B.29[01a]

Report of the Controller and Auditor-General

Tumuaki o te Mana Arotake

on

Local Government: Results of the 1999-2000 Audits

Presented to the House of Representatives pursuant to section 33 of the Public Finance Act 1977

Rt Hon Jonathan Hunt
Speaker
House of Representatives
WELLINGTON

Mr Speaker

I am pleased to forward this report to you for presentation to the House of Representatives pursuant to section 33 of the Public Finance Act 1977.

Yours sincerely

D J D Macdonald
Controller and Auditor-General

Wellington
18 June 2001

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Introduction

This report constitutes our "annual report" on the audits for 1999-2000 of the local government sector of the Audit Office's audit portfolio. The majority of these audits are of the regional and territorial local authorities – including subsidiary entities – that are established and governed principally by the Local Government Act 1974.

Purposes of this Report

The purposes of this report are to:

- advise Parliament and local authorities on matters arising from our role as auditor of regional and territorial local authorities;
- identify areas appropriate for legislative clarification or amendment; and
- outline the Audit Office's expectations of "best-practice" on issues of financial management and reporting, governance, and contracting.

As well as being of interest to Members of Parliament and local authorities, we envisage this Report will be of interest to a broad range of individuals and groups that have an interest in the local government sector.

Contents of this Report

The articles in this report are grouped into six parts:

Part One outlines a number of issues arising from the 1999-2000 audits:

- the management of and accounting for infrastructural assets.
- setting operating revenues to cover operating expenses;

- timeliness of annual reporting;
- legal compliance; and
- separate properties and rating apportionments.

Part Two deals with a mix of other issues that arose during the course of 1999-2000:

- reporting CEO remuneration;
- reporting severance payments;
- competing with the private sector;
- defamation costs; and
- members discussing and voting when interested.

Part Three deals with the special reviews carried out during 1999-2000:

- sale and lease of land;
- reviewing a Long-term Financial Strategy and Funding Policy;
- reporting on achievement of and changes to plans and policies;
- Auckland City Council's administration of the Gulf Islands;
- good practice for involvement in a major project – which draws on the experience of local authority involvement in the Opuha Dam Project; and
- local authority governance of subsidiary entities.

Part Four provides some useful information for any local authority considering entering into a long-term contract for services – with particular reference to maintenance services.

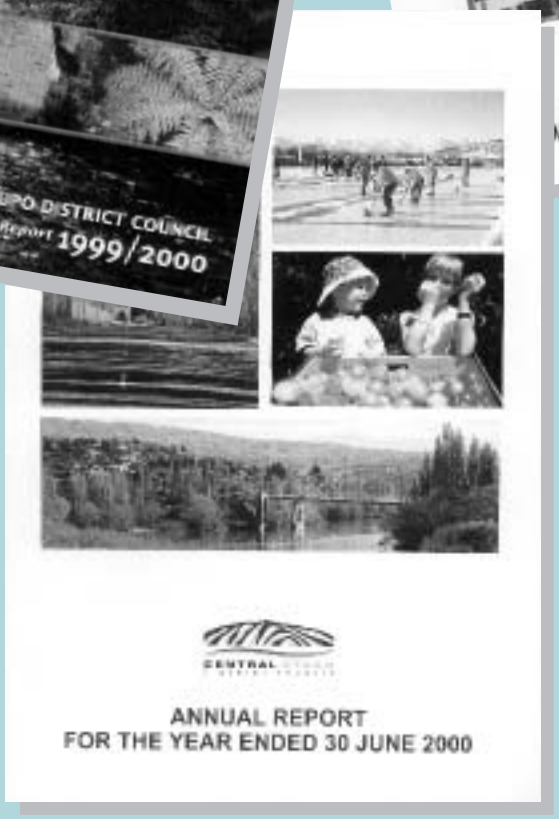
Part Five presents the results of our follow-up audit to review how Papakura District Council has managed and monitored the water and wastewater franchise agreement it has with United Water International Pty Limited.

Part Six describes some of the special matters we have identified for our attention during the 2000-01 audits:

- impact of the Public Audit Act 2001;
- reviews of legislation affecting local government;
- accounting for environmental obligations;
- the integrity of procedures for carrying out regulatory functions;
- the sustainability of essential services; and
- anticipating future rates increases to fund depreciation.

One

Issues from the 1999-2000 Audits



1.1 Management of and Accounting for Infrastructural Assets

1.101 The results of our 1999-2000 audits of local authorities indicate that they have made steady progress in addressing the issues that we have raised in our past reports. In particular, we continue to see improvements in the management of and accounting for infrastructural assets.

1.102 Last year, we reported on how local authorities fared in 1998-99 in complying with Part VIIA of the Local Government Act 1974 and the challenges that the authorities faced in accounting for infrastructural assets.[1]

1.103 The improvements local authorities have made in meeting their accountability obligations are reflected in the reduction in the number of qualified audit opinions we issued on the 1999-2000 financial statements. One authority received a qualified audit opinion because of how it accounted for some of its infrastructural assets. But we are pleased to report that all other authorities made sufficient progress for us to be able to issue unqualified audit opinions.

1.104 Even the one local authority – Kaikoura District Council – that received a qualified audit opinion made significant progress, and it expects to complete the task of identifying and valuing its infrastructural assets so as to receive an unqualified opinion in 2001.

1 *Second Report for 2000*, parliamentary paper B.29[00b], pages 13-18.

1.105 The situation in 1999-2000 compares favourably with the previous year when we issued 13 qualified audit opinions on the grounds that the local authorities did not have sufficient reliable information about their infrastructural assets to:

- prepare a long-term financial strategy;
- make a reasonable estimate of costs that require funding;
- calculate the decline in service potential (depreciation); or
- determine asset valuations.

1.106 However, our overall observation from 1999-2000 is that a number of issues are emerging where further effort is required:

- integrating asset management plans with strategic direction;
- further developing asset management plans;
- defining levels of service;
- risk management practices; and
- valuing infrastructural assets.

Integrating Asset Management Plans with Strategic Direction

1.107 Local authorities are becoming increasingly aware that it is critical that the asset management plan is fully integrated with the authority's strategic direction. Because many authorities developed their Long-term Financial Strategy and asset management plan without reference to each other, there is often a lack of linkage between the two. Authorities are now beginning to address the issue of full integration between the Long-term Financial Strategy and asset management plan.

Further Developing Asset Management Plans

1.108 All local authorities have made progress in further developing and refining their asset management plans, but some are making progress at a significantly faster rate than others. As a result, the gap between the leaders in asset management planning and the laggers grows. Most local authorities have put emphasis on:

- identifying and quantifying their infrastructural assets;
- gathering information on the assets' age, condition, and location;
- developing systems to collate the information;
- determining renewal profiles for components of their total infrastructure;[2] and
- identifying their asset management data needs, and determining the need for integration of this data with other information systems.

1.109 The leading exponents of asset management planning are developing, or have developed, advanced asset management plans. Advanced asset management plans are characterised by the local authority having:

- A much better understanding of its infrastructure built up from maintaining an information base over time. This information base then allows predictions to be made about the performance of the assets in the conditions and circumstances to which they are subject.
- Greater confidence in the assumptions and underlying information than for earlier versions.
- A better understanding of the desired standard (level of service) that the community wants the infrastructure maintained to provide and the technical specification required to deliver that standard.
- A focus on addressing the risks associated with managing the infrastructure, including the identification of critical risk elements within systems.

2 For example, within a road system the land, pavements, formation, kerbs and channels, footpaths, bridges, and lighting are "components" or separate items to the extent that they have different useful lives.

1.110 Local authorities have better information on the state and condition of their infrastructural assets and the requirements for renewing those assets. Nevertheless, the optimal management of infrastructural assets will come from the authority having a better understanding of what quality and level of service the community desires the infrastructure to be capable of delivering.

1.111 The challenge for a local authority is to balance the costs of maintenance, renewal and new work on its infrastructural assets against these desires. Achieving that balance requires a good standard of risk management. But, when the balance is reflected in the authority's Long-term Financial Strategy, it will have a better appreciation of how managing its infrastructural assets will affect its finances.

Defining Levels of Service

1.112 Infrastructural assets exist only to enable the local authority to provide services.

1.113 Determining the level of service to be provided is one of the more challenging aspects of managing infrastructural assets. Many local authorities have not placed a great deal of emphasis on determining what level of service is being provided, nor (in fact) what level of service the community desires. In their first asset management plans authorities adopted the view (not unreasonably) that:

- future management of the infrastructure would be based on how it is currently managed; and
- the current level of service was the level that would continue to be provided.

1.114 However, there is a risk that the current level of service does not align with the community's expectations – especially where the infrastructural assets are approaching the later stages of their life or service levels vary significantly between parts of the community. Having determined the minimum acceptable engineering or legislative standards that must be complied with, giving communities options on the possible levels of service and associated financial consequences gives greater confidence that the asset management plan has been developed taking account of community needs and desires.

1.115 Those local authorities that have undertaken service level reviews with their communities have found the feedback to be worthwhile. Before a local authority undertakes any further review of its asset management plan we believe that it needs to give serious consideration to gaining a better appreciation of what the community needs and is willing to pay for. The National Asset Management Steering Group has recognised the issue and is developing a framework to address more uniformly issues surrounding levels of service.

Risk Management Practices

1.116 The leading exponents in asset management planning have begun a structured approach to managing the risk to their infrastructural assets. In doing so, these local authorities have assessed the impact of the risks on their objectives and considered the consequential financial losses and service implications. The authorities have then developed strategies to address those key risks and systems to monitor progress in mitigating them.

1.117 The major benefit that a local authority gains from undertaking such a risk management exercise is that it can have confidence that it has actively considered and addressed key risks associated with each component of its infrastructure.

1.118 From a financial perspective, undertaking risk management has meant that the local authorities can better prioritise their spending on renewing infrastructural assets. Risk management and prioritisation have helped to ensure that investment is made in components of the infrastructure that are needed to supply critical services or are at risk.

1.119 Consequently, investment in renewing assets is targeted. This, in turn, has an effect on the Long-term Financial Strategy, where the local authority can often smooth renewal expenditure and (therefore) better manage its cash and borrowing requirements.

1.120 By utilising risk management practices a local authority can see, and demonstrate, the benefits of developing systems and processes for enhancing the management of its infrastructural assets.

Valuing Infrastructural Assets

1.121 Since enactment of Part VIIA of the Local Government Act many local authorities have revalued their infrastructural assets. In most cases, the new valuations were prepared based on the best information available at the time and a number of assumptions had to be made.

1.122 However, local authorities have continued to gather more information about their infrastructural assets. Using this additional information, some authorities have revalued their infrastructural assets again.

1.123 Not unexpectedly, almost every local authority that has undertaken a revaluation has seen a significant movement in values (both up and down). The reasons for the movement have arisen from:

- errors in the initial data collection (including errors in the type and age of assets);
- more information on the performance and condition of the assets; and
- better assessment of the total lives of the assets and their remaining useful lives.

1.124 Local authorities have used the results of the revaluations when updating their Long-term Financial Strategy. With this better information, authorities have been able to:

- assess more accurately, and have greater confidence in, the depreciation charge for their infrastructural assets; and
- incorporate more reliable asset renewal profiles into their revised Long-term Financial Strategy.

1.125 Clearly, the improvements that local authorities have gained from undertaking further revaluations are significant and worth the additional effort.

1.126 The introduction of Financial Reporting Standard No. 3 – *Accounting for Property, Plant and Equipment* (FRS-3) will place additional requirements on local authorities in respect of valuation methodologies, component accounting, and revaluation cycles. In relation to valuations of infrastructural assets, FRS-3 provides much more detailed guidance than the previous standard.

1.127 Using the FRS-3 guidance as a base, the National Asset Management Steering Group (through a Valuation Working Party) has developed the *New Zealand Infrastructure Asset Valuation and Depreciation Guidelines*. The *Guidelines* provide help at a practical level and will contribute to more reliable and consistent valuations among local authorities. We applaud this initiative.

1.128 Local authorities need to become familiar with the new provisions of FRS-3 and the implications for them in how they account for, and manage, their infrastructural assets and other non-current assets. The new standard will first apply to local authorities' financial statements for the year ending 30 June 2002.

1.129 Our auditors will be paying particular attention to valuation issues during the 2000-01 and 2001-02 audits.

1.2 Setting Operating Revenues to Cover Operating Expenses

1.201 Also last year, we reported on some concerns about local authorities complying with section 122C(1)(f) of the Local Government Act – which requires them in any financial year to set operating revenues at a level adequate to cover all operating expenses, including depreciation.

1.202 We noted a significant improvement in local authorities' understanding and application of that requirement. Authorities have responded to the requirement in different ways:

- many took steps to address funding shortfalls by either increasing revenue or reducing costs; while
- some applied the exemptions provided for in section 122J of the Act.

1.203 Six local authorities, four of which had consulted their communities, opted not to fund depreciation in respect of part of their infrastructure. Where the decision not to fund related to essential services (roading, water, wastewater and stormwater), the services were mainly rural water and wastewater schemes. In our audit opinions on the authorities' financial statements we made reference to the non-compliance with the requirements of the Act.

1.204 These six, and other local authorities, also elected not to fund depreciation in respect of some non-critical assets (such as community halls, recreational facilities, or other assets that the authority does not intend to renew). Provided that the community had been advised of the Council's decision and consulted about it, we have taken no further action as a result of the decision not to fund.

Use of Exemptions

1.205 We examined the decisions of those authorities that applied the exemptions provided for in section 122J. As a result, two aspects of the exemptions still cause us concern.

1.206 The first aspect is where the local authority is anticipating future rate increases to offset the current year's deficit. We reported on this practice last year.[3] In our 2000-01 audits we will establish whether local authorities that have adopted this practice are following through with the rates increases projected to be required to meet deficits (see pages 183-184).

1.207 The second aspect is where the local authority has applied an exemption in order to offset the current year's funding deficit, but the exemption may not be available to the authority in future years. An example of this is where the authority has utilised reserves to fund a deficit. Then, having exhausted all available reserves, the authority is faced with a funding deficit in future years, but in the interim has taken no action to address the underlying problems causing the deficit. In other words, the authority has complied with the legislative requirement by addressing the current year's deficit, but in reality has just deferred the problem. We expect that a few authorities will have to address such issues in their 2001-02 and 2002-03 Annual Plans.

1.208 The terms of reference for the review (see pages 168-169) of the Local Government Act include aspects of the Act relating to funding depreciation. Until any changes that flow from the review are enacted, we will continue to apply the same approach to interpreting the legislation as we have over the past two years.

3 *Second Report for 2000*, parliamentary paper B.29[00b], pages 23-24.

1.3 Timeliness of Annual Reporting

1.301 We have received comments and queries from interested parties about the length of time that it takes local authorities to complete (including being audited), adopt, and release their annual report to the public. As a result, we decided to find out the timeliness with which authorities achieved those three steps for their 1999-2000 annual report.

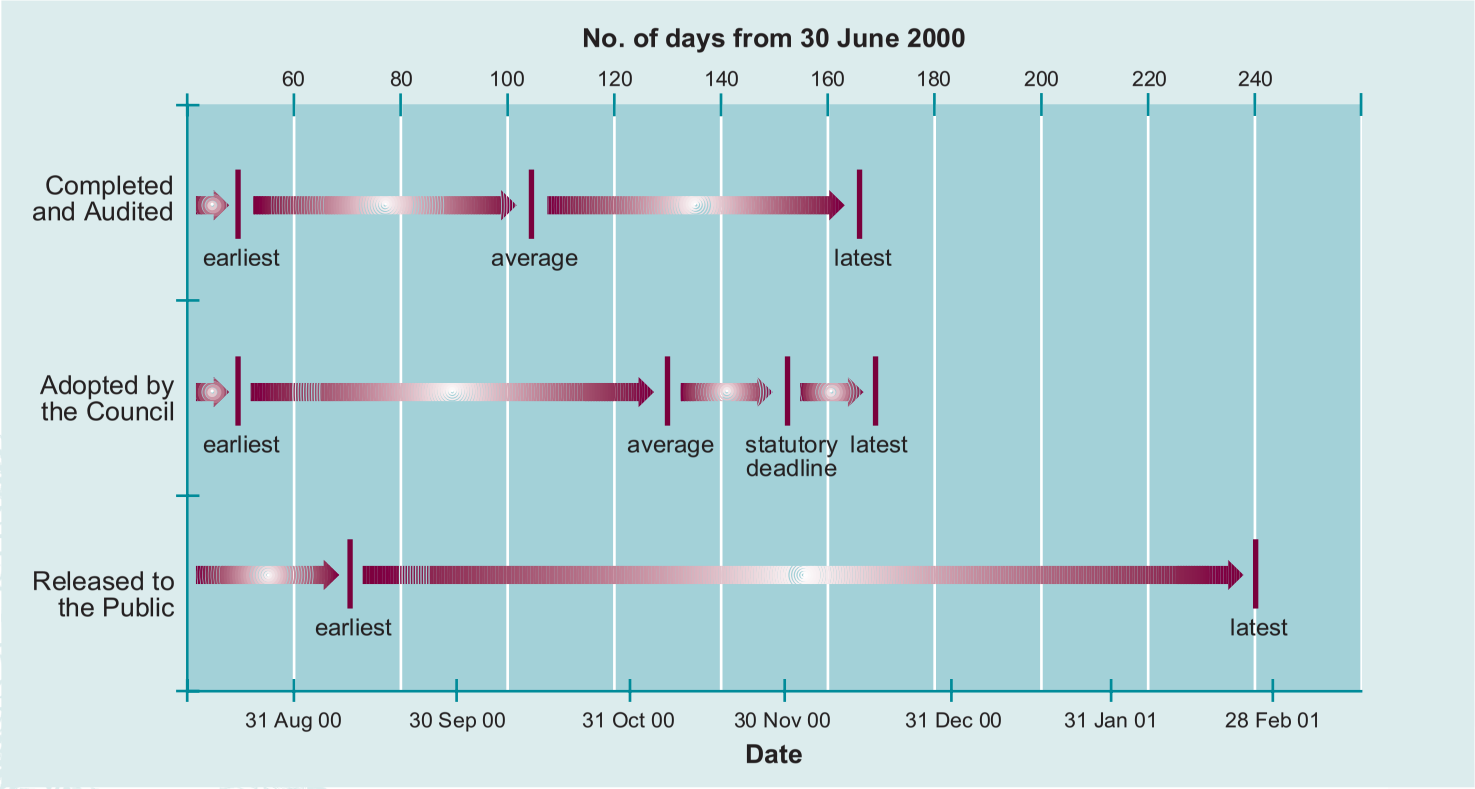
1.302 The data we gathered is summarised in Figure 1.1 opposite, in terms of the elapsed time after the balance date of 30 June 2000.

1.303 The only statutory deadline is that a council is required to adopt the audited annual report within five months of balance date (i.e. by 30 November following the end of the financial year on 30 June). That deadline was met by all but two councils, with 53 councils adopting their annual report in the month of November.

1.304 In some instances the delay in completing and/or adopting the annual report was merely a result of a lack of priority being afforded to the task. For the others, there were three main explanations for the delay in finalising the annual report and having it audited:

- having to wait for Local Authority Trading Enterprises (which are required to have their financial statements completed and audited by 30 September) to complete their financial statements to allow consolidation of their results into the authority's group financial statements;
- waiting for clarification on the issue of rating apportionments (see the article on pages 25-27); and
- revaluing assets and the work associated with the revaluation exercise.

Figure 1.1
Timeliness of Annual Reporting for 1999-2000



1.305 Transparent accountability for performance is dependent on the timely provision of information to stakeholders. We consider that, in general, local authorities have been tardy in meeting that objective, and opportunities exist to significantly reduce the delays to producing the annual report by:

- having a better timetable for the report's preparation; and
- placing a higher priority on its completion, adoption, and public release.

