hot water to houses owned by the council, a housing association and private owners. A second phase would extend the service to other properties and, with the addition of specialist equipment, provide income from the sale of electricity to the national grid. In the event, the CHaP company decided in 2005 to combine these phases. The equipment was installed but by 2008 financial and technical difficulties became apparent and the project failed.

¹ http://www.audit-scotland.gov.uk/docs/local/2010/sr_100624_chaps.pdf

² http://www.audit-scotland.gov.uk/docs/local/2010/sr_110201_chap_followup.pdf

³ http://www.audit-scotland.gov.uk/docs/local/2010/sr_110302_chap_findings.pdf

7. Between project approval in October 2004 and May 2008, when the scale of the problems became clear, only three reports were made to the council, in each case when the CHaP company was urgently seeking funds.
8. Overall, my report in February 2011 concluded that there was a lack of a coordinated, corporate response to governance and ultimately the project, service users and council finances were left exposed. At that time, the council estimated that its total commitment, including provisions, was £13.8 million.

Developments since 2008

9. A summary of key events since 2008 is provided in [Exhibit 1](#). The following paragraphs in this section of the report summarise the main developments at each stage.

Exhibit 1 - KEY EVENTS SINCE 2008

August 2008	Council takes control of the CHaP company
October 2008	CHaP company arranges equipment trials by expert advisors
December 2008	Expert advisors report that the system is not operational
May 2009	Council funds procurement exercise to appoint provider
April 2010	Preferred bidder appointed. Ignis appointed reserve bidder
September 2010	Preferred bidder status terminated. Negotiations with Ignis start
May 2011	Negotiations with Ignis cease. Council commences reinstatement
November 2011	Ignis purchases equipment from the CHaP company
December 2011	CHaP company's remaining assets and liabilities transfer to council
May 2012	Ignis takes over district heating system and starts supply

10. In June 2008, the council considered a report from officers advising of the need to cap its financial support for the CHaP company. In August 2008, the council considered the costs, benefits and risks associated with options to protect its interests and agreed to take control of the CHaP company.
11. In October 2008, the CHaP company instructed technical advisors to test the existing combined heat and power system, which included the specialist equipment needed to generate electricity. In December 2008, the technical advisors reported that the trial had not achieved target outputs and that the equipment was unreliable.

12. In May 2009, the council considered the following options:
- CHaP company, or the council, or a private company providing a sustainable district heating system
 - CHaP company, or the council reinstating conventional heating systems
 - CHaP company continuing to provide a district heating system using an oil-fired boiler.
13. The council decided to seek bids from private contractors to run a sustainable district heating system. A preferred bidder was appointed in April 2010, but it was unable to provide the assurances required. The reserve bidder, Ignis Energy Ltd (Ignis), accepted preferred bidder status, but it too was unable to meet the council's conditions. The council terminated the procurement process in May 2011 and decided to dispose of the CHaP system and implement a reinstatement strategy.
14. At key stages between May 2009 and May 2011 the council considered the option to reinstate conventional heating systems, but chose to pursue a conclusion to the procurement exercise. The time taken reflects the complexity of the negotiations with bidders and the work required to investigate whether they could satisfy the council's conditions. The council was also keen to ensure proper governance of the process.
15. The reinstatement strategy agreed in May 2011 involved the installation of electric heating and the auction of the CHaP company's equipment. The auction, which was run by specialists with experience of disposing of equipment of this type, took place in November 2011. Ignis bought the equipment needed to provide a district heating system. The council is satisfied that, in the circumstances, the best prices were achieved from the auction.
16. Following public consultation and meetings, householders connected to the CHaP system were requested to choose whether to accept the council's offer to install electric heating or to enter into a contract with Ignis for the supply of heat and hot water. [Exhibit 2](#) summarises the outcome as regards the 246 houses initially connected to CHaP.