1.306 Criticism has been levelled at local authorities generally, and at some authorities specifically, for not making their annual report available to the public more quickly.

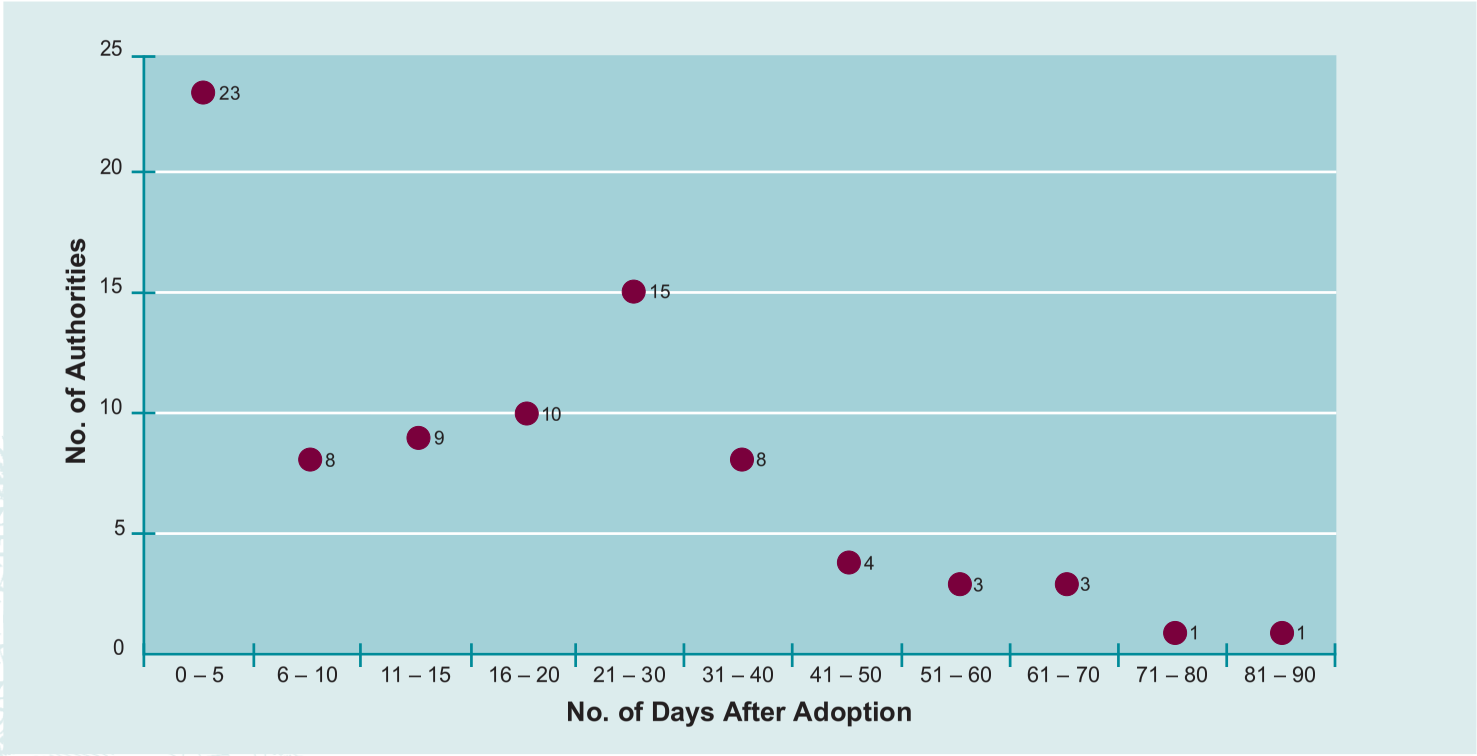
1.307 As shown by Figure 1.2 opposite, for the 1999-2000 annual reports:

- 31 authorities publicly released the report within 10 days of adoption;
- 20 authorities took more than 30 days to publicly release the report after adoption;
- the average number of days between the date of adoption of the report and its release to the public was 21; and
- the longest time that an authority took to publicly release the report was 89 days after adoption.

1.308 Our review showed that the timeliness of the public release depended principally on the standard of publication desired. Those authorities that have their annual report published either internally or externally to a high standard (e.g. glossy pages) took longer to have the reports publicly available than those that set a lower publication specification (e.g. computer printed and spiral bound).

1.309 Local authorities that published reports to a high standard commented that, should anyone request a copy of the report tabled at a council meeting, it would have been supplied in its 'unpublished' form.

Figure 1.2
Public Availability of Adopted Annual Report for 1999-2000



1.4
Legal Compliance

1.401 Over the past four to five years we have been encouraging local authorities to apply a more systematic process to managing the legal risks that may arise in relation to the multitude of functions and activities that they are responsible for. Individually, many authorities recognised that the cost and resources required to develop such a comprehensive framework and compliance system were prohibitive.

1.402 We are delighted with the initiative that the Society of Local Government Managers (SOLGM) Top of the South branch began in 2000 to develop a legal compliance framework and management system. Currently, about 30 local authorities are contributing to the cost of developing the framework and compliance modules. A pilot project has been completed that produced two modules (for regulatory functions and property acquisition and sale), and a further three modules are intended to be completed by the end of this year.

1.403 This type of collaborative arrangement – that draws on the skills and expertise of staff from contributing authorities to address common issues – is another excellent example of authorities working collectively for the common good. We applaud these efforts.

1.5 Separate Properties and Rating Apportionments

1.501 For the past two years we have reported on a matter that has developed into a difference of opinion between local authorities and the Valuer-General as to what can or should constitute a 'separate property' for the purposes of valuation and rating.[4] The issue is significant for local authorities because they can only levy certain separate charges, such as a uniform annual general charge, on each 'separate property'.

1.502 In some cases where parts of a single 'separate property' are separately occupied – for example, blocks of flats – the Valuer-General's practice had been to apportion the rateable value of the property among the separately occupied parts. Some local authorities have levied separate charges on each apportionment. The Valuer-General required a separate legal title in order to create a new 'separate property' (the "certificate of title" approach).

1.503 Following advice from the Crown Law Office in 1998 confirming that the Rating Powers Act 1988 precludes local authorities levying separate charges on rating apportionments, various authorities sought a declaration from the High Court on the matter. The authorities claimed that, rather than apportion the rateable value of a single property among its separately occupied parts, the Valuer-General should treat each separately occupied part of a property as 'separate property' in its own right (the "separate occupation" approach).

4 *Second Report for 1999*, parliamentary paper B.29[99b], pages 71-72; and *Second Report for 2000*, parliamentary paper B.29[00b], pages 35-38.

1.504 In 1999, the High Court found in favour of the local authorities' "separate occupation" approach. However, in September 2000, the Court of Appeal confirmed the Valuer-General's "certificate of title" approach to determining 'separate property'. But the matter was again put in abeyance in mid-November 2000 when Local Government New Zealand and the group of local authorities were given leave to appeal the Court of Appeal decision to the Privy Council.

1.505 We said in our 2000 report that, even though the parties were endeavouring to clarify the matter through the courts, a legislative solution could also be required. We understand that local government has proposed validating legislation, and the Government is considering the options for resolving the matter.

1.506 Validating legislation could potentially address the lawfulness of many past rating apportionment practices. However, local authorities have used a range of practices to achieve their desired objective and there is a risk that neither a court decision nor legislation will address all issues.

1.507 For the future, we understand that the Department of Internal Affairs intends the issues to be resolved by clearly identifying the unit of liability for rating purposes as an outcome of the Funding Powers Review.

Financial Statement Disclosure

1.508 In 1998 we took the view that where authority for collection was in doubt local authorities should disclose the value of rates collected as a contingent liability in the financial statements for the year ended 30 June 1998. Because of the lack of resolution we maintained that view for the years ended 30 June 1999 and 2000.

1.509 The timing of the Court of Appeal decision in September 2000 resulted in a few affected local authorities reporting a liability in their financial statements for the amount of the rates in question.

Potential Obligation to Refund

1.510 Unless Parliament passes validating legislation or the Privy Council disagrees with the Court of Appeal, local authorities will need to consider refunding unlawfully collected rates. However, making refunds presents some questions:

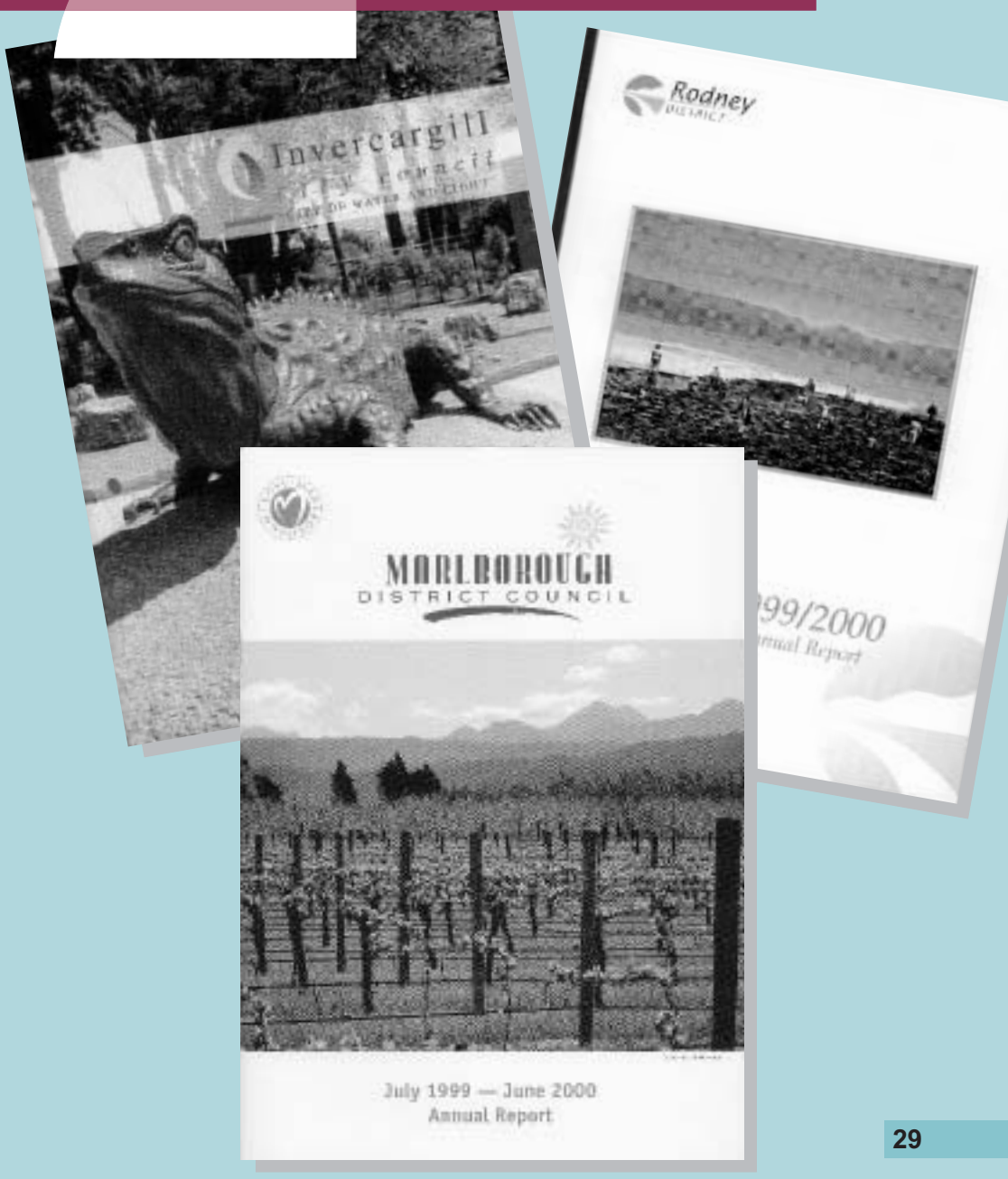
- Is it practicable to refund all rates collected unlawfully? Because several financial years are involved and a proportion of properties would have changed ownership, some local authorities have said that they would have difficulty in locating all the people from whom the rates were collected.
- What is the period for which there is a liability to refund? It is not clear whether any statutory provision limits the period of liability for refunding such rates.

1.511 We have not attempted to give specific advice to any local authorities proposing to refund, but we have indicated our general expectation that:

- a local authority will make reasonable efforts to locate and give refunds to all ratepayers against whom rates have been unlawfully levied; and
- the period for which such rates are refunded will be based on legal assessment of the local authority's liability.

Two

Other Issues Arising During 1999-2000



2.1 Reporting Chief Executive Officer Remuneration

2.101 Section 223E(11) of the Local Government Act 1974 requires a local authority to disclose in its annual report – in a form determined by the Minister of Local Government – the remuneration received by the chief executive officer (CEO).

2.102 The current determination by the Minister is the *Local Government (Information on Remuneration of Chief/Senior Executive Officers) Determination 1991*.[1] The Department of Internal Affairs has prepared guidelines for calculating the information required by the determination.[2]

2.103 Consistent with the disclosure requirement, the determination and the guidelines apply to remuneration received by a CEO as an employee of the local authority. That is, the remuneration specified in the contract of employment between the CEO and the council. However, some CEOs also receive remuneration for positions that they hold in companies and other organisations that are owned by or have other links with the local authority.

2.104 In our view, the disclosure required under section 223E(11) does not extend to include remuneration received by the CEO of a local authority other than in that capacity.

2.105 We believe that:

- the public have a right to know the full amount of remuneration that a CEO is receiving (directly and indirectly) as a consequence of holding that position; and
- the council, when negotiating remuneration with the CEO, should take into account the total remuneration received as a consequence of holding that position.

1 Dated 27 February 1991.

2 *Guidelines for calculation of information concerning executive officer remuneration for inclusion in annual report under section 223E of Local Government Act 1974* – issued on 8 August 1991.

2.106 We therefore encourage full disclosure of the total remuneration received by the CEO in the local authority's annual report.

2.107 The matter of disclosing CEO remuneration also raises a broader issue in relation to the CEO's role. We take the view that a CEO (and other local authority managers) should take no take part in the internal governance of subsidiary entities.

2.108 Lack of involvement ensures that the CEO is independent when assessing subsidiary entity performance against expectations and providing independent strategic advice to the council. This position was outlined in our recently published report *Local Authority Governance of Subsidiary Entities*.[3]

3 ISBN 0 477 02873 X, March 2001.

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2.2 Reporting Severance Payments

2.201 Section 223E(12) of the Local Government Act 1974 requires a local authority to disclose in its annual report – in a form determined by the Minister of Local Government – information on the cost of any severance agreement between the authority and an employee under which:

(a) the employee has agreed to the termination of the employee's employment; and

(b) the local authority has … agreed to provide any consideration, whether of a monetary nature or otherwise, additional to any entitlement of that employee to –

(i) any final payment of salary; or

(ii) any holiday pay; or

(iii) any superannuation contributions; and

(c) the total cost of the consideration referred to in paragraph (b) …, including any liability for taxation, exceeds $50,000.

2.202 The words in paragraph (a) have caused confusion among local authorities and the auditors as to when the disclosure requirement applies and, therefore, when reporting is required.

2.203 In our view, the disclosure requirement applies only to the year in which the cost of compensation is incurred in return for the employee agreeing to leave the local authority's employment. (These agreements are some-times known as "golden handshakes".) The application of this section is, therefore, likely to be rare.

2.204 The disclosure requirement does not apply to any arrangement under which an employee receives compensation where the employer terminates the employment relationship – for example:

- by way of redundancy; or
- for misconduct or poor performance.

2.3 Competing with the Private Sector

2.301 We receive a steady stream of enquiries about authority business units competing with private sector providers for contracts inside and outside the authority's district. Some business units competed in those areas to test the market before being established as LATEs.

2.302 The enquirers tend to be contractors who have missed out on contracts given to local authority business units, or organisations representing particular groups. Their concern is about the local authority effectively competing with its own ratepayers and other constituents, and they question the legality of the authority's actions.

2.303 This article summarises the legal framework applying to local authority contracts with external parties and discusses a recent example.

The Doctrine of *Ultra Vires*

2.304 Local authorities are statutory corporations, and the Local Government Act 1974 and other relevant legislation limit their powers. The common law doctrine of *ultra vires* is well established and, in the case of a local authority, requires that any activity undertaken must be expressly or impliedly authorised by statute.

2.305 The scope of local authorities' implied or incidental powers can be unclear. The courts have considered the line between what is and what is not permissible for local authority business units in numerous cases. In the case of trading activities, Palmer notes in *Local Government Law in New Zealand* that –

> *the courts tend to require clear statutory authorisation for a distinct trading activity, having regard to taxation exemption and ratepayer subsidies which councils may enjoy.*[4]

The Purposes of Local Government

2.306 Parliament has spelled out the purposes of local government in section 37K of the Local Government Act (enacted in 1989). One of those purposes is to provide [*f*]*or the efficient and effective exercise of the functions, duties, and powers of the components of local government*.[5]

2.307 However, the requirement to operate efficiently does not justify an activity if it is outside the local authority's power. As an example, an English court found that a local authority's power to provide washing facilities did not extend to running a full collection and laundry service for ratepayers, as doing so was not reasonably incidental to the provision of washing facilities.[6]

2.308 Local authority business units sometimes do other work to utilise spare capacity in the interests of efficiency. However, the courts have held that the existence of spare capacity is not sufficient justification for unauthorised activity. For example, the use of spare council ferries for excursions has been held to be *ultra vires*.[7]

Competitive Neutrality

2.309 Another purpose of local government is to provide [*f*]*or the operation of trading undertakings of local authorities on a competitively neutral basis*.[8]

4 K A Palmer, *Local Government Law in New Zealand*, 2nd ed., 1993, page 51.

5 Section 37K(h).

6 *Attorney-General v Fulham Corp* [1921] 1 Ch 440.

7 *Dundee Harbour Trustees v D & J Nichol* [1951] AC 550 at 561.

8 Section 37K(e), Local Government Act 1974.

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2.310 Parliament also enacted in 1989:

- section 247C, giving local authorities a general power to be involved in business and other ventures; and
- Part XXXIVA, allowing local authorities to establish trading enterprises and divest undertakings to them.

2.311 The purpose quoted in paragraph 2.309 above does not impose any positive duty on local authorities. Nevertheless, it illustrates Parliament's intention – that trading activities of LATEs, or authority business units, should not affect competition (for better or worse) in their districts. It is clear that an authority business unit competing with ratepayers for private sector contracts is unlikely to be operating on a competitively neutral basis, because authorities are largely exempt from income tax.

Broad Enabling Provisions

2.312 A local authority may be able to justify the activities of a business unit by one of the broad enabling sections in the Local Government Act or by a specific section of the Act that concerns the particular activity.

2.313 Sections 247B, 247C, and 247D of the Local Government Act concern the powers of local authorities to carry out works and contracts and to be involved in business and other ventures.

Undertaking Work Inside or Outside the District

2.314 Section 247B(1) gives every territorial authority:

> *… the power to undertake the planning, implementation, and maintenance of any work that, in the opinion of the territorial authority, is necessary or beneficial to the district, whether inside or outside the district.*[9]

9 Regional councils have the same power but the work must be necessary to the performance of the regional council's functions and duties, (section 247B(2), Local Government Act 1974).

2.315 "Work" is not defined in the Local Government Act, but the words "planning, implementation and maintenance" in section 247B(1) indicate that the power relates to physical works, rather than the operation of services. Therefore, in our view, the section does not authorise a local authority to perform *services* for external parties inside or outside its district.

2.316 When undertaking the work the territorial authority must consider it to be "necessary or beneficial to the district" (unless the work is explicitly authorised by a section of the Local Government Act other than section 247B). This means that any physical work carried out by a territorial authority *outside* the district is permitted only if it is necessary or beneficial to that authority's district. Work will be beneficial to a district if it benefits the people living in the district.

2.317 Work that may be of benefit to people living in a territorial authority's district could include:

- "Public" works – such as roading carried out in the authority's own district.
- Work carried out in public amenities – such as school playgrounds or public hospitals.
- Efficient use of the authority's resources (both staff and plant). If a business unit has spare capacity, earning additional income from work for external parties inside or outside the district should decrease the cost to the authority of work inside the district.[10]

2.318 In considering whether a local authority may carry out works for other parties, it is clear that an authority may perform works or functions for another local authority (paragraphs 2.319 and 2.320). An authority may also perform works for other public bodies or persons, so long as doing so is "necessary or beneficial" to its own district. In each case, the authority must ensure that there is no cost or detriment that outweighs the benefits accruing to the district.

10 Subject to the *ultra vires* rule.

B.29[01a]

Performing Works or Services for Other Authorities

2.319 Section 247D allows a local authority to choose whether to carry out its works or perform its functions using its own staff or by contracting with another party, including any local authority.

2.320 Section 247D(1) authorises a local authority to perform services for another authority if the latter authority has met the requirements of section 247D(2).[11] However, as with section 247B, section 247D does not authorise an authority to perform *services* for external parties inside or outside the district.

Other Broad Empowering Provisions

2.321 The Local Government Act 1974 contains various broad empowering provisions that authorise local authorities to provide services in particular areas. For example:

- section 598, which authorises territorial authorities to *undertake, promote, and encourage the development of such services and facilities as it considers necessary to maintain and promote the general well being of the public…*;
- section 601, which gives any territorial authority similar powers in the area of *recreation, amusement, and instruction of the public*, and provision or improvement of public amenities; and
- section 602 – under which territorial authorities may provide "information services", including the power to fund organisations whose primary aim is to promote development or advancement of the district.

11 In deciding how to carry out any of its works or functions, section 247D(2) requires a local authority to have regard to:
- section 223C, which sets out the manner in which a local authority must conduct its affairs;
- the objects stated in its Annual Plan; and
- the advantages and disadvantages of the different options available.

2.322 These sections may be particularly relevant in cases where a local authority is providing a service to the community that the private sector is not prepared to provide or is unwilling to provide at a reasonable price.

Example of the Issue

2.323 A person was concerned that a local authority business unit was "competing with ratepayers" (i.e. with private sector suppliers) for work unconnected with the authority. The contract in question was for maintaining gardens, and providing cleaning and rubbish removal services, at an education institution in the authority's district. The work was similar to that which the business unit carried out in maintaining public spaces in the authority's district.

2.324 The annual value of the contract was around $13,000 and did not constitute significant revenue for the business unit. However, for some time the business unit had faced an uncertain future. The council had considered over a long period whether to divest the business unit's activities to a LATE. This uncertainty provided an incentive for the business unit to expand its activities and seek new customers.

2.325 The activities under the contract were in the nature of services rather than "works", so a "benefit to the district" approach based on section 247B was not possible. The council obtained legal advice that various sections of the Local Government Act expressly authorised the activities covered by the contract – in particular:

- Rubbish removal – a local authority may contract for waste management, provided that to do so is in accordance with its waste management plan.[12]
- Cleaning services – a local authority may, with the agreement of the owner, carry out any works in respect of drainage or sanitation on the owner's premises.[13]
- Gardening/lawn mowing – a local authority may *lay out and maintain gardens, shrubberies, and lawns on any private land or public place within the district* for payment.[14]

12 Sections 538 and 540.

13 Section 673.

14 Section 621.

2.326 The council's legal advice also referred to sections 601 or 605 of the Act as possible justification for aspects of the contract. As already noted (paragraph 2.321), section 601 authorises a territorial authority to undertake such services as it considers necessary to provide for the instruction of the public or improvement or development or maintenance of amenities for the public. Section 605 authorises an authority to provide community centres in its district and a community centre can have an educational purpose.

2.327 We agreed with the legal advice on the authority for the rubbish removal part of the contract, but had a different view on the authority for the other parts. We did not think the cleaning part of the contract was authorised. In our view, the other provisions referred to had an element of public benefit – for example, through beautification of a public place or provision of services necessary for public instruction. It was not clear to us how the contract met those purposes, or why the council would consider it necessary to assist another public body with routine maintenance. Doing so would be of direct benefit to ratepayers only if no other contractor would provide such services.

2.328 We noted that the council was entitled to rely on its own legal advice but asked that our comments be considered. We understand that the future of the business unit concerned has been resolved and the incentives to seek other work no longer apply.

Conclusion

2.329 The line is not easily drawn between what is and what is not permissible when it comes to local authorities competing with the private sector to provide works and services. However, the issue is important and it is not surprising that members of the public who find themselves in direct competition with a local authority operation challenge the right to compete with them.

2.330 While it may be efficient for the staff of a local authority business unit to be fully employed, that may not be sufficient in itself to justify a contract – especially as local authorities that operate trading activities are intended to do so on a competitively neutral basis.

2.331 The *ultra vires* rule requires that a local authority acting in competition with the private sector carefully considers the statutory authority for doing so. In our view, the council should in each case closely consider the purpose in engaging in the activity, particularly as the broad empowering provisions in the Local Government Act tend to require a benefit to the public. The council should obtain legal advice in cases of uncertainty.

2.332 The mixture of the older prescriptive provisions and more recent broad enabling provisions in the Local Government Act creates a complex legal frameword for councils to have to deal with. We hope that a new Local Government Act may provide some clarity in this area. We encourage councils with experience and views to comment on the issue during the review of the current Act.

2.4 Defamation Costs

Introduction

2.401 We are often asked to provide guidance on whether a local authority can meet the costs of a defamation action taken by or against a member or an employee of the authority. In this article we outline our view and discuss the way in which the defence of qualified privilege applies to local authorities.

Can Local Authorities Fund Defamation Actions?

2.402 In our view, a local authority can meet the costs of a defamation action taken by or against a member or an employee where:

- the action is taken to protect the interests of the local authority member or employee in his or her capacity as an authority member or employee, as opposed to his or her interests as an individual; and
- the local authority is satisfied that it would be in the interests of the city, district or region for the action to be taken, or defended, at the authority's expense.

The Extent to Which Costs Can Be Met

For Employees

2.403 Section 119F of the Local Government Act requires a local authority to act as a good employer. This obligation does not, in our view, require an authority to meet the costs of a defamation action taken by or against an employee.

However, giving such support would clearly be consistent with the obligation, provided that the subject matter of the defamation action relates to something done or said by the employee in the course of his or her employment.

For Members

2.404 A local authority is a statutory body and, as such, its powers are limited by the statutes that regulate it. The Local Government Act does not expressly authorise local authorities to meet the costs of defamation actions taken by or against authority members.[15]

2.405 Nevertheless, in our view a local authority can meet (or contribute towards) the costs of a defamation action, taken by or against a member or an employee of the authority, using the "unauthorised expenditure" provision contained in section 223K of the Local Government Act.[16]

2.406 Defamation litigation can be notoriously prolonged and expensive. When making a commitment to meet the cost of such litigation in respect of a member, local authorities should be mindful of the limited nature of the expenditure authorised by section 223K.

Conditions of Funding

2.407 A risk exists that a decision to fund a defamation action could be seen as providing an "open cheque book" to a local authority member or employee. Such a perception could create a disincentive for the member or employee (who may feel extremely wronged by a defamatory comment) to work towards a settlement of proceedings.

15 Section 707 of the Local Government Act 1974 provides for a council to deal with legal proceedings involving the local authority, rather than the individual member.

16 Under section 223K, a local authority whose district has a population not exceeding 100,000 people can spend up to $20,000 in any financial year on unauthorised expenditure, while a local authority whose district has a population in excess of 100,000 can spend up to $50,000.

2.408 In our view, funding should be provided so that the local authority is able to:

- control the choice of legal representation for the member or employee;
- control the costs of the action; and
- review its support if the member or employee fails to pursue reasonable settlement opportunities.

2.409 As part of the agreement to meet the costs of taking or defending a defamation action, we think it reasonable for the local authority to expect the member or employee to agree to refund the costs met out of any money that is awarded or paid as a result of the action.

Liability Insurance

2.410 In our 1998 report,[17] we commented on the indemnification of members and employees of local authorities from personal liability by way of liability insurance. We noted that authorities have the power to indemnify members and employees against personal liability for actions arising out of their duties as members or employees.[18]

2.411 Depending on the coverage of the particular policy, liability insurance could be called upon in the event that a member or an employee of a local authority faced an action in defamation. Where liability insurance is available for a *member*, we consider that the authority would not be restricted by the limited nature of the expenditure authorised under section 223K, except to the extent that the policy required the authority to pay an excess.

The Defence of Qualified Privilege

2.412 A defamation action cannot succeed if the defamatory material is privileged. Two types of privilege exist – absolute privilege and qualified privilege.

17 *First Report for 1998*, parliamentary paper B.29[98a], pages 23-30.

18 Section 223J(1)(a), Local Government Act 1974, which allows a local authority to spend money for the *insurance of, or the making of any other prudent and reasonable financial provision against any risk facing the local authority, its assets, or its interests.*

2.413 The defence of ***absolute privilege*** does not apply to local government. It protects proceedings in Parliament, judicial proceedings, and communications for the purpose of obtaining legal advice between legal advisers and clients.

2.414 The defence of ***qualified privilege*** can apply in a wide variety of situations, including various local government situations. The defence is based on:

> *[A]n identified public interest in allowing people to speak and write freely, without fear of proceedings for defamation unless they misuse the privilege. On occasions of privilege the public interest is seen as prevailing over the protection of individual reputations.*[19]

2.415 The defence of qualified privilege is found in statute (the Defamation Act 1992 and Local Government Official Information and Meetings Act 1987 (LGOIMA)) and the common law. In the remainder of this article, we discuss the way in which the defence applies to local authority members and employees.

Protection Available to Members

2.416 Section 53 of LGOIMA provides that any oral statement made at a meeting of a local authority will be protected by the defence of qualified privilege – as long as the statement is made in accordance with the authority's rules for the guidance and order of its proceedings (e.g. its standing orders).

2.417 If a member was to make an offensive remark about the private affairs of another member at a local authority meeting, that remark is likely not to be protected by section 53 of LGOIMA – as such a remark is likely to be in contravention of the authority's standing orders.

2.418 Section 53(2) of LGOIMA provides that the defence will not be available if the plaintiff can show that the defendant, when publishing the material:

- was predominantly motivated by ill will towards the plaintiff; or
- otherwise took improper advantage of the occasion of publication.

19 *Vickery v McLean*, unreported, 20 November 2000, CA125/00.

2.419 Section 52 of LGOIMA protects local authority members from a defamation action if defamatory material is published in either the minutes of a local authority meeting that was open to the public or the agenda[20] for that meeting.

Protection Available to Employees

2.420 The defence of qualified privilege will also protect any oral statement made by a local authority employee during a meeting of the authority that is open to the public.[21] This defence will not apply if:

- the oral statement was made in contravention of the authority's rules; or
- the employee *was predominantly motivated by ill will towards the plaintiff, or otherwise took improper advantage of the occasion of publication*.

2.421 The Defamation Act 1992 also lists a number of matters that will be protected by the defence of qualified privilege. One matter that is relevant to local authority employees is that the defence protects a fair and accurate report or summary of a statement, notice or other matter, issued for the information of the public by any local authority or officer of the authority.

2.422 However, section 19 of the Defamation Act also negates the defence on the grounds of "ill will" or "taking improper advantage".

The Common Law Defence of Qualified Privilege

2.423 The defence of qualified privilege is not limited to the matters set out in LGOIMA and the Defamation Act. This means that a local authority member or employee may be able to avail themselves of the defence of qualified privilege where they have made a defamatory statement that does not fall within the circumstances set out in LGOIMA or the Defamation Act.

20 Any further statements or particulars that are attached to the agenda for the purpose of indicating the nature of any item on the agenda will also be protected.

21 Section 53 of LGOIMA.

2.424 The defence exists generally where the maker of a statement has a duty to make the statement and the recipient of the information has a duty or interest in receiving it. One example of the common law application of the defence was discussed in the case of *Lange v Atkinson* [2000] 3 NZLR 385 (*Lange No. 2*).

2.425 The origin of *Lange No. 2* was a claim in defamation by the Rt Hon David Lange against the author of an article published in a magazine with a New Zealand-wide circulation, and against the publisher of the magazine.

2.426 In *Lange No. 2*, the Court of Appeal reconsidered the circumstances in which qualified privilege is available as a defence to defamatory political statements that have been widely published. The Court reconfirmed that qualified privilege does apply to such statements, and stated:

> *(1) The defence of qualified privilege may be available in respect of a statement which is published generally.*
>
> *(2) The nature of New Zealand's democracy means that the wider public may have a proper interest in respect of generally-published statements which directly concern the functioning of representative and responsible government, including statements about the performance or possible future performance of specific individuals in elected public office.*
>
> *(3) In particular, a proper interest does exist in respect of statements made about the actions and qualities of those currently or formerly elected to Parliament and those with immediate aspirations to such office, so far as those actions and qualities directly affect or affected their capacity (including their personal ability and willingness) to meet their public responsibilities.*
>
> *(4) The determination of the matters which bear on that capacity will depend on a consideration of what is properly a matter of public concern rather than of private concern.*
>
> *(5) The width of the identified public concern justifies the extent of the publication.*
>
> *(6) To attract privilege the statement must be published on a qualifying occasion.*[22]

22 This point was added to the five-point summary given in the 1998 judgment; see paragraph 41 of *Lange No. 2*.

2.427 The defence discussed in *Lange No. 2* is limited to defamatory statements, which are widely published, about people who are elected or seeking election to Parliament only. The Courts have not yet determined whether the defence should be extended to apply to defamatory statements made about elected members of local authorities, or those seeking election to local authorities. The Court of Appeal discussed such an extension in the recent case of *Vickery v McLean*.

The Case of *Vickery v McLean*

2.428 The case of *Vickery v McLean* involved three employees of Papakura District Council (the Council) who alleged that they had been defamed by a long-term resident of the Papakura district, Mr Vickery.

2.429 In early-1997, Mr Vickery had become suspicious of a proposal by the Council to franchise the district's water and wastewater services. In June 1997, he wrote to the Serious Fraud Office suggesting that it should question *all councillors and executive staff* in relation to "corrupt dealings" regarding the franchising proposal. Three days later, he wrote to two local newspapers and one national newspaper about the Council's franchise decision. In his letter, he set out his view that *[t]here was serious enough circumstantial evidence to suggest that criminal irregularity may have taken place.*

2.430 Mr Vickery argued that:

- The defence of qualified privilege protected his letter to the newspapers. In making this argument, he was attempting to extend the scope of the defence beyond what was determined in the well-publicised case of *Lange No. 2*.
- The subject matter of his letter was of a sufficiently "political" nature to qualify for the defence of qualified privilege under *Lange No. 2* or a reasonable extension of it.

2.431 The Court of Appeal did not agree that Mr Vickery's letter could sensibly be regarded as political discussion.

2.432 Furthermore, the Court noted that even if the subject matter had been political discussion, it involved allegations of serious criminality. Such allegations, if made on a good faith basis to the appropriate authorities, are protected by qualified privilege. However, the Court noted that the privilege is lost if the allegations are published on a wider basis.

2.433 In conclusion, the Court of Appeal held that it was unnecessary for it to decide, for the purposes of the case, whether the defence of qualified privilege should be extended in this way. Mr Vickery's appeal was dismissed and the judgment of the High Court, awarding the three Council employees $55,000 in compensatory damages, was upheld.

2.434 The significance of the Court of Appeal's decision for local authorities is that it leaves unresolved the issue of whether the defence of qualified privilege can protect defamatory political statements, that are widely published, about elected members of local authorities, or people seeking election.

Election Year

2.435 We acknowledge that in an election year members of local authorities may be more prone to make statements that may be seen as defamatory about fellow members or prospective members. Such statements, if made about elected members of Parliament or those seeking election to Parliament, may be protected by qualified privilege. However, until the defence is extended to cover local government, local authority members should tread carefully when making potentially defamatory statements about others in an election year or otherwise.

2.5 Local Authorities (Members' Interests) Act 1968 – Discussing and Voting When Interested

2.501 In our 2000 report we commented on the power of the Audit Office to issue an exemption or a declaration under the Local Authorities (Members' Interests) Act 1968 (the Act).[23] The effect of an exemption (paragraph 2.507 below) or declaration (paragraph 2.508 below) is to allow a member of a local authority who has a pecuniary interest in a particular matter to nevertheless take part in discussion and voting on that matter.

2.502 We urged local authorities and their members to make greater use of the procedure, because seeking an exemption or declaration reduces the risk of an allegation later being made against the member that the pecuniary interest rule has been breached.

2.503 It is also important for local authorities to bear in mind that the participation of a member in a decision in which he or she has a pecuniary interest can invalidate that decision.

2.504 Since our 2000 report we have noticed an increase in the number of applications – particularly for declarations.

2.505 In this article, we set out summaries of some actual situations in which we granted an exemption or a declaration to a member of a territorial local authority. We hope these summaries will be of assistance to authorities and their members when considering whether an application for an exemption or declaration may be appropriate.

23 *Second Report for 2000*, parliamentary paper B.29[00b], pages 109-114.

The Procedure

2.506 The Act requires a two-step approach when considering whether an exemption or declaration is appropriate:

- The first step is to ask whether the member has a pecuniary interest, direct or indirect, in the matter under consideration, other than an interest in common with the public.
- If the answer to that question is "Yes", the second step is to determine whether there are grounds to justify the granting of an exemption or declaration.

2.507 An ***exemption*** can be granted under section 6(3)(f) of the Act if a pecuniary interest is, in the Audit Office's opinion, so remote or insignificant that the member cannot reasonably be regarded as likely to be influenced in voting on or taking part in the discussion of the matter.

2.508 A ***declaration*** can be granted under section 6(4) of the Act if the Audit Office is satisfied that:

- the application of the pecuniary interest rule would impede the transaction of business by the authority; or
- it would be in the interests of electors or inhabitants of the district that the rule should not apply.

2.509 Being satisfied about "the interests of electors or inhabitants" involves a balancing of competing interests. The considerations that we take into account in determining if a declaration is appropriate include:

- whether the member has any particular expertise in the matter under consideration, and the proceedings of the local authority would be adversely affected by the member not being able to participate; and
- whether the views of the people in the area would be adequately represented if one of the elected representatives from that area was not able to participate.

2.510 For example, a matter may be of major significance to the community as a whole, justifying the involvement of all elected members in decisions to be made on the matter. Alternatively, a member may have a special expertise or knowledge of the matter in question.

2.511 When deciding if a declaration is appropriate, we weigh the benefit to the public of having a member participate against the risk that a member's pecuniary interest could be seen to unduly affect the outcome.

Remote or Insignificant Interest

Dairy Farm Heavy Traffic

2.512 The chief executive of a territorial local authority approached us seeking an exemption for a councillor who wanted to take part in a Community Board decision regarding the most appropriate route for tankers and trucks travelling to and from a dairy farm. The councillor owned properties along the current route and one of the several proposed alternative routes. The councillor acknowledged that he had a pecuniary interest in the Community Board's decision as the route taken by the tankers and trucks could affect the value of his two properties.

2.513 When we consider whether a member's pecuniary interest in a particular matter is remote or insignificant, it can be helpful for the member to obtain independent evidence and submit that evidence to us.