Exhibit 2 - PROPERTIES CONNECTED TO THE CHaP SYSTEM

	Initially connected to CHaP	Reinstated by council	Contracted to Ignis	Demolished
Council houses	163	54	109	0
Private owners	18	2	16	0
Housing associations	65	14	39	12
TOTAL	246	70	164	12

17. The remaining assets and liabilities of the CHaP company were transferred to the council in December 2011, at which point the CHaP company ceased trading. In May 2012, Ignis started its district heating system and, since then, it has been supplying heat and hot water to its customers. Until the transfer to Ignis, the CHaP company, and then the council, supplied houses connected to the CHaP system using an oil-fired boiler. The system operated by Ignis uses sustainable woodchip.

Governance

18. When the council took control of the CHaP company in August 2008⁴, it appointed six elected members as company directors who formed the company board. The board made decisions on the day-to-day running of the CHaP company, supported by senior officers of the council. The council also established a project team of senior officers from relevant departments who provided advice on technical, financial and legal matters.
19. The council maintained close oversight of the project from 2008. In contrast to the position before then, it considered regular reports on progress. When decisions were required, reports contained options and summaries of the associated costs, benefits and risks.
20. The Head of Internal Audit and Risk Management provided advice to the CHaP company on certain aspects, eg the sale of equipment, in the period following the council's decision to take control of the CHaP company. However, having been requested by the council to undertake an audit of the project, he recognised the need to be independent of operational aspects. His detailed, desk-based review highlighted fundamental failings in the way in which the project was initiated and authorised, and in risk management.
21. In response to the internal audit report, the council approved an action plan in March 2010 which set out steps aimed at preventing similar situations. Actions included training and awareness sessions for elected members and officers to highlight the implications of weak governance and to share the lessons learned more generally. In April 2012, internal audit reported to the council that the response to the action plan had been positive overall.
22. Internal audit used the Accounts Commission's 'How councils work' report on arm's-length external organisations (ALEOs)⁵ to review governance arrangements in council ALEOs. Internal audit's report to the Audit and Scrutiny Committee in November 2013 concluded that the council's larger ALEOs have well developed governance arrangements in place and largely comply with good practice set out in the Commission's report. Internal audit also identified scope to improve oversight of ALEOs, particularly in relation to those that were set up a number of years ago, to ensure compliance with current guidance. An action plan aimed at securing further improvements is in place.

⁴ CHaP Limited was formed in December 2004 as a company limited by guarantee, with three members: Inverhouse Distillers, the Pulteneytown People's Project and The Highland Council. In August 2008, with the agreement of the other parties, the council became the sole member of CHaP Limited.

⁵ How councils work: Arm's-length external organisations (ALEOs), Accounts Commission, June 2011.
http://www.audit-scotland.gov.uk/docs/local/2011/nr_110616_aleos.pdf

The cost of the CHaP project

23. Exhibit 3 summarises the financial consequences of the council's involvement in the CHaP project. It reflects:

- the estimated commitment at the time of my report in February 2011 (£13.8 million)
- the estimated costs of reinstatement of traditional heating systems (£1.6 million), which the council calculated subsequent to my report in February 2011
- the main differences between the overall estimated cost of £15.4 million (£13.8 million plus £1.6 million) and the final cost to the council (£11.5 million).

Exhibit 3 - COUNCIL EXPENDITURE ON THE CHaP PROJECT

	Estimate in Feb 2011 (£m)	Actual at Sept 2013 (£m)	Variance (£m)
Committed in November 2005	1.6	1.6	0.0
Advances to CHaP	5.0	5.3	0.3
Premature redemption of lease	4.0	3.4	(0.6)
Procurement costs	0.3	0.3	0.0
Other (net) costs	0	0.4	0.4
Provision for repayment of grants	2.9	0	(2.9)
PROJECT EXPENDITURE	13.8	11.0	(2.8)
Reinstatement costs	1.6	0.5	(1.1)
TOTAL EXPENDITURE	15.4	11.5	(3.9)

24. Total expenditure reflects external costs and does not include the time-cost of senior officers working on the project. The council continues to pursue amounts owed by former customers of the CHaP company, amounting to about £0.2 million, recovery of which would reduce the total expenditure.