2.514 The councillor submitted to us a letter from a real estate agent discussing the effect of heavy traffic on his two properties. The real estate agent said that:

- between one property and the current route was an extensive tree-lined green area which minimised the impact of heavy traffic on the property; and
- with regard to the other property on one of the proposed alternative routes, the property had plenty of potential to build well back from the road and this, again, reduced the impact of heavy traffic on the value of the property.

2.515 The real estate agent concluded that neither property would be affected to any great extent – either favourably or unfavourably – by the re-routing of the tankers and trucks.

2.516 We were satisfied that the effect of the route taken or to be taken by the tankers and trucks on the value of the councillor's two properties was so insignificant that it could not reasonably be regarded as likely to influence him when voting or taking part in the discussion. Accordingly, we granted the exemption.

2.517 Several months later, the councillor approached us again because the route options being considered by the Community Board had changed. A new route option cut through a corner of one of the councillor's two properties. The amount of land that would be affected, by comparison with the total size of the property, was minimal. However, in principle the councillor stood to gain financial compensation from the Council if the option was chosen.

2.518 The councillor had not participated in any discussion concerning the proposed new route options. The local community had expressed concerns that the councillor's lack of participation was depriving it of a voice in the Community Board's deliberations. The councillor told us that, should the route affecting his property be chosen, he would gift the land to the Council rather than accept any compensation.

2.519 We were satisfied that:

- the councillor's intention to gift the affected land to the Council; combined with
- the minimal value of the land;

resulted in the councillor's pecuniary interest in the matter being insignificant. We granted a second exemption to the councillor.

Transaction of Business Would Be Impeded

Redevelopment of a Town's Commercial Area

2.520 We received a request for a declaration to enable five members of a Community Board to take part in the consideration of reports concerning the future of the town's commercial area. We were told that five out of the seven

members of the Community Board had commercial property interests in the area under consideration. The members accepted that they were likely to have a disqualifying pecuniary interest in the Community Board's consideration of the reports.

2.521 We were told that the Community Board's role in the matter was one of advocacy and leadership, and that any decisions that were to be made would be of a general nature.

2.522 We were satisfied that:

- a declaration should be granted, because otherwise the transaction of business of the Community Board would have been impeded; and
- the redevelopment of the commercial area of the town was a matter of importance to the inhabitants of the area, and that it was in their interests for all Community Board members to discuss and vote on the matter.

Participation Justified By Interests of Electors or Inhabitants of District

Bridging of a Harbour

2.523 A councillor applied to us for a declaration to allow him to participate in the consideration of matters concerning the bridging of a harbour. It was clear from the outset that the matter was of major significance to the district as a whole and of particular significance to people who lived in the area that would be directly serviced by a bridge. It was also clear that the matter was the subject of much interest and debate in the area.

2.524 We considered that the councillor had a pecuniary interest in the decisions that were to be made about the building of a bridge, because he owned:

- land in the vicinity of the proposed bridge, some of which was covered in forest; and
- a timber mill in the area.

2.525 The councillor's pecuniary interest arose from:

- the potential for increased land value if a bridge was built; and
- a potential increase in custom for his timber mill, which would be more easily reached if a bridge was built.

2.526 In order to assist us in determining whether a declaration was appropriate, we visited the area and spoke to a number of people about the bridge proposals. We also interviewed:

- the councillor;
- the other members of the local authority;
- some officers of the local authority;
- a member of the public who opposed the councillor's involvement; and
- a group of supporters who wanted the councillor to participate in the issue.

2.527 We heard a range of views on whether the councillor brought particular expertise to the debate. On balance, we were satisfied that he did bring particular expertise to the debate through his background on the question of a harbour crossing and his involvement in forestry. We considered that there would be some adverse effect on debate if he were not able to participate.

2.528 In order to determine whether the views of the people of the district would not be adequately represented if the councillor were unable to participate, we needed to ascertain what the interests of the people were in the matter. Our interviews revealed a number of interests – including transport, forestry, farming, tourism, education, health, community, cultural, and family. We decided that, because of the significance of the matter and the range of different interests involved, it was in the interests of the people of the district that all elected representatives were able to take part in considering the matter.

2.529 We also took into account the fact that the councillor had been the highest polling candidate in his Ward in the previous local authority election and that his electoral pamphlet had contained a statement about his involvement in advancing a two-bridge option for the harbour crossing. We were satisfied that the councillor had a mandate from those who voted for him to take part in the local authority's consideration of the matter.

2.530 We granted the declaration sought. We also informed the councillor that we would want to reconsider the appropriateness of the declaration should the local authority pursue another option in the future or should his individual circumstances change.

The Future of a Wastewater Treatment Plant

2.531 We granted a declaration for the involvement of a councillor in a local authority decision about the future of a wastewater treatment plant. One of the options under consideration was relocating the plant to another site. The location of the councillor's home, opposite the plant, gave rise to a pecuniary interest in the decision on the future of the plant.

2.532 In order to gather enough information to determine whether a declaration was appropriate, we visited the area and spoke to the councillor at her property. We also spoke to the chief executive of the local authority and corresponded with the Mayor and the other members of the local authority.

2.533 We learned that the councillor had been actively involved in issues concerning the plant for a number of years before being elected a councillor. We were satisfied that she brought considerable knowledge to the debate arising from her long involvement in sewage and water matters in the district.

2.534 Our enquiries also indicated that the location of the treatment plant was of importance to the electors and inhabitants of the immediate area and had wider significance for the district as a whole. We were told that the plant had substantial odour problems, which affected not only the residents living in the vicinity of the plant but also residents in other surrounding areas and people using the nearby recreational facilities.

2.535 We took into account:

- the extent of the councillor's pecuniary interest in the matter; and
- two reports that the councillor provided to us – one by a local real estate agent and the other by a registered valuer.

2.536 Both of those reports concluded that relocating the treatment plant away from the location of the councillor's property would have little impact on the value of her property. The conclusion in both reports was based on the reason that the value of the councillor's property was affected to a larger extent by odour from an abattoir situated on the other side of the property.

2.537 We considered that the councillor's pecuniary interest in the matter was not substantial, and we took this into account when we balanced the competing interests involved.

2.538 We granted the declaration sought because our overall impression was that the location of the treatment plant was of considerable significance, and that the issues involved in the decision were much bigger than those that would be of concern to the councillor personally. We were satisfied that the balance of the public interest favoured the councillor being able to participate, despite her pecuniary interest.

Conclusion

2.539 We hope that local authorities and their members continue to make use of the facilities for exemption or declaration in the Act. We are able to consider applications urgently and may be able to respond within a few hours. We are also available to discuss the pecuniary interest rule with members personally.

Three

Special Reviews Carried Out During 1999-2000

3.1
Sale and Lease of Land

Introduction

3.101 Concerns about the way in which a local authority has sold or leased council land are often the subject of complaints that we receive from ratepayers. The legal requirements for selling or leasing land are reasonably complex, and the procedures that the council has to follow depend on the type of land being disposed of and its history.

3.102 The complainants usually allege that the council has failed to meet the legal requirements, especially by failing to ascertain the precise status of land before disposing of it. Sale of endowment land and the use of sale proceeds is an area of particular concern. There have been several instances of alleged misuse of council powers to sell or lease land for commercial or industrial purposes.

3.103 We asked our auditors to review a small sample of property transactions at every local authority. Our aim was to assess each authority's compliance with the legal requirements, as well as raise awareness of the issue and consider any concerns that the authorities may have about the requirements.

3.104 In this article, we outline our auditors' findings and give examples of the concerns raised with us by ratepayers and by local authorities.

General Findings

3.105 Almost all local authorities had sold or leased land during 1999-2000. Most of the transactions sampled were of a fairly routine nature, such as:

- sale of surplus council houses and land (often to tenants);
- sale of land no longer required for council activities, such as works depots;

- sale of land acquired for industrial or commercial purposes and no longer required for those purposes; and
- lease renewals.

3.106 In the majority of transactions sampled, council officers were aware of the legal requirements affecting the sale or lease of council land and of the need to ascertain the history and status of the land before disposal. Several councils had a formal procedure in place to guide disposal. A few that did not said they would find some guidance on the subject helpful.

3.107 We found that the larger local authorities tended to involve legal staff or council solicitors in property transactions – especially where the land was originally acquired for public works, or is trust or endowment land.

3.108 In one instance, the local authority failed to meet the requirement to give notice of its intention to sell the land. In another case, the authority gave notice of its intention to dispose of a list of surplus properties in 1990, but did not give further public notice when any of the surplus properties were sold. The latter did not comply with the requirement to notify the public of the date and time of the *meeting* at which the council intends to resolve to sell land, unless the land is sold for residential purposes. Such notice must be given within 14 days of the meeting.[1]

Trust or Endowment Land

Example of Complaints Received

3.109 A local authority subdivided endowment land to sell the sections for residential purposes. The council met the requirements for notice and valuation, but did not appear to have any real intention of applying the proceeds to purchase or improve other endowment land. Instead, the council wished to apply some of the proceeds to projects elsewhere in the district. The council had previously applied proceeds from the sale of other endowment land towards upgrading a council building, for which it did not seek the approval of the Minister of Local Government.

1 Section 230(2), Local Government Act 1974.

Legal Position

3.110 Endowment land is intended to earn income for a local authority. The terms of any particular trust or endowment may regulate the authority's ability to spend that income – for example, an endowment could be for a particular area in the district. However, most endowments tend to be general so that any income from the endowment may be spent for general authority purposes. The majority of local authorities own endowment land.

3.111 Where land is vested in a local authority by way of a trust or as an endowment, the land may be sold unless the instrument creating the trust or endowment specifically prohibits the sale. If disposal is not prohibited, endowment land may be sold, but the council:

- must give public notice of its intention to sell; and
- cannot sell the land for below its value (a registered valuer's report must be obtained within six months of the date of sale).

3.112 Proceeds from the sale of endowment land must:

- be applied towards the purchase of other endowment land as soon as practicable; or
- be applied to improving other endowment or trust land; or
- with the approval of the Minister of Local Government, be applied towards the purchase of other land to be held for such other purposes as the Minister specifies.[2]

What We Found

3.113 In all of the sampled instances of the sale of trust or endowment land, we found that the councils had ascertained the history of the endowment and checked for restrictions on disposal. The councils had also sold the land for not less than valuation, obtained within six months of sale, as required. However, it was not clear whether any of the councils had any present intention to purchase more

2 Section 230(5), Local Government Act 1974.

endowment land. In one case, the Minister of Local Government approved the council spending the sale proceeds on land for a kindergarten, rather than on other endowment land.

3.114 We are aware of a concern among some local authorities that the provisions concerning disposal of endowment land are unduly restrictive – particularly the requirement to apply proceeds from the sale of such land towards the purchase of other land. Some authorities consider that they should be able to apply sale proceeds towards other council projects or investment other than in land. However, we are not aware of any widespread use of the ability to seek the approval of the Minister of Local Government to spend proceeds on land not to be held as an endowment.

3.115 One smaller local authority considered the expense (for research and legal fees) of disposing of endowment land outweighed the benefits.

Leases

3.116 Many local authorities leased land or renewed leases during 1999-2000. Councils have wide leasing powers, and different provisions apply depending on the type of land leased and the purpose for which the land will be used. We found no compliance issues in relation to leases.

Commercial and Industrial Development

Examples of Complaints Received

3.117 A local authority became the owner of an area of land as a result of the 1989 local government reorganisation. The land had a designation for harbour works under the transitional district plan. The council granted a lease of the land to a local organisation without publicly auctioning or tendering the lease, using section 572 of the Local Government Act 1974 as authority. However, it seemed unlikely that land with a designation for harbour works was actually "land owned by the council for the general

purposes of the district, and not held for any particular purpose", as required by section 572. Nor did it appear that the purpose of the lease was commercial, as only a token rent was charged.

3.118 A local authority sold land to a local organisation without public notice, on the basis that the land had been purchased by the authority for industrial purposes (a landfill) and was being sold to a person desiring to use the land for commercial or industrial purposes. However, because only part of the land was to be used for industrial purposes – and the bulk was to be used for farming purposes – there was an issue as to whether the land should in fact have been disposed of and public notice given under section 230 of the Local Government Act.

Legal Position

3.119 Territorial local authorities have broad powers to promote commercial or industrial development – including the power to develop, sell or lease land and buildings for commercial or industrial purposes.

3.120 Those local authorities may sell or lease the following types of land or building to any person who wishes to use the land or building for *commercial or industrial purposes*:

(a) *Any land or building within the district purchased by the council by agreement with the owner for commercial or industrial purposes;*

(b) *Any land or building owned by the council for the general purposes of the district, and not held for any particular purpose;*

(c) *Any land or building held by the council on trust or endowment unless the subdivision, development, sale, or lease of the land or building is prohibited by the terms of the trust or endowment.*

3.121 A local authority may also subdivide or develop land of the types listed in paragraph 3.120 for commercial or industrial purposes.

3.122 All money received from the sale or lease of such land or buildings must be credited to a "Housing and Property Account".[3]

What We Found

3.123 We found no significant compliance issues in relation to the sale or lease of land for commercial or industrial purposes. Council officers were aware that only land fitting within the three categories listed in paragraph 3.120 can be dealt with under section 572 of the Local Government Act.

3.124 Some councils credit the proceeds of sale of land for commercial or industrial purposes to a housing property activity (or equivalent) as required, but others do not. Many councils regard the requirement as no longer relevant given the changes to the local authority financial management regime introduced in 1996.

3.125 We share the view that a requirement to credit proceeds from commercial property transactions to a particular account is inconsistent with the new financial management regime. However, local authorities would still need to identify and correctly record revenue from property transactions.[4]

Conclusions

3.126 On the basis of our auditors' findings, it appears that (on the whole) council staff are well aware of the legal requirements and complexities involved in disposing of land. Specialist staff and legal advisers tend to handle such transactions.

3.127 The statutory provisions for dealings with council land are reasonably prescriptive. The reviews of the Local Government Act and the Public Works Act currently being undertaken (see pages 168-169 of this report) provide the opportunity for reconsideration of the provisions relating to disposal of land. Local authorities that have concerns about the requirements should ensure that they make those concerns known to the reviewers.

3 Section 572(7), Local Government Act 1974. The Act does not define "Housing and Property Account".

4 Section 223F, Local Government Act 1974.

3.2
Reviewing a Long-term Financial Strategy and Funding Policy

3.201 During 2001 most local authorities will adopt the first reviewed versions of their Long-term Financial Strategy and Funding Policy (from here on referred to as "the Strategy and Policy") required by the statutory three-yearly review cycle for these important documents.

3.202 When the strategy and policy were first required to be prepared by Part VIIA of the Local Government Act 1974, we took the view that (because of the newness and extensiveness of the legislative specifications) it would have been unrealistic to expect local authorities to get everything right the first time. Thus, our focus until recently has been on whether local authorities had their Strategy and Policy (together with their Investment and Borrowing Management Policies) in place.

3.203 Latterly, however, we have been indicating to local authorities our view that:

- greater attention needs to be placed on the processes applied to the preparation of strategic documents; and
- greater accuracy will be expected in reconciling information over the life of documents.

3.204 To assist local authorities prepare for the review of their Strategy and Policy in 2000 we undertook three projects:

- pilot audits of the Long-term Financial Strategies of Opotiki District Council[5] and Western Bay of Plenty District Council; and
- document reviews and interviews with six of the early nine about their experiences in their first three-yearly review of their Strategy and Policy.[6]

3.205 The remainder of this article draws on our findings from those three projects, together with our further experience and developing views on the subject.

Planning in the Legislative Framework

3.206 At its essence, Part VIIA is about undertaking integrated business planning and decision-making. Therefore, the Strategy and Policy are most meaningful and best understood when there is a strategic plan that provides a rationale (or the 'why') to the key questions that Part VIIA asks a council to consider.

3.207 Given this focus on strategic planning and supporting information and processes, three key themes recur:

- the need for the actions and proposals of local authorities to be driven by strategic intent;
- the need for sound asset management and information systems to support informed decision-making; and
- the need for information to be appropriate to the needs of elected representatives, residents, and ratepayers, to assist them in participating in the decision-making processes.

5 See our report *Auditing a Long-term Financial Strategy – Opotiki District Council Pilot Project*, September 2000, ISBN 0 477 02870 5. Presented to the House of Representatives on 25 September 2000.

6 See our report *Reviewing a Long-term Financial Strategy and Funding Policy* – Experiences of the Early Nine, published on 27 October 2000 and distributed to local authorities. The six were: Waipa District Council, Masterton District Council, Porirua City Council, Wellington Regional Council, West Coast Regional Council, and Dunedin City Council.

Local Authorities' Experience with the Part VIIA Framework

3.208 Our review of the experiences of the early nine found that the most common approach to the review process was to:

- incorporate the review requirement into the Annual Plan preparation process;
- have staff update the estimates for the Strategy, incorporate any revisions to the policies (in the course of the preceding two years), and identify areas where problems had arisen in the Strategy and Policy;
- circulate the updated Strategy and Policy to councillors for consideration and confirmation;
- consider separately the specific problem areas; and
- make the Strategy and Policy available for public comment in conjunction with the Annual Plan.

3.209 In our view, this approach to decision-making and information preparation was not centred on developing the Strategy and Policy as documents of strategic intent. This created problems in the transparency of public information and affected councillors' and staff perceptions of the relevance and value of the Strategy and Policy.

3.210 Based on the experience of the early nine, the two reports on our projects in 2000 offer some suggestions about where that focus should be directed and identify the four key areas emerging:

- decision-making processes that engage elected representatives and encourage a longer-term view;
- integrating information for the Strategy and Policy with other council policies and plans;
- ensuring that information achieves legislative compliance, and that the underlying data required to support the Strategy and Policy is complete; and
- dealing with transparency requirements, and communicating with and engaging residents and ratepayers in strategic decision-making.

Issues Arising from the Experiences of the Early Nine

3.211 The intention of the Part VIIA framework is to improve local authorities' financial management by:

- specifying principles of financial management to be observed in decision making;
- providing a framework for financial policy and funding decision-making; and
- providing for public participation in financial policies and funding decisions.

3.212 We therefore considered the extent to which the principles, framework and process served to facilitate prudent financial management. As a result, a number of issues emerged which we believe are appropriate to report to Parliament because they concern the effective operation of the legislative framework. These issues are:

- the principles of prudent financial management and the need for asset management plans and service level specification;
- compliance with and assurance on strategies, policies, and plans;
- effective and timely consultation in the planning regimes;
- the funding policy decision process and the interaction with rates setting; and
- the legislative intent of the planning and reporting provisions.

Prudent Financial Management Requirements

3.213 Part VIIA provides a framework and guidance to enhance financial decision-making by elected representatives. As part of ascertaining the experiences of the early nine, we attempted to form a view about the extent to which the planning regimes currently promote a strategic approach and balance short and long-term interests.

3.214 Some of our difficulties in interpreting the current depreciation requirements stem from our obligation (as the auditor) to assess whether local authorities have met the 122C(1)(f) annual funding rule (see paragraphs 1.201-1.208 on pages 18-19).

3.215 Compliance with Part VIIA meant (in our view) that local authorities were required to prepare asset management plans for key infrastructural assets for the 1998-99 financial year. Our logic was that, without adequate asset management plans, authorities lacked reliable determinations of asset lives and valuations. Consequently, the information underlying projected depreciation was deficient. In addition, when setting revenues to cover projected expenditure, the amount of depreciation budgeted was based on incomplete information and was often understated.

3.216 However, both local government and we have expressed concern over whether depreciation is (of itself) the most appropriate tool for determining the level of funding to maintain local authorities' assets over the long term. This is because:

- depreciation is not a proxy for the amount needed to fund local authorities' long-term asset requirements; and
- accounting for the past consumption of an economic benefit is not the same as providing for the full cost of services and assets in the future.

3.217 Those two purposes differ and, consequently, need to be considered separately. Indeed, the depreciation charge over the life of an asset will equal the renewal cost of the asset only by chance – especially if a revaluation occurs.

3.218 The planning regimes as they stand mean that local authorities must balance the pressure from today's ratepayers to constrain rates with the legislative need to manage prudently and recognise intergenerational equity in their funding decisions. The key source of assistance in trading off between long-term and short-term interests lies in information about:

- the service needs and expectations of communities from core assets; and
- the resources needed to maintain the core assets to provide those services.

3.219 Therefore, while the requirement to fund the depreciation expense has been a major impetus for the development of asset management plans, there are more compelling reasons for the preparation and maintenance of these plans and for the specification of service levels. Yet (at present) there is no explicit legislative basis for either asset management plans or service level specifications.

3.220 In our view, the decision-making framework established by Part VIIA is deficient in not recognising the importance of asset management information and specification of service levels.

Compliance with and Assurance on Strategies, Policies, and Plans

3.221 While the provisions of Part VIIA have improved local authorities' financial management, they have also increased the importance and complexity of planning information. As a result, it has become difficult for residents and ratepayers to determine whether significant legislative requirements are being met.

3.222 As the auditor of local authorities, we are required to audit and report on their annual financial statements. But there is no similar requirement for local authorities to obtain assurance on their strategic planning documents. However, we believe that an important part of our work is to provide assurance to ratepayers and residents that plans comply with legislative requirements.

3.223 We have given attention to the Annual Plan since the requirement to produce one was introduced in 1989 – because it is a key accountability document and forms the basis on which, among other things, the community is rated to pay for the year's activities. The financial management provisions of Part VIIA have led to us placing further emphasis on the Annual Plan, and have required us to actively interpret the legislation to have a view of what constitutes "compliance".

3.224 In the past, when dealing with issues that we have identified in an Annual Plan we have written to the council pointing out the deficiencies. But this does not provide information that would help the public. Where there are serious deficiencies in an Annual Plan, we have referred to the legislative breach in the next audit report issued (which relates to an earlier year). If we wait until the report on the financial statements for the year that the Annual Plan relates to, it could be 18 months before the public is told of the deficiency.

3.225 At this stage, it not clear who should be responsible for drawing attention to serious deficiencies or breaches in a Long-term Financial Strategy, or how it should be done. We undertook pilot audits at Opotiki and Western Bay of Plenty District Councils as a means of developing assurance opportunities for councils interested in pursuing best practice in their planning. However, there is no legislative requirement for any assurance to be provided to communities when a council is adopting its Long-term Financial Strategy.

3.226 Similarly, while the financial and non-financial achievements reported in a local authority's Annual Report are required to be audited, there is no requirement for attestation of the veracity of the achievements of the strategy and policies adopted under Part VIIA.

3.227 In our view, there are two issues on which (because of the complexity of the information and considerations involved) the public may need assurance:

- That the strategy, plans, and policies meet legislative requirements. The Part VIIA financial management provisions are empowering rather than prescriptive. Therefore, it can be very difficult for a community to readily ascertain, for example, that –
  - its local authority is being managed prudently;
  - services important to the community are being maintained; and
  - costs are being fairly distributed between ratepayers over the long term.

- That the intentions of the strategy, plans, and policies are being carried out over time. Observance of the principles of Part VIIA should lead to longer-term records of performance achievements being made available, and provide greater assurance to communities that the objectives of the strategy, plans, and policies are being met. However, there are limitations (see paragraphs 3.321-3.326) with the current legislative provisions for reporting and assurance on Part VIIA Strategy and Policy achievement.

3.228 Because of the importance of the planning regimes in allowing for communities to participate in choosing directions to pursue and the services sought from their council, we think that the review of the Local Government Act needs to include development of:

- processes to ensure that strategies and plans placed before communities are soundly based and comply with legislative requirements, including any assurances that the local authority should be required to obtain; and
- coherent requirements for reporting on implementation and achievement of the strategies and objectives, including any assurance to be obtained.

Effective and Timely Consultation

3.229 The councils we spoke to when reviewing the early nine raised the concern that maintaining the requirement to consult on the full extent of the Annual Plan, as well as requiring consultation every three years on the Strategy and Policy, was creating process duplication and incurring compliance costs.

3.230 These councils held the view that there was potential for the public to misunderstand or minimise the processes of consultation on the Strategy and Policy. The councils' reason was that, understandably, the public might have the impression that all the matters dealt with in these two documents are being raised within the Annual Plan consultation process.

3.231 A local authority has to be responsible in its expectations of people – who must commit their own time and energy – in making submissions, and be clear about what is being considered in any consultation exercise. It is also important that the legislation is clear about why in each case consultation is required to be undertaken, so that the energy and effort of communities, councillors, and staff are put to the best use.

3.232 Our review of the early nine leads us to the view that the intended purpose of requiring consultation may not in every case be as clear as it could be. The Annual Plan consultation regime has been in force since 1989 and has developed a level of recognition and familiarity for many. Several of the early nine councils commented to us that they thought this may have contributed to lower levels of comment on strategic documents. Many councils, because they tend to receive more comments during the Annual Plan consultation process, release their Strategy and Policy for comment at the same time as the Annual Plan.

3.233 Since 1989, councils have become much more conscious of the need to consult citizens and obtain their participation. In particular, while consultation on decisions about operational service choices is becoming quite sophisticated – for example, consultation to support decisions about services such as roading upgrades and playground location – the techniques for engaging citizens in long-term planning are still developing.

3.234 We have tended to the view that the Long-term Financial Strategy should set out:

- the objectives or outcomes that a council is pursuing;
- the strategies and services it employs to achieve them; and
- the costs involved.

3.235 One chief executive likened the long-term decision-making for councils to steering an oil tanker – it is always possible to change direction but it takes time to do it. We think this is a good description because, for a number of council services that involve assets and resources with long life spans, there are long lead times and costs involved in

making changes. Many significant changes may take place over a period greater than the three years covered by the Annual Plan.

3.236 Therefore, it is important that a community can, at relevant times, make known clearly its expectations about the long-term future of the district and services it wants from the local authority. The Annual Plan provides detailed information about the implementation of these longer-term decisions – and (where relevant) signals that changes to that direction are necessary.

3.237 However, it is also important that local authorities are responsive to their communities and are willing to consider feedback on a wide range of issues – regardless of whether feedback has been specifically sought on the issues. We have also noted that:

- there can be many reasons why a council may choose not to follow through with a proposal as indicated in its Strategy or Policy; and
- despite limitations, the legislation provides for this through disclosures in the Annual Plan and Annual Report (discussed in paragraphs 3.301-3.326).

3.238 We expect the Local Government Act review to consider how the various planning and consultation regimes can be better integrated to provide timely and effective consultation opportunities between communities and their local authorities.

Funding Policy Interaction with Setting Rates

3.239 Over the last two years, we have become increasingly aware of the complex interaction between the principles and process for formulating the funding policy and the determination of rating mechanisms and rate levels – as set out in the Local Government Act 1974 and the Rating Powers Act 1988, respectively.

3.240 In our report on reviewing a Strategy and Policy (paragraph 3.204) we commented on the need for transparency on the consequences of funding decisions for the impact on rates. In our view, a sound method of formulating the Funding Policy will assist in making transparent the way in which rates and charges are determined – improving consultation and community input into local authority decisions on rate setting and expenditure.

3.241 A sound method would involve undertaking a thorough review of the Funding Policy, including considering (within the three-step process required by the legislation):

- why the council undertakes the activity;
- based on that reason, who the activity is intended to benefit;
- whether the environment in which the activity is provided has changed;
- what customer usage and feedback is saying; and
- what way of paying for the activity best serves the council's reasons for being involved in the activity.

3.242 As a result of many of the ratepayer enquiries we have dealt with, we have become aware that this is a complex set of questions – the answers to which are finally determined in the rates levied. In addition, the final act of levying the rates is the result of a number of incremental steps, including:

- agreeing the Strategy and Policy that set out the amount required to be funded, who should pay, and the type of rate/charge that would be used to meet the costs of delivering services;
- deciding the basis of property valuation for general rating;
- formulating the contents of the Annual Plan;
- making the special order to set differential rates where the council chooses to use such modifiers of the general rate; and
- striking the rates.

3.243 The fact that these steps take place separately and in sequence can mean that many ratepayers are not aware of the likely effects for them of the Long-term Financial Strategy or Annual Plan. Those ratepayers therefore lack information to help them make decisions about the services that they want from their local authority and the cost they are willing to bear for those services.

3.244 This lack of information can be further complicated for ratepayers and residents by:

- significant changes in the Strategy and Policy, or in valuations between different locations or categories of properties within the district;
- a local authority typically carrying out around 30 different activities for which funding policy allocations are required; and
- the use of a mixture of rating approaches, or funding policy allocations for different services benefiting different communities being amalgamated into a single rate.

3.245 The cumulative way in which these decisions are currently made means that the logic of the process can be difficult for the community to understand and participate in. Transparency is achieved, in our view, when the effect of the Funding Policy decisions is made known to the community in easily understandable rating and service price information.

3.246 To achieve that transparency means the logic should be clearly discernible and consistent – from the Funding Policy, through the council resolution making the rates, to the rates invoice. The current legislation does not help to achieve this objective because it:

- disaggregates decisions about funding needs, who should pay, and how, throughout the planning regimes; and
- does not anticipate or require that funding policy decisions about the allocation and type of rates should be reflected in information given to the community about striking or levying rates.

3.247 We have encouraged local authorities (as a matter of best practice) to seek to improve the transparency of their decisions throughout the process of preparing their Strategy and Policy, Annual Plan, and rating resolutions. Some authorities already take steps to better communicate the impact of the Funding Policy and Annual Plan for rates by, for example:

- preparing indicative information illustrating the likely level of rates for a property resulting from the draft Annual Plan or Funding Policy;
- providing 'calculate your own rates' formula sheets within the draft Annual Plan or Funding Policy;
- sending out mock-up rates invoices that show the impact of the draft Annual Plan for individual property owners; and
- setting out rates resolutions and rates invoices so that they reflect funding policy choices and give information about and the reasons for the allocation of rates that the council has chosen.

3.248 We encourage local authorities to continue with such efforts – both within the existing legislative framework and in any revised legislation that may amend the current funding policy process. However, because rating decisions involve the use of local authorities' coercive powers, we also encourage the Department of Internal Affairs to consider, as part of the Local Government Act review, legislative requirements and best practice guidance to promote transparency and community participation in funding and rating decisions.

Intent of the Planning and Reporting Provisions

3.249 The current provisions in the Local Government Act for planning and reporting on local government service performance reflect their development through several legislative reforms. While an intention for an overall framework can be inferred, the actual language used varies throughout the requirements. For example:

- in the Annual Plan, service performance is to be identified in terms of ***significant activities*** and ***performance targets***;
- in the Annual Report, the local authority must report on the ***performance targets*** and ***other measures*** by which the performance of the authority may be judged in relation to its ***objectives, outputs, and outcomes***;
- the funding policy analysis is required on a ***function by function*** basis;
- the local authority is to state the reasons why it is involved in ***activities***; and
- in the Annual Report, the local authority must state the extent to which the ***objectives*** of the Long-term Financial Strategy and other Part VIIA policies have been achieved – but the contents of the Long-term Financial Strategy do not include ***objectives***.

3.250 As a matter of making information coherent (and best practice) many local authorities use a particular planning model or framework for determining and reporting on performance, and we commend these efforts. However, there is no explicit framework within the legislative model. Where the local authority chooses a performance-based framework for preparing information the absence of a statutory framework should not matter. But the absence of both a statutory framework and a chosen performance-based framework can detract from the presentation of coherent and understandable non-financial performance information.

3.251 We expect to publish shortly a report providing some high-level guidance on enhancing the reporting of performance. We will be considering how else we can cooperate with local government to improve the reporting of local authority performance.

3.3
Plans and Policies – Reporting on Achievement and Changes

3.301 In our *Second Report for 2000* we discussed our views about what local authorities are required to do in order to comply with sections 122T, 122U and 122V of the Local Government Act 1974.[7] These sections:

- require disclosure in annual plans and reports of changes, errors and variations in the Long-term Financial Strategy, Funding Policy, Investment Policy and Borrowing Management Policy; and
- provide the operative means by which changes are made to these documents.[8]

3.302 The nature of the disclosure required is determined by whether the change is "significant" (section 122T(1)), or the error or inconsistency is "material" (section 122T(2) and section 122U).

3.303 In 1999-2000 local authorities were finding that their strategy and policies required adjustment as a result of better information about assets, the introduction of the requirement to fund depreciation, and changes in the council's policy direction following the 1998 local authority elections. Local authorities were asking us for advice about the requirements of sections 122T, 122U and 122V.

7 Parliamentary paper B.29[00b], pages 95-100.

8 Ibid., paragraphs 6.007-6.010.

3.304 To assist us in advising local authorities, we asked our auditors to collect information during the 1999-2000 audits about each local authority's experience of reporting under the provisions. In particular, we asked for information on:

- how local authorities determined "significance" and "materiality"; and
- compliance with the disclosure requirements, and whether the disclosures made were full and meaningful.

Significance and Materiality

3.305 Part VIIA of the Act places reliance on the exercise of judgement by decision-makers, which is reflected in the need to consider what is "significant" or "material" for the purposes of sections 122T, 122U, and 122V. We have suggested that each local authority needs to formulate its own policy or guidance on what those terms mean. To that end, an authority should:

- identify the users of the various documents and their differing interests in the services and activities of the local authority;
- consider what constitutes change, inconsistency, variation or error; and
- provide direction on how to evaluate the significance of changes, inconsistencies, variations or errors, taking into account the two previous considerations.

3.306 We were surprised to find that, at the time our auditors collected the information, most local authorities had not developed any guidance for the public, councillors, or staff about what might be regarded as significant or material. Where a formal approach had been taken, it tended to consist of setting a dollar value – often the amount determined for the section 247E threshold for a significant contract for which tenders would be called.

3.307 Several local authorities indicated that developing guidance was either planned or under way. In setting materiality levels, a few authorities referred to the materiality thresholds our auditors applied in auditing their financial statements.

Judging Significance

3.308 The words "significant" and "significance" are used often throughout the Local Government Act. Although the Act does not define "significant"[9], the fact that Part VIIA uses both the terms "significant" and "material" suggests a different intent lies behind each.

3.309 The financial statements in the Annual Plan and Annual Report must be prepared in accordance with generally accepted accounting practice. Consequently, Statement of Standard Accounting Practice 6: *Materiality in Financial Statements* is likely to be of assistance to local authorities in considering their obligations under section 122T and section 122U in relation to material inconsistencies and errors.

3.310 We are not aware of any consideration by the Courts of local authority assessments of "significance" under the Local Government Act. Dictionary definitions of "significant" and "significance" include the words and phrases "important", "noteworthy", "inviting attention", "not insignificant or negligible", "of considerable amount or effect or importance".[10]

3.311 We concluded that "significant" can be better equated with the word "noteworthy" and is of a lower order than terms such as "material", "substantial" or "major" which are also used in the Local Government Act.

9 There is a definition of "significant control" in section 594B(2) of the Act, but it is only for the purpose of determining whether an organisation is a local authority trading enterprise.

10 *Concise Oxford Dictionary*, 7th ed.

3.312 Some sections of the Local Government Act clearly make judging significance a subjective matter for the local authority, for example:

- ***247E Contracts and tenders –***
  (1) Where any local authority is contemplating entering into any contract … that is likely to involve the local authority in expenditure or financial commitment that the local authority considers significant, the local authority shall consider whether or not the matter shall be put be tender.

- ***594O Power of local authority in relation to divestment of undertakings –***
  (2) If a local authority proposes to divest itself of any undertaking that it regards as significant, it may deal with the proposal only in accordance with the special consultative procedure.

3.313 In other cases, notably in Parts VIIA and XIIA of the Act relating to planning and reporting, an objective assessment of whether a decision or disclosure is significant appears to be required – meaning that the local authority needs to be able to justify its decisions and disclosures based on objective criteria. If such a decision was challenged, a court could choose to hear evidence from a range of parties – including ratepayers and interested groups, as well as the local authority – to determine whether the decision could be objectively justified.

3.314 The requirement to make decisions based on objective criteria can be contrasted with the language of sections 247E and 594O noted above, which allow local authorities to make valid decisions based on the feelings and opinions of local authority members.

3.315 As a matter of best practice, a local authority assessing significance for planning and reporting under Parts VIIA and XIIA should consider matters of cost, interests, and impact from the perspective of other parties (such as ratepayers, residents and interested groups).

3.316 It should be borne in mind that, while some sections in the Act clearly allow a subjective assessment by the local authority, the authority's assessment is still reviewable by a court. A ground for challenging a local authority decision could be that a decision (which may involve a subjective assessment of significance) is so unreasonable that no reasonable authority could have made it.

Putting Significance into Practice

3.317 We have noticed that some local authorities use a different significance threshold for decisions that are not being taken as part of preparing the Annual Plan. For example, a council may use a significance threshold of $500,000 for decisions for the purposes of the Long-term Financial Strategy or Annual Plan, and a threshold of $100,000 for other decisions – so as to discourage decisions being taken separately outside the context provided by the planning process.

3.318 We think that this is a useful approach. The differential value serves to encourage evaluation of significant costs and choices through the coherent preparation and consultation process of the Annual Plan, rather than through a series of individual decisions.

3.319 When making information publicly available, the local authority needs to be clear about what has been treated as significant and, therefore, is explicitly identified – as opposed to the sort of information that does not appear or has been aggregated into other summary information. Such an approach could allow the council to consider – according to its evaluation of the significance of the decision – whether the matter will be dealt with solely by the council or would require some form of public consultation prior to a decision.

3.320 We recommend to the Department of Internal Affairs that, in the course of reviewing the Local Government Act, it seek to assure itself that its intentions on the following matters are clear in relation to the use of the term "significant" in legislation:

- the order of magnitude intended;

- whether the judgement of significance is intended to be subjective or objective;
- the range of considerations that might be expected to be taken into account in determining significance – including cost, interests, and impact; and
- the circumstances under which the council may be expected to use a consultation process to inform its decision-making.

Compliance with the Disclosure Requirements

3.321 The absence of policies and guidance on how local authorities determine what is significant or material made assessing the adequacy and meaningfulness of disclosures difficult. In some instances, the authority had chosen to report every change made to its strategy and policies, which allowed the auditor to consider the adequacy of the disclosures made. The auditors considered these disclosures to be largely adequate.

3.322 Reporting of achievements under section 122v is more problematic. We have already raised our concern about what disclosure section 122v actually requires (see paragraph 3.249). The contents of the Long-term Financial Strategy are specified as a set of financial estimates, yet section 122v requires the Annual Report to include:

> *… sufficient information about the long-term financial strategy, funding policy, investment policy, and borrowing management policy as will enable an informed assessment of the extent to* ***which the objectives and provisions*** *of the strategy and policies have been* ***met during the year to which the annual report relates****.*

B.29[01a]

3.323 Given the growing importance of the strategy and policies, in our view communities should have greater access to longer-term records of performance achievements than simply the achievements in the year of the Annual Report. Disclosures under section 122V should be:

- complementary to, and enhance, the information provided in the statement of service performance required by section 223E(3)(e); and
- consistent with the information required for the Long-term Financial Strategy.

3.324 Despite uncertainty about the legislative intent of section 122V, we can report that many local authorities made constructive efforts to report meaningfully on the extent to which their Long-term Financial Strategy was being achieved.

3.325 Last year we also asked the Department of Internal Affairs to consider incorporating the section 122V disclosures in the contents of the financial statements that section 223E(3) requires to be audited. In many respects, we see a parallel between:

- section 122V information and the reporting required on the Annual Plan statement of service performance; and
- a need for greater assurance for communities that the objectives of these key strategies and policies are being met.