25. There are three main reasons why the total cost to the council is £3.9 million less than previous estimates:

- The council informed the organisation that had provided sustainable energy related grants to the CHaP project about the changed circumstances, and recognised the potential for repayment by setting up a £2.9 million provision in its accounts. Based on the council's assessment of the likelihood of repayment, it decided to remove the

provision. The external auditors considered this during the audit of the council's 2012/13 accounts and, having reviewed the related documentation, concurred with the council's assessment and the accounting treatment.

- The cost of installation of electric heating in houses where householders opted for reinstatement was £1.1 million lower than forecast. This was because 164 householders decided to enter into contracts with Ignis.
 - The amount due on redemption of a lease taken out to finance the purchase of equipment was £0.6 million less than anticipated because of the recovery of VAT.
26. The council has an ongoing obligation to council house tenants, and would need to provide an alternative source of heat and hot water to the 109 council-owned properties currently connected to the district heating system if for any reason the system is withdrawn. The council has no legal obligation to houses owned by registered social landlords or to private owners.
27. The council's Director of Finance reported the costs incurred on the CHaP project to the council's Audit and Scrutiny Committee in November 2013. His report shows the costs as at September 2013; the figures are consistent with those set out in [Exhibit 3](#) of this report. The Director of Finance's report also identifies the risk to the council should the supplier discontinue its service to customers in council houses. The council currently assesses this risk as low but acknowledges that should the risk crystallise, the council would have to meet the costs of reinstating heating supplies in council houses. The Director of Finance's report notes that to mitigate or partly mitigate the cost of this risk, £0.4 million is earmarked within the council's balances. This will be reassessed at the end of the current financial year.

Conclusions

28. The primary purpose of this report is to meet the Accounts Commission's request for a final report identifying the financial consequences of the council's involvement in the CHaP project. Based on recent audit work, I conclude that the total cost to the council is £11.5 million. If for any reason the district heating system currently operating is withdrawn, the council will have responsibilities to tenants in council-owned houses. If it is required to reinstate traditional heating, the associated costs would add to that total.
29. Since 2008, the council has worked to minimise costs and to secure the best possible outcome for households connected to the CHaP system. The total cost of £11.5 million is £3.9 million (or about 25 per cent) less than estimated. Also, because the district heating system uses woodchip and provides heat and hot water at relatively low prices, the council has retrieved a contribution to its initial renewable energy and fuel poverty related objectives. However, as a result of its own actions between 2002 and 2008 and, in particular, the lack of good governance, the council has not secured value for money from the substantial amount of public money spent on this project.

30. It is clear that the council has taken this seriously and continues to approach matters in an open and transparent manner. Over four years, from August 2008 (when the council took control of the CHaP company) to May 2012 (when houses were reinstated or connected to the current district heating system) the council received regular reports and considered options with related information on costs, benefits and risks. In the circumstances, and in the face of an urgent need to protect its financial position and service users, it was appropriate to involve senior officers in supporting the CHaP company and advising the council.
31. The council also shows commitment to building on the learning from its experience with the CHaP project and continues to develop its approach to dealing with ALEOs and similar funding situations. Discussions with council officers indicate that the council is aware of the financial and reputational issues which can flow from poor decisions and weak oversight and that elected members now take a more robust approach when faced with funding requests from external organisations.
32. This and the two preceding Controller of Audit reports cover a range of matters concerning governance and accountability when councils are involved in ALEOs. This includes fundamental issues relating to the roles and responsibilities of elected members and senior officers. Taken together, the reports on The Highland Council's involvement in the CHaP project demonstrate the serious financial consequences of weak governance in dealings with ALEOs.