3.326 The Department has indicated that it intends to deal with the issue as part of its review of the Local Government Act.

3.4
Auckland City Council: Administration of the Gulf Islands

3.401 The following paragraphs summarise our report *Auckland City Council's Management of its Responsibilities in the Hauraki Gulf,* which we issued in October 2000 at the conclusion of our inquiry.[11]

Introduction

3.402 On 22 February 2000, Mr Owen Jennings MP presented to the House of Representatives a number of documents relating to Auckland City Council (the Council) and its dealings with residents on Great Barrier and Waiheke Islands.

3.403 Included within these documents were itemised schedules containing 214 allegations of what became commonly referred to as "abuses of power" by Council officials over Hauraki Gulf Island residents.[12]

3.404 Two days after presentation of these documents, the Council's Chief Executive asked the Deputy Controller and Auditor-General to conduct an investigation into the allegations.

3.405 On 2 March 2000, the Local Government and Environment Committee of the House endorsed the Audit Office as being the appropriate agency to investigate these matters.

11 ISBN 0 477 02872 1, 6 October 2000.

12 The documents presented by Mr Jennings included two separate schedules:
- *Abuse of Power on Great Barrier Island*, containing 165 allegations; and
- *Information on cases to be investigated by Inquiry into the mismanagement by Auckland City Council and the Waiheke Island Community Board*, containing 49 allegations.

The Purpose and Objectives of Our Inquiry

3.406 Most of the documents presented by Mr Jennings – including the list of "abuses of power" – contained details on the concerns of residents and their dealings with the Council. These concerns were particularly over the actions of officials and the application of the Resource Management Act 1991 and the Hauraki Gulf Islands District Plan.

3.407 The 214 allegations were wide-ranging, but largely centred around issues of harassment and obstruction, including:

- deliberate obstruction of the process of obtaining a resource consent;
- continued harassment by Council officers in ensuring that consent holders complied with the conditions of resource consents;
- unreasonable and open-ended demands being placed on individuals wanting to obtain a resource consent or to comply with the condition of a consent, resulting in cost over-runs; and
- complaints being ignored.

3.408 The allegations also referred to the impact on people's lives as a result of this harassment and obstruction – including businesses failing, people leaving the Gulf, and projects not being carried through to completion.

3.409 The documents presented by Mr Jennings were a catalyst that led to our inquiry being undertaken, but they were not the central focus of the inquiry. Instead, after preliminary discussions with the Council and the Select Committee, we developed a broader, high-level set of objectives.

3.410 We decided to conduct an inquiry having the following purpose:

> *To ensure that the Auckland City Council has complied with its statutory responsibilities, and its own policies, in its administration of the Islands of the Hauraki Gulf.*

3.411 Our objectives for the inquiry are set out (as appropriate) in each of the substantive chapters of the report. The objectives were process-focused – but, as the inquiry progressed, it became clear to us that the problems occurring on the Islands concerned issues of *culture* rather than issues of *process*. For this reason, we did not fully pursue some objectives when it became apparent that there were no major process-related concerns.

3.412 We also made it clear that we were not limited to the inquiry objectives. We have a statutory role within local government and we indicated that, should other relevant matters be disclosed during the course of our inquiry, we would investigate them as well.

Our Method of Review

3.413 We took a three-phase approach to meeting the inquiry objectives:

- Conducting a high-level process review, which involved obtaining and reviewing all relevant documentation relating to the inquiry objectives.
- Speaking to the residents of Great Barrier and Waiheke Islands and the members of the Community Boards on each Island. We provided an opportunity, through public advertisements, for Island residents to speak to us, and we interviewed those residents who sought such an opportunity and had information relevant to the inquiry.
- Interviewing Council staff.

3.414 It was not the purpose of our inquiry to investigate and resolve specific grievances. We examined specific cases only to identify common themes that would demonstrate how the Council was undertaking its role in the administration of the Islands of the Hauraki Gulf.

Other Inquiries and Actions

3.415 The documents presented by Mr Jennings included allegations of sexual harassment. The Council considered that, as the employer, it was obligated to conduct its own investigation into these allegations. We asked that we be kept informed of the Council's investigations.

3.416 It was also appropriate to exclude from our inquiry those allegations that were either subject to legal action or had legal action pending.

Structure of the Report

3.417 In order to place the report into context:

- Part 1 contains background information on the Islands of the Hauraki Gulf.
- Parts 2 to 6 discuss the key issues arising from the inquiry.
- Finally, during the course of our inquiry we spoke to many current and former residents of Great Barrier and Waiheke Islands. We were concerned that the inquiry had built up high expectations for Island residents and that the current momentum by the Council to work through and resolve some of the issues would not be maintained after publication of the report.

3.418 To maintain the momentum in dealing with and resolving the issues, we suggested to the Council that we should include a *Where to from Here?* section in the report. The text (prepared by the Council) appears as Part 7 and is a strategy for:

- following up on the recommendations in the report; and
- more importantly, identifying a closer working relationship between the Council and Island residents.

There was a certain amount of ill-feeling towards the Council on the Islands, and the strategy outlines how the Council was going to address this.

Conclusions

Significance of the District Plan

3.419 The Hauraki Gulf Islands District Plan was one of the first plans to become operative under the Resource Management Act 1991. Because of this, it was not possible to fully appreciate in advance the impact that the Plan was going to have as it was applied over the years after it became operative.

3.420 Many of the issues and concerns that were raised with us are, we believe, the consequence of a natural tension that is going to develop when a District Plan is trying to reflect a number of competing and conflicting interests and, ultimately, achieve a balance. In many cases, these tensions are heightened by the factors which make the Gulf Islands – in particular Great Barrier Island – unique.

3.421 Some individuals feel disadvantaged as a result of the District Plan. The Council is aware of these feelings and is factoring them into the rolling reviews of the Plan. The Council should invite those individuals who feel disadvantaged to make submissions when the Plan is reviewed.

Enforcement Processes

3.422 Auckland City Environments – the Council division that implements the District Plan in the Hauraki Gulf – is "ISO 9001 certified" and has documented processes for enforcement of the Plan and carrying out the Council's regulatory function role. We are satisfied with the processes that the Council has in place to deal with non-compliance with both the Plan and the conditions of consents and permits issued from carrying out its regulatory function role. As discussed in Part 6, our concern is with the way in which these processes have been carried out.

Culture

3.423 Our interviews with Island residents revealed a number of common themes, which we discuss in Part 6. Central to these themes is an issue of *culture*, by which we mean:

- the way in which the Council carried out its role on the Islands;
- the way in which Council officers were supported and trained to fulfil that role; and
- the behaviour of some Council officers.

3.424 We identified instances where there was a lack of a customer- and solution-focused approach in the way that a small number of officers interacted with residents in the Islands. We identified a number of occasions when a small number of Council officers had not worked in a constructive manner with customers, either to assist them in the consent process or to undertake corrective action to achieve compliance.

3.425 We identified instances in which some Council officers had received insufficient training to do their jobs effectively and had not received the appropriate support that we would expect.

3.426 Improvements need to be made to the Council's internal procedures for dealing with complaints. Acknowledging that enhancements were needed, the Council had already begun work on improving its procedures at the time of our inquiry. The results of this work have yet to be implemented.

The Future

3.427 The Council responded to the substance of each of the foregoing points in *Where to from Here?* in Part 7.

Other Considerations

3.428 The Council is currently working through a small number of complex cases which involve a range of issues largely relating to resource consent and building permit matters. The Council is involved in mediation with the affected parties in most of these cases.

3.429 The Council submitted to us that, in its view, it had done a good job under challenging circumstances in the Gulf. The Council's submission also:

- noted that there is a special context in which its administration of the Gulf takes place and has taken place; and
- gave an overview of the context and changes in the Gulf, which have affected, influenced and shaped its administration of Great Barrier and Waiheke Islands.

3.430 We accept the Council's submission about this special context and have attempted to reflect this, where appropriate, throughout the report.

3.5 Good Practice for Involvement in a Major Project

3.501 In March 2001 we published our report *Good Practice for Involvement in a Major Project* Lessons from the Opuha Dam Project.[13] The report was based on a review of the involvement of several local and other public authorities in the project to build the Opuha Dam and associated works.

What Was the Purpose of Our Review?

3.502 Public sector entities, especially local authorities, are involved in large-scale capital projects. These projects:

- can be complex and, therefore, expose all parties to considerable risk;
- are generally expensive;
- often involve a number of entities from both the private and public sectors; and
- are often unique in nature and not likely to be repeated.

3.503 The purpose of our review was to see what messages for good practice we could find from looking at one such large-scale project. While much is known about the circumstances of the breach of the Opuha Dam, the lessons for public authorities that might be involved in such projects have not hitherto been explored.

Why Did We Choose the Opuha Dam Project?

3.504 The Opuha Dam project made headlines on 5 February 1997 when the dam was breached, releasing a large volume of

13 ISBN 0 477 02871 3. Presented to the House of Representatives on 13 March 2001.

water – causing both a danger to the public in the vicinity of the river and significant damage to public and private property downstream from the dam.

3.505 In addition to the public interest in the project arising from the public money invested in it, we were concerned that the apparent "failure" of the project was significant because of:

- six public authorities being involved, two in a regulatory capacity;
- the dam being ultimately owned by a local authority trading enterprise; and
- a related local authority trading enterprise having engaged the contractor.

3.506 In examining the circumstances surrounding the breaching of the dam and its consequences, we were not concerned with what caused or who was responsible for the breach. Apportionment of blame is the responsibility of the courts after taking account of technical specialist argument and expert opinion.

3.507 However, we did consider it our role to see whether the public authorities:

- ***regulating the project*** had acted in accordance with, and had fulfilled, their statutory duties; and
- ***investing in the project*** had taken appropriate steps to establish that the project was, and continued to be, a sound investment.

3.508 The public authorities involved in the project and the nature of their involvement are shown in Figure 3.1 opposite.

3.509 Our ultimate aim was to identify any lessons that could be learned from the project to the benefit of any public authority being similarly involved in the future. Such lessons could include drawing on good management practice and avoiding identifiable shortcomings.

3.510 Consequently, the report is not about the causes of the dam breach. Nor does it in any way attempt to establish who was responsible for the breach. It also does not cover the actions of private sector entities, except where they affect the public sector.

B.29[01a]

Figure 3.1
Public Authorities Involved and Their Roles

AUTHORITY	INVOLVEMENT
Alpine Energy Limited	Owner (through Timaru Electricity Limited) of a 50% equity interest in Opuha Dam Partnership, and able to appoint four of the eight members of the Executive Committee of Opuha Dam Partnership.
Canterbury Regional Council	Responsible for issuing various resource consents.
Mackenzie District Council	Exercising regulatory functions in dealing with applications: • to modify the Mackenzie District Transitional Plan; and • for the issue of building consents for the dam and downstream weir. Owner of a 4.96% equity interest in Alpine Energy Limited. Provided $1,125,000 of loan capital to Opihi River Development Company Limited (a partner in Opuha Dam Partnership).
Opuha Dam Limited	A local authority trading enterprise, acting as trustee of the assets of Opuha Dam Partnership and (under power of attorney from the partners) contracting party with the dam builder.
Opuha Dam Partnership	A local authority trading enterprise formed to construct, operate, manage, and control the dam, generation plant, and all related facilities.
Timaru District Council	Owner (through TDC Opuha Investments Limited) of a 14.9% equity interest in Opuha Dam Partnership. As a result, able to appoint one member of the Executive Committee of Opuha Dam Partnership. Also has a 47.5% equity interest in Alpine Energy Limited.

What Are the Main Messages from Our Review?

3.511 The Building Act 1991 together with the Building Code made under that Act[14] impose specific requirements on the construction of all buildings, including large dams. This legislation is concerned with the risks that water flows may pose to buildings, and the risks that buildings which are subject to water flows may pose to people and to other property, should those water flows cause the collapse of a building.

3.512 The Resource Management Act 1991 is concerned with the management of effects on the environment of allowing certain activities, including the activities of erecting dams in river beds and of damming water. In the case of the Opuha Dam project "effects" on the environment were brought about by the sudden release of flood waters that had collected behind the partially constructed dam and the resulting discharge of dam materials into the Opuha River.

3.513 There is a grey area between the Resource Management Act and the Building Act concerning dam breaches. Uncertainty surrounds the extent to which consent authorities under the former Act can rely on procedures under the latter Act to address and guard against negative environmental impacts resulting from failures during construction.

3.514 Government agencies have given some consideration to changes to the legislation to address dam safety issues. We consider that clarity in this area is necessary and suggest that the matter be revisited. However, until such time as the law is clarified, local authorities or other public authorities with a regulatory role need to co-ordinate their procedures to ensure that both environmental risks and building risks are adequately addressed.

14 The Building Code is set out in the First Schedule to the Building Regulations 1992 (SR 1992/150).

3.515 **The main messages for a local authority or other public authority that has a regulatory role in a major project are that it should:**

- **Ensure that all decision-makers are fully aware of their statutory responsibilities and, in particular, are provided with appropriate advice in relation to risk. If an independent person is appointed in an advisory or decision-making role, the authority should ensure that the person has the appropriate expertise, experience and qualifications to enable them to meet all relevant statutory requirements and appreciate the issues involved.**
- **Wherever practicable, establish procedures that ensure that all material relevant to the conditions of consent (whether a building or resource consent) are physically incorporated in the consent or, if this is not possible, the consent includes clear cross-reference to the identity of that material. This is important to establish the certainty and enforceability of the conditions of consent.**
- **Ensure that the risks associated with the design and construction of a project are fully assessed by in-house staff or consultants, and that the conditions of consent (whether building or resource) adequately cover the risks identified. This is particularly important when a project (as in the case of the Opuha Dam with the diversion of flood water) has design, construction and environmental impact implications.**
- **Plan and implement a systematic approach to monitoring compliance with the conditions of consent (whether building or resource).**
- **Ensure that its review procedures are directed at the critical phases of the project and are not limited to being applied at standardised review times.**

3.516 A local authority or other public authority should ensure that it has (either on its staff or by engagement specially for the purpose) the relevant expert advice for the purposes of:

- assessing proposals and establishing the integrated management regime referred to in paragraph 3.518;
- advising on consent conditions; and
- monitoring compliance with the consent and other statutory procedures.

3.517 In particular, decision-makers and advisers need to identify critical times of risk in the construction process. In other words, the right expertise needs to be applied to the project at the appropriate times to allow risks to be identified and minimised or avoided.

3.518 The over-riding message for any local authority or other public authority that invests in a major project is to have an integrated management regime, including:

- sound and enforceable contractual arrangements – to enable the contractor to be held accountable;
- adequate insurance – to protect the investment;
- a sound overall project management structure – to be able to recover and continue with the project should problems be experienced;
- a quality assurance system (for example, peer reviewers and experts) in place at the appropriate stages – to ensure that the project is being completed in accordance with the appropriate professional standards; and
- a system for monitoring its investment.

3.6 Local Authority Governance of Subsidiary Entities

3.601 Also in March 2001 we published our report *Local Authority Governance of Subsidiary Entities*.[15]

What Is The Report About?

3.602 The report is about current and emerging issues of how local authorities govern their subsidiary entities. In our 1994 report *Governance of Local Authority Trading Activities*, we commented on the relationships between local authorities and their commercial trading entities.[16]

3.603 Since then, local authorities have continued to explore new ways to carry out their commercial and non-commercial functions. In this report, we examine how some of these new governance arrangements are working and make a number of recommendations for good practice.

What Is The Report Based On?

3.604 We based our report on our expectations of good governance practice. We discuss our findings from three case studies:

- Watercare Services Limited;
- Infrastructure Auckland; and
- the Canterbury Landfill Joint Venture.

3.605 We also review relationships between local authorities and trusts or other non-profit entities.[17] Finally, we examine relationships between shareholding local authorities and their commercial trading enterprises.

15 ISBN 0 477 02873 X. Presented to the House of Representatives on 30 March 2001.

16 ISBN 0 477 02844 6, June 1994.

17 In other jurisdictions the equivalent description is "not-for-profit" entities.

Summary of Recommendations

3.606 We make a number of recommendations on three subjects:

- roles and responsibilities;
- governance structures; and
- monitoring and accountability arrangements.

3.607 Our recommendations are intended primarily for local authorities. However, effective governance relies on constructive, well-understood relationships among a number of different parties. In particular, governing bodies and individual board members play an important part in making governance arrangements work. We encourage all parties to consider how our recommendations could usefully be applied to their own circumstances.

Roles and Responsibilities

Responsiveness to the Expectations of the Public Owner

3.608 A local authority should ensure that a subsidiary entity's board is responsive to its expectations as a public owner, without compromising the board's responsibility as the governing body to direct and control the conduct of the entity's business.

3.609 In consultation with the board, the local authority should establish:

- director selection and appointment processes which require non-councillor directors to have a sound understanding and acceptance of the wishes, needs, and priorities of the public owner, and the needs of the community;
- a clear statement outlining the council's expectations of the board, including a commitment by the board to "no surprises" on matters likely to cause community concern or have political implications;

- periodic forums for discussion between the board and councillors on strategic business issues and ownership objectives; and
- ongoing communication between the council and the board chairperson, and between entity executives and local authority officers, on matters of common interest.

The Accountability of a Non-profit Entity

3.610 A local authority with an interest in a trust or other non-profit entity should ensure that:

- a service agreement framework is drawn up within which the entity can be held transparently accountable for the use of ratepayer funds or assets; and
- performance monitoring is undertaken at arm's length and with reference to a clear and agreed set of expectations.

Appointing the Governing Board of a Non-profit Entity

3.611 A local authority should:

- document clearly its processes for appointing the governing body of a trust or other non-profit entity; and
- consider following processes similar to those used for board appointments to commercial trading enterprises.

The Role of the Local Authority Chief Executive Officer

3.612 A local authority chief executive officer (CEO) has important advisory responsibilities to the council. To exercise these responsibilities in an independent and informed manner in relation to subsidiary entities, the CEO should:

- Be kept fully informed of all material matters about the local authority's subsidiary entities.

- Take no part in the internal governance of subsidiary entities. In many local authorities this advisory role will be delegated to local authority managers – who also should not, as a rule, sit on the governing bodies of subsidiary entities.
- Be assigned formal responsibility for reviewing, or commissioning regular reviews of, the subsidiary entities and for putting policy options to the council based on those reviews.

Governance Structures

The Role of a Holding Company

3.613 A local authority with a holding company should:

- monitor the performance of its holding company in managing local authority investments against measures of financial and non-financial performance specified in the company's Statement of Corporate Intent (SCI);
- obtain, and where necessary respond to, information about activities or intentions of a subsidiary company which may have political implications or raise community concerns;
- review its investment strategy at regular intervals, having regard to the objectives specified in investment policies and balancing strategic, community, and commercial considerations; and
- consider whether to reserve the right to approve board appointments and SCIs in order to obtain assurance about governance and strategic direction in operating subsidiaries.

3.614 The board of the holding company should ensure that the company is fully accountable to the parent local authority, by:

- defining, through the SCI, the role and reporting requirements of the holding company;
- establishing and reporting against a range of financial and non-financial performance measures;
- maintaining an awareness, and keeping the local authority informed where required, of strategic and business issues in subsidiary companies;
- monitoring the quality of SCIs of subsidiary companies, reviewing them for compatibility with the local authority's strategic aims; and
- keeping the local authority fully informed of all significant matters relating to management of its investment portfolio through regular reporting and briefings to councillors.

3.615 In determining the balance of councillor and external directors consideration should be given to:

- the desired mix of skills and experience for the holding company's role as the local authority's professional investment manager;
- the nature of the local authority's investment portfolio; and
- the relationship between the holding company and the local authority.

Joint Ventures

3.616 In establishing the governance framework for joint ventures, a local authority should have regard to the following key factors which are likely to be vital to the success of any such venture:

- A governance framework that creates a forum for effective collective decision-making, preserves the autonomy of the local authority, and maintains a balance of power and influence among the participants.

- Delegations, authorities, and lines of communication that underpin the relationship between the joint venture partners collectively and each individual partner. These should reflect the commitments of the local authority to the partners collectively, on the one hand, and the ultimate accountability of the authority to its community, on the other.
- Agreed policies and strategies that ensure that a venture is based on common objectives at political and operational levels.
- Provisions to promote the commercial viability of the venture, and the proper control of current and future costs.

Trusts and Other Non-profit Entities

3.617 A local authority should:

- specify key accountability arrangements when setting up a trust or other non-profit entity;
- draw up a formal service agreement which documents the scope and purpose of the association between the entity and the local authority, defines the services to be provided, and specifies how the entity will be held to account for delivery of those services;
- follow an objective process for appointing the governing body, based on a documented set of competencies relevant to the functions and activities of the entity;
- establish a means (conceivably in the context of its own annual planning process) for the local authority to approve or endorse the entity's philosophy, direction and strategies, planned programmes and activities, financial and non-financial targets, and outcome measures; and
- put in place an agreed framework for regular reporting against stated measures of performance, in order to provide the local authority with information as to how the entity is meeting the terms of its service agreement and contributing to the achievement of agreed outcomes.

Group Structures

3.618 A local authority should ensure that it:

- has the opportunity to consider proposals by sub-entities to make significant investments, on the basis of a comprehensive assessment of risk and opportunities; and
- is kept fully informed about the status and outcome of new business ventures.

Monitoring and Accountability Arrangements

Information Flows

3.619 A local authority should:

- seek strategic information, as necessary, in order to manage its investments as a diligent and informed investor; and
- where necessary, negotiate arrangements for the supply and handling of commercially sensitive information.

Business Planning and the SCI

3.620 A company board should consult its shareholding local authority on the key features of the board's business plan, and brief the authority on the strategic outlook for the company.

3.621 Drawing on the business plan and strategic outlook, a local authority should:

- review its interests in light of issues facing the company; and
- use this information as a framework against which to consider the draft SCI and the local authority's options as an investor.

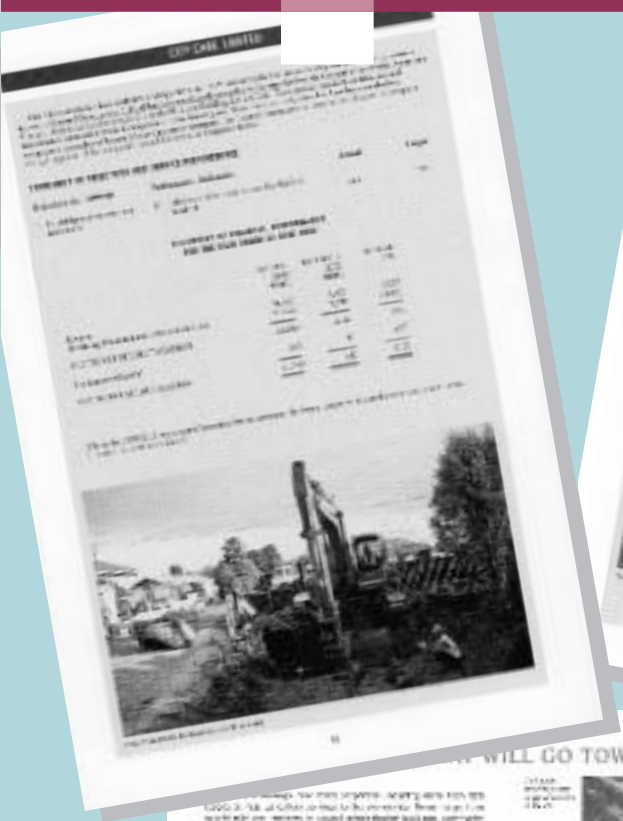
Disclosing Corporate Governance Practices

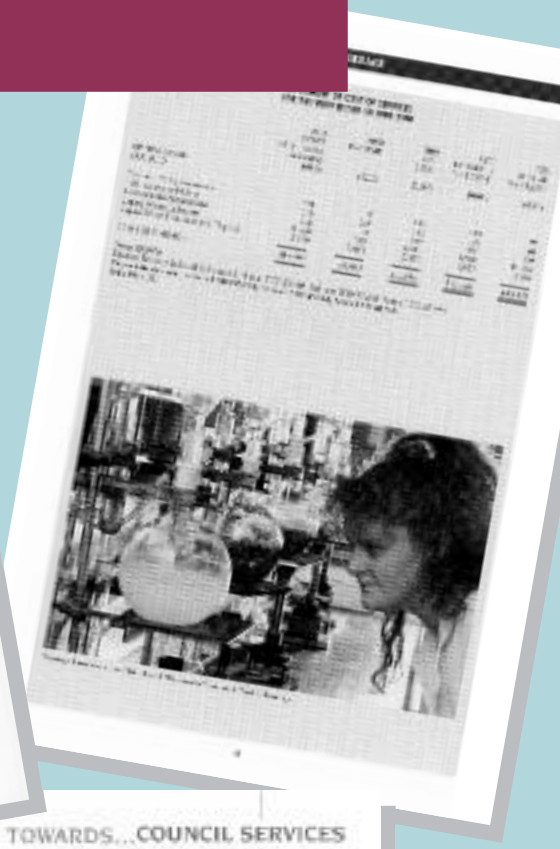
3.622 A company board should:

- include in its SCI a corporate governance statement disclosing how the board proposes to conduct its business and discharge its obligations; and
- outline in the company's annual report how those commitments and obligations have been met.

Four

Long-term Contracts for Services





Introduction

4.001 We have looked at contracting in local government in a number of reports over the past few years:

- In our 1997 report *Contracting for Maintenance Services in Local Government*, we looked at how five local authorities were managing major contracts for maintaining key assets and community facilities.[1]
- In 1998, we reported on Papakura District Council entering into a franchise agreement for running its water and wastewater services.[2] We describe in Part 5 of this report (pages 131-160) how the Council is managing and monitoring the agreement.
- In 1999 we reported on *Contracting Out Local Authority Regulatory Functions*, prompted by Queenstown Lakes District Council contracting with a private sector contractor for the performance of most of its regulatory functions.[3]

4.002 The purpose of this article is to provide some useful information for any local authority considering entering into a long-term contract for services – with particular reference to maintenance services. The article is not intended to be comprehensive, but as general guidance only. Our reports on the water and wastewater franchise at Papakura District Council – both in 1998 and in Part 5 of this report – also provide lessons about longer-term relationships.

1 ISBN 0 477 02849 7.

2 ISBN 0 477 02852 7.

3 ISBN 0 477 02865 9.

Queenstown's Experiences

4.003 Queenstown Lakes District Council (QLDC) has a history of contracting with private sector contractors – including for maintenance services, regulatory functions, property management, and refuse disposal (in partnership with Central Otago District Council).

4.004 For maintenance services, QLDC changed some time ago from in-house provision to external supply under a contract with a private contractor – Lakes Contract Services (LCS). The contract with LCS resulted from a management buy out involving QLDC's former works manager, and was not tendered. The contract has several years to run.

Proposed Total Maintenance Management Contract

4.005 In 2000, QLDC and LCS discussed entering into a longer-term "partnering" type contract for maintenance services, described as Total Maintenance Management (TMM). QLDC asked us for some assurance as to the soundness of its evaluation and decision-making processes.

4.006 QLDC intended not to tender the TMM contract but to negotiate it directly with LCS.[4] Both parties wished to enter into a long-term contract, and a term of up to 30 years (based on the life span of the water and sewerage infrastructure) was considered.

4.007 QLDC later decided not to proceed with a TMM contract with LCS. Nevertheless, we thought it would be useful to outline what QLDC intended to achieve and describe the process it followed, as well as comment on issues arising. We hope that this will provide some guidance to any other local authorities intending to enter long-term service contracts.

4 Because the existing works contract with LCS had several years to run, QLDC could not tender for a new contract without LCS's agreement.

Scope of the Contract

4.008 The scope of the proposed TMM contract covered water and wastewater, parks and reserves, street lighting, and other works functions (excluding subsidised roading). The key components of the TMM contract were to be:

- an outcome-based specification;
- QLDC to retain ownership of assets, but risks usually associated with ownership would be transferred to LCS, as would "stewardship" of the assets, in return for a longer-term contract based on a "partnering relationship";
- LCS being responsible for investing in and managing QLDC assets, including replacing and upgrading infrastructure, as well as ongoing maintenance;
- LCS being responsible for paying for all costs of maintenance and replacement in return for regular payments to LCS by QLDC throughout the life of the contract; and
- the position of subcontractors being protected (a joint QLDC-LCS tenders panel would allocate work to subcontractors).

Steps Taken by QLDC

4.009 As at February 2001 QLDC had:

- Received some preliminary advice from its solicitor on competition considerations and from its Chief Executive on the requirements of the Local Government Act 1974 (the Act).
- Made contact with the Commerce Commission.
- Outlined the proposed TMM contract to various business representatives (including both business associations and private developers) and local contractors and subcontractors.
- Made available to the public the papers that were being presented to the Council on the proposed TMM contract and the progress QLDC was making in working out the details of the arrangement.

- Developed outcome measures for the proposed TMM contract in conjunction with LCS. For example, for parks and reserves LCS was to be required to ensure that any park chosen at random during monitoring would be up to the standard of the "model" park. Outcome measures were to be assessed by an independent adviser to avoid risk of 'contractor capture'.
- Formed subgroups to work on certain matters such as pricing and asset management plans.

4.010 LCS had done some work on existing valuations and asset management plans. LCS also intended to seek expert advice on issues affecting pricing the contract.

Our Advice to QLDC

4.011 We reported to QLDC on the process that it was following, based on our expectations on certain topics. Our overall view was that QLDC had a good understanding of the amount and complexity of the work it faced to implement the proposed TMM.

4.012 In the following paragraphs we summarise and update the advice we gave to QLDC. What we say is not necessarily exhaustive, and a local authority considering entering into a long-term service contract will need to identify and address itself to all factors relevant to its proposed contract.

Legal Considerations

Expectation

4.013 We expect the local authority to be able to demonstrate that it has analysed the legal issues and legal risks involved, and sought expert advice as necessary, particularly in relation to:

- its obligations under the Act, including the requirements of sections 247D and 247E;
- the liability for the performance of a specific function;

- the contractor's employees needing to exercise any of the authority's enforcement powers;
- the authority being appropriately indemnified against the contractor's failure to perform or negligence; and
- the proposed term of the contract, including any implications of the Commerce Act 1986.

Statutory Obligations

4.014 Section 247D of the Act requires a local authority to consider the advantages and disadvantages of different options for contracting out services and functions as opposed to using its own staff.

4.015 Section 247E of the Act requires a local authority to consider whether to put to tender any contract that is likely to involve it in expenditure or financial commitment that the authority regards as significant. Should the authority decide not to put a contract to tender, it must record its reasons in writing.

4.016 In making decisions under both sections 247D and 247E a local authority must have regard to:

- its objectives, as stated to the public in its annual plan; and
- in the case of section 247D, the requirements of section 223C of the Act.[5]

Delegation of Powers

4.017 Should a contractor's employees need to exercise the local authority's enforcement powers the authority will also need to consider any legal issues arising from that need. For a discussion of those issues see our report *Contracting Out Local Authority Regulatory Functions*.[6]

5 Section 223C concerns the conduct of local authority affairs and includes the requirements that local authorities conduct their business in a manner that is comprehensible and open to the public; that clear objectives are established for each activity and policy; and that local communities are adequately informed about local authority activities.

6 Paragraphs 631, 637-639, and Appendix B.

Competition Considerations

4.018 QLDC intended not to tender the TMM contract but to award it to the existing contractor. A term of 30 years was discussed. QLDC intended to meet with Commerce Commission staff to discuss the proposed contract.

4.019 The purpose of the Commerce Act 1986 is to promote competition in New Zealand markets. The Commerce Commission is an advisory and regulatory body under that Act.

4.020 Section 27 of the Commerce Act prohibits a local authority from entering into a contract that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market (one of several "restrictive trade practices" under the Act). It is illegal to enter into a contract that substantially lessens competition.

4.021 The Commerce Commission can issue a warning or reach a settlement with a person in breach, or seek to have the person prosecuted in the High Court. A body corporate can be fined up to $5,000,000 for a restrictive trade practice.[7]

4.022 The Audit Office has limited expertise in competition matters. However, we considered that the proposed TMM contract could have the effect of shutting out potential maintenance contractors in the QLDC district for a long period, thereby lessening competition in the market for maintenance services. However, the contract would not affect the subcontractor market as subcontractors were still able to tender for work under the proposed TMM contract.

4.023 We met with a Commerce Commission Chief Investigator in preparing this report. The Chief Investigator told us:

- A decision not to tender a contract is not necessarily relevant to the Commerce Commission (the Commerce Act does not require that contracts be tendered).
- The length of the contract is relevant to competition considerations. In considering whether a contract is anti-competitive, the Commission needs to consider the nature of the market in the area and the effect on that

7 Section 80 of the Commerce Act 1986.

market over the proposed length of the contract. If a contract shuts out other contractors for a considerable period it may be more likely to substantially lessen competition than a contract for a shorter period.

- In considering the nature of the market for providing maintenance services in the Queenstown district, the Commission would consider the position of potential contractors. In considering the proposed TMM contract, the Commission would have considered the geographical extent of the market, i.e. whether potential maintenance contractors could operate in other areas besides Queenstown over the next 30 years. If so, awarding a contract to a local firm may not *substantially* lessen competition. Whether the TMM contract would represent a substantial part of the market for maintenance contracting in the market area would also be relevant.

- If a local authority believes that a contract may substantially lessen competition, it may apply to the Commerce Commission for an authorisation under section 58 of the Commerce Act. That section allows the Commission to grant an authorisation for a contract that substantially lessens competition, if it is satisfied that the benefit to the public outweighs the lessening of competition in the circumstances. In assessing public benefit, the Commission has regard to efficiency improvements and looks for true benefits (in the local authority context, net gains to ratepayers) not just redistribution of wealth. The expected duration of any benefit is relevant.

- The Commerce Commission can advise a local authority on whether any proposed contract may substantially lessen competition and, if so, what action the Commission might take. (The fee for an authorisation is currently $12,000.) The granting of an authorisation protects the applicant from action by the Commission or private individuals over the contract, and the process from application to decision takes 60 working days.

4.024 We suggest that a local authority intending to enter into a long-term contract seek early advice from a competition law specialist on the Commerce Act implications.

Consultation

Expectation

4.025 We expect the local authority to carry out sufficient consultation to satisfy itself that it has identified the needs, issues and any concerns of stakeholders. The results of the consultation should be clearly documented and used in the decision-making process.[8]

4.026 Stakeholders should be given the opportunity directly to comment on any proposal. The stakeholders include the public, the business sector in general, and subcontractors in particular.

Consulting the Public

4.027 The public has to be able to understand a range of reasonably complex issues associated with a long-term contract. For example, with the proposed TMM contract the public needed to understand what QLDC described as "stewardship". QLDC meant by this that the contractor would "look after" the assets (such as the total water supply network) for the life of the contract – including those assets that the contractor built or repaired during the contract – but would not own those assets.

4.028 A local authority wishing to have such a "partnering relationship" with a contractor would need to explain to the public the basis of that relationship and how the contract would give effect to it. A major change to an outcome-based contract would also need careful explanation.

4.029 Members of the public need sufficient time to absorb the implications of any change of service arrangements, both as to how they may be affected personally (e.g. service delivery levels at their own home) and how the local authority itself will be affected.

8 Sections 247D and 223C of the Local Government Act refer.

4.030 QLDC intended to hold several public meetings and made considerable detail available on its web site. The proposed TMM contract also received considerable press coverage.

Consulting the Business Sector

4.031 The business sector can have various expectations of the local authority. Those business people that we spoke to in Queenstown told us of their expectations that:

- a sound decision-making process is followed;
- there is a definite ability to reduce costs through contracting out;
- high-level management and monitoring capability exists;
- "at the worksite" accountability is taken on by the TMM contractor, and the TMM contractor has a high level of knowledge about the location and condition of assets; and
- there would be good communication between the various QLDC contractors (in QLDC's case, good communication between the TMM contractor and the contractor providing regulatory approvals would be essential).

4.032 Good communication may require the local authority to establish protocols between its various contractors for managing any conflicts between their respective functions and obligations. Any such protocols would need to be agreed before finalising the long-term contract so that both parties are aware of any cost implications before the contract price is set.

Consulting Subcontractors

4.033 Subcontractors also expect the local authority to think long term. Their concerns include:

- the need for subcontract work to be available on an ongoing basis;
- how the head contractor would handle bids for subcontracts (e.g. whether or not the head contractor had to accept the lowest bid); and

- the degree to which a subcontractor could be locked out of subcontract work after a dispute with the head contractor.

4.034 The local authority needs to be able to demonstrate:

- that it is clear about what may happen in the subcontractor market place; and
- how it intends to respond to any complaints about the operation of that market place.

4.035 QLDC and LCS intended to establish a joint tenders panel to consider subcontracts. Such a protection for subcontractors should prevent the contract substantially lessening competition in the subcontractor market.

Responsibility to the Public

Expectation

4.036 We expect the local authority to consider, define, and reflect in the contract the respective responsibilities of itself and the contractor to the public (inherent in an outcome-based contract) that put day-to-day decision making into the hands of the contractor.

Who Should Be Responsible for What?

4.037 One of QLDC's reasons for the proposed TMM contract was to transfer all operational decision making and associated risk to the contractor. In addition to the usual decisions affecting day-to-day service delivery, the contractor rather than the Council would decide, for example, when to replace pipelines.

4.038 The nature of the proposed TMM contract was such that the Council would retain the function of revenue-raising from the ratepayers and other service users, and have a quality assurance role, but would otherwise take no responsibility for service delivery.

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4.039 As we said in our report *Contracting Out Local Authority Regulatory Functions:*

> *Contracting out under section 247D [of the Act] does not relieve the local authority (or any member or officer of the local authority) of the "liability" to perform or ensure the performance of any function or duty imposed on the local authority or person by the Act or any other Act.*[9]

4.040 The local authority may also need to consider (in addition to the legal position) the 'political' implications of the transfer of responsibility to the contractor. The public can probably be expected to look to the contractor in the first instance for performing the expected services. But, ultimately, the public can be expected to hold the council responsible – because only the council is in a position to influence the contractor's behaviour. And the members of the council are electorally responsible to the public.

Formulating the Contract

Expectation

4.041 We expect the local authority to:

- ensure that the contract is drawn up in such a way that it creates the type of relationship intended, and neither party can obtain some unilateral advantage;
- agree to a contract period that is consistent with its long-term goals and the realisation of the desired benefits; and
- be able to demonstrate that the contract provides the means for it to be assured that the services are being provided, and the public assets are being maintained, to the required standards.

9 Paragraph 207, page 22.

Equality of Benefit

4.042 A long-term contract should ensure that the contract starts with an equality of benefits between the parties and (as far as can be foreseen) neither party is able subsequently to obtain some unilateral advantage. Matters such as the outcomes required and the price to be paid need to be determined so that they may only be changed by mutual agreement.

4.043 If there is to be a change in the terms and conditions of the contract, or if there is a change in external conditions, that benefits the contractor, there needs to be a complementary benefit for the local authority. There should not be a possibility for the contractor alone to gain an advantage by varying the outcomes required, payments, or the risk allocation during the term of the contract.

4.044 It is important that councillors understand that "equality of benefit" needs to work both ways. The local authority will not be able to claw back additionally (and without "cost") any "perceived loss" to it that it considers might be occurring.

What Is an Appropriate Contract Period?

4.045 There is, in our view, no standard or "ideal" period for a long-term contract for services. Rather, an appropriate term should be determined by reference to factors such as the life-span of physical assets covered by the contract and the level of investment required of the contractor.

4.046 The costs and benefits of different contract periods should be explored.

4.047 A contract period that is too short to provide the appropriate incentives for a contractor could lead to a higher contract price. A period that is too long could lead to circumstances such as:

- the contractor obtaining very high unanticipated profit levels for a long length of time towards the end of the contract; and
- the contractor rather than the council obtaining the benefit of changes and advances in technology over the contract period.

4.048 Transit New Zealand (TNZ) has opted for a 10-year period for its "performance maintenance contracts" (PMCs). We understand that TNZ considered 15 to 20 year periods in order to encourage better 'whole of life' decision making. However, TNZ was concerned about who would benefit from efficiency gains over the longer periods.

4.049 TNZ believes that 10-year contracts, under which it continues to cover some risks, are cheaper than contracts of even longer periods. A 10-year period also exerts pressure on the contractor to perform quickly.[10]

4.050 A key risk is that the contractor does not have the incentive to continue on to the end of the contract, or to perform effectively throughout the contract period. The contract should address that risk. For example, an appropriately structured payment profile could ensure that the payments to the contractor do not provide higher returns in the early years – reducing the incentive to complete the contract period.

4.051 Another factor to consider in determining the length of the contract is the contractor's capacity to continue in operation for the entire period. The contractor may have the opportunity to borrow against future cash flows to fund investment decisions (as was intended with the TMM) during the early period of the contract. Nevertheless, the local authority will need to be assured that the contractor has the financial security and backing to perform the contract obligations for the period committed to.

Quality of Service

4.052 Securing quality of service based on outcome measures and standards requires particular care in deciding what constitutes "quality" and how it will be reflected in appropriate measures. One such measure and standard proposed by QLDC has been mentioned in paragraph 4.009.

10 However, roads tend to have an economic life of 10-15 years compared with, for example, water and wastewater systems that have much longer economic lives.

4.053 For road signs, TNZ has created a 1-5 scale of scores for sign condition, based on physical characteristics such as visual appearance and reflectivity. An outcome-based contract with TNZ may therefore require the contractor to achieve an agreed score "on average across all signs".

4.054 However, in a local authority context such a quality measure and standard might mean that a particular sign remains in a poor condition (at, say, level 1) for longer than a complainant and their councillor representative would have considered acceptable previously.

4.055 Another consideration is that the local authority could face increased costs if it wishes to specify quality of service measures at too detailed a level.

Quality of Assets

4.056 The contractor will be responsible for the local authority-owned assets that are at the heart of the contract. The local authority and the contractor need to be agreed on:

- the identity of all the assets involved;
- the standard of physical condition of those assets at the start of the contract;
- what standard of physical condition the assets need to be kept up to (including renewal or replacement as necessary); and
- what standard of physical condition the assets must be in at the end of the contract (whether that is at the end of the agreed contract period or earlier as the contract provides).

4.057 Meeting those objectives requires both a proper asset register and an adequate asset management system to which the local authority has full and open access.

Contractor Performance

4.058 Contractor performance needs to be addressed in three dimensions:

- meeting the quality of service measures and standards;
- maintaining the local authority's assets to the required standard of physical condition; and
- satisfying public expectations of the services being provided.

4.059 The first two of those performance dimensions were dealt with in the preceding paragraphs.

4.060 The contractor needs to be able to respond to public complaints directly, and the contract would need to at least outline how a complaints procedure should work in practice. The local authority needs to monitor public satisfaction with the services provided by the contractor and the contract should recognise this need.

4.061 The contract also needs to provide for:

- what constitutes poor performance or non-performance on the part of the contractor, and how it is established; and
- what remedies are available to the local authority in the event that poor performance or non-performance is established.

4.062 Those remedies might range from a formal warning, through monetary penalty, to termination of the contract.

Managing and Monitoring the Contract

Expectation

4.063 We expect the local authority to establish procedures for:

- assuring itself of the quality of –
  - day-to-day service provision under the contract; and
  - asset management by the contractor;

- assuring itself of the continuing financial viability and stability of the contractor; and
- ensuring that it obtains all the information it needs for the purposes of managing and monitoring the contract.

Quality Assurance

4.064 The basis for the local authority being assured about the quality of service delivery and asset management will be contained in the contract. The local authority needs to determine its policy on, and establish the corresponding procedures for:

- who is responsible for dealing with the information provided by the contractor;
- what is to be done when the information is not received on time or is not received at all;
- who is responsible for assessing the information received (which could be a local authority staff member, or an external expert adviser, or a combination of the two);
- what reports of the assessments (or non-receipt of the information) are to be made and to whom the reports should be sent; and
- who is responsible for taking what action on the basis of the reports.

4.065 Among the matters that the policy and procedures should address are:

- the balance between concern about day-to-day operational performance and concern for overall contract performance; and
- the frequency of contact between the local authority and the contractor about performance issues.

4.066 The local authority should consider telling the contractor about its satisfaction with the contractor's performance as well as about matters for dissatisfaction.

Contractor Viability and Stability

4.067 The local authority has an interest in whether the contractor:

- is in a viable financial condition to continue to perform the contract obligations; and
- remains committed to performing those obligations.

4.068 The level of information that the contractor should be expected to provide about its financial position is a matter for the local authority to decide and the contractor to agree on. For example, there should be no need for the local authority to know the degree to which any particular services turn out to be more profitable for the contractor than originally envisaged. At the least, we think that the local authority should obtain regular assurance as to the contractor's financial position by being provided with audited annual financial statements.

4.069 There is also the possibility that the contractor may remain financially viable but might take a view of its business direction that means the contract with the local authority is no longer in its best interests. The authority needs to ensure that it has access to any information that suggests such an attitude on the part of the contractor. It could include some sort of 'notice' provision in the contract, but may also (in addition or instead) establish its own intelligence-gathering mechanism for the purpose.

Information Flows

4.070 The local authority has a range of requirements for information in order to manage and monitor the contract and for other related purposes – including:

- revenue raising;
- reporting to the public;
- monitoring contractor performance;
- monitoring asset condition;

- taking over in the event of contractor failure; and
- potentially, changing to a new contractor at the end of the contract.

4.071 We have mentioned all but the last of those purposes in the preceding paragraphs.

4.072 At some point in the future the relationship with the contractor will end. The local authority needs sufficient information from the contractor as the contract progresses and at the end of the term to be able to adequately inform any new contractor. In the absence of sufficient information, a new contractor may add a premium to the new contract price to cover uncertainties from poor information.

Accounting Considerations

Expectation

4.073 We expect the local authority to identify the accounting implications of a long-term maintenance contract before entering into the contract. Where the contract is extremely complex, the authority should seek advice to ensure that the accounting treatment for the transactions arising from the contract is in accordance with generally accepted accounting practice.

What Kind of Implications?

4.074 The proposed TMM contract provided for QLDC to make an annuity payment to the contractor for each asset type. The amount of each payment was to cover operating costs and the projected capital expenditure over the contract period (i.e. 30 years). However, the capital assets (whenever purchased) were at all times to remain owned by QLDC.

4.075 So far as QLDC would be concerned, that arrangement gave rise to such questions as how it should account for:

- the difference in any year between the portion of the annuity payment to pay for capital expenditure and the actual capital expenditure by the contractor; and
- the obligation attaching to the capital portion of future annuity payments where actual capital expenditure by the contractor exceeds the cumulative value of the capital portion of annuity payments.

4.076 There are no accounting standards in New Zealand that deal specifically with accounting for long-term service contracts. Such contracts are often complex agreements and accounting for the resulting transactions is unlikely to be straightforward.

4.077 Consequently, it is important that the appropriate manner of accounting for the transactions is determined early so that there are no surprises to the authority's shorter-term plans for revenues and expenses.

4.078 Determining the appropriate accounting treatment requires:

- a thorough understanding of the substance of the agreements in the contract; and
- an ability to apply accounting concepts to the transactions arising out of the contract reflecting the substance of the agreements.

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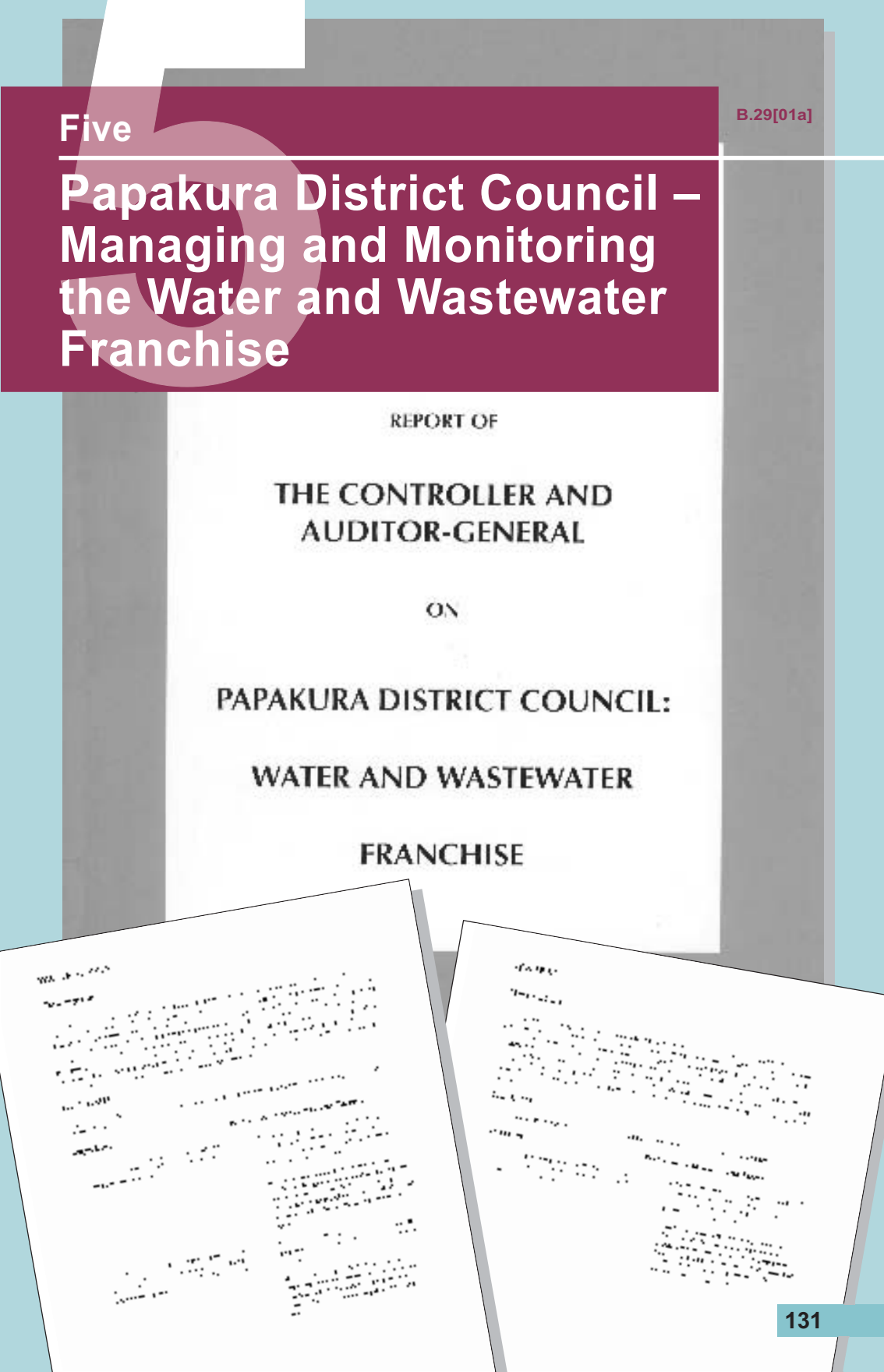
Papakura District Council – Managing and Monitoring the Water and Wastewater Franchise



Contents

Introduction

5.001 In July 1997 the Papakura District Council (the Council) entered into a franchise agreement with United Water International Pty Limited (United Water) to operate the water and wastewater services within the Papakura District for a period of up to 50 years.[1]

5.002 In April 1998 we published a report on our audit of the franchise agreement[2] in which we highlighted:

- lessons and guidelines for other local authorities that might be considering such an approach;
- the need for an appropriate, planned monitoring and maintenance regime – including an Asset Management Plan – for protecting the public assets involved throughout the life of the agreement; and
- concerns about the Council's arrangements for managing and monitoring the franchise.

5.003 In September 2000 we carried out a follow-up audit to look at how the Council has managed and monitored the franchise agreement so far, and whether any of the issues we raised in 1998 remain a matter for concern.

Our 1998 Recommendations

5.004 In our 1998 report we drew lessons for local authorities in managing and monitoring a franchise. We recommended that a local authority should:

- *Establish the necessary systems and allocate suitable resources to manage and monitor the franchise from its commencement.*
- *Implement a programme of auditing the performance of the franchise to provide the level of assurance it requires.*

1 The initial term is 30 years with provision for renewal for a further 20 years.

2 *Papakura District Council: Water and Wastewater Franchise*, ISBN 0 477 02852 7.

- *Develop an Asset Management Plan, which establishes clear benchmarks for existing asset condition and service levels. This will provide a sound basis to develop clear procedures for –*
  - *dealing with poor performance or non-performance by the franchisee;*
  - *assessing the required condition of the assets before they are returned to the authority's control at the end of the franchise;*
  - *dealing with a range of extreme events; and*
  - *communicating with the franchisee as a basis for ongoing administration of the franchise.*

Objectives of Our Follow-up Audit

5.005 When we reported in 1998, the Council was still in the process of establishing the regime for managing and monitoring the franchise agreement. We were therefore unable to examine these aspects of the franchise agreement at that time.

5.006 Our follow-up audit addressed how the Council was:

- applying itself to monitoring the operation of the franchise agreement; and
- measuring United Water's performance of its responsibilities under the agreement.

Overall Conclusions, Recommendations and Lessons

Our Conclusions

5.007 Changes to local government legislation, other public sector reforms, and public expectations have encouraged local authorities to develop new partnership approaches to the delivery of public services. The franchise agreement entered into by the Council is an internationally recognised partnership approach.

5.008 Nothing in this report is intended to suggest any inherent failing in the franchise or asset management model for outsourcing as a way to provide services to the public in a financially prudent and effective manner.

Asset Management and Development

5.009 The franchise agreement requires United Water to maintain the water and wastewater infrastructure to an overall standard better than its initial condition and in good operational order. The intention is that, on the expiry or earlier termination of the agreement, the infrastructure be in better condition than at the start of the agreement.

5.010 In our 1998 report we emphasised the need for an Asset Management Plan as part of a suitable asset management regime, but noted that the Council included in the body of the franchise agreement no specific requirement for such a plan to be prepared. In our view, this was an oversight that had the potential to adversely affect the Council's ability to manage and monitor the franchise agreement, and to protect the water and wastewater asset in the long term.

5.011 United Water has produced an Asset Management Plan, and many aspects of the franchise more generally are working well. In particular, we note that United Water, in carrying out its obligations under the agreement, has:

- begun investing in maintenance and upgrading of the infrastructure in a manner that is consistent with a long-term approach;
- kept to the two-year price freeze and subsequent price control limits;
- produced the things required for effective planning – such as drought contingency plans, disaster recovery plans, monthly water quality reports, and reports on water and wastewater charges;
- applied professional working standards and procedures; and
- brought international knowledge and experience to the management of the water and wastewater systems.

5.012 Within the terms of the franchise agreement, the Council has no right of access to the contents of the Asset Management Plan. However, United Water has cooperated and allowed access to specific information in the Plan for particular purposes. In our view, the Council's lack of access to the Plan could adversely affect its ability to manage the franchise. This has not been a problem to date, but only because of United Water's cooperation and goodwill.

5.013 The Council's appointment of a firm of consulting engineers to monitor on its behalf the requirements of the franchise agreement and the activities of United Water is proving to be a successful arrangement because of the firm's initiatives in developing and implementing a monitoring framework.

5.014 Despite these positive developments, we continue to have a number of concerns about aspects of the franchise agreement that require the Council's attention, as described in the following paragraphs.

Monitoring Franchisee Performance

5.015 The Council still needs to establish, through the consultants, a specific mechanism for identifying and managing poor performance or non-performance by the franchisee. In our view, the Council has taken too long to address this need.

Price Control

5.016 The Auckland Average Price mechanism measures prices charged in other local authority districts in the Auckland region. The Council still needs to clarify the definitions within the price control provisions of the franchise agreement (as suggested by the consultants) in order to avoid potential disputes with United Water over calculation of Auckland Average Prices.

5.017 In addition, until the consultants have completed (as instructed by the Council) the audit of United Water's own prices as part of the 1999-2000 monitoring programme, the Council has no assurance that charges are being correctly applied.

Customer Service

5.018 United Water is operating a Customer Charter that sets performance standards for a variety of customer service issues. However, the Council has not monitored United Water's performance against the Charter. And the current method used by the Council to assess customer satisfaction provides insufficient specific information to provide assurance about United Water's performance on customer service.

5.019 The consultants recommended that additional work be done on compliance with the Customer Charter, and that the Council should establish some customer best practice comparisons. The recommendation was taken up by the Council and included in the 1999-2000 monitoring programme, but this component of the programme was incomplete at the time of reporting.

Asset Management

5.020 The franchise agreement contains very few specific performance indicators relating to the maintenance and improvement of the water and wastewater infrastructure assets. The Council needs to work with the consultants and United Water to address this omission.

5.021 The agreement requires United Water to make an Asset Condition Report in July 2002 and every five years thereafter. We would expect the parties to co-operate to ensure that, by the time this report is prepared, they are in agreement about how the condition of the infrastructure is to be measured over the duration of the franchise. In order to achieve agreement, sufficient indicators and information will be required to support an assessment of United Water's performance.

Council Involvement

5.022 We consider that much of what has been achieved to date in managing and monitoring the franchise agreement is largely due to the initiatives taken by the consultants and United Water, with limited direction from the Council. The Council's appointment of the consultants was a positive step in improving the information available that is needed to support the Council in its governance role. However, we understand that some members of the Council's Monitoring Committee have been frustrated by the information available to them to conduct the committee's monitoring activities.

5.023 Concerns about the availability of information need to be addressed to enable the Council to play its part as a full partner in the franchise agreement. The Council should also actively conduct an ongoing dialogue with both the consultants and United Water in order to properly manage the franchise and protect the long-term interests of the public of Papakura.

5.024 The Council should take the lead in ensuring that the issues highlighted in this report are resolved.

Our Recommendations

5.025 We recommend that the Council articulates and enforces its interests as owner and principal by:

- reviewing its role in monitoring in order to test whether the role adequately reflects the Council's responsibility to protect the public interest; and
- adopting measures to strengthen its engagement as a full partner in the franchise – in particular by increasing direct dialogue between itself, the consultants, and United Water.

5.026 Our follow-up audit has identified specific issues that the Council needs to address. The most important issue relates to monitoring the condition of the water and wastewater infrastructure asset and ensuring that the asset is returned to the Council in the required condition at the end of the franchise agreement. To that end, we recommend that the Council:

- ensures that it and the consultants have ongoing access to sufficient information to provide assurance about the long-term condition of the asset, the future service levels to be provided, and United Water's performance; and
- ensures that the Asset Condition Report due in 2002 contains sufficient information for that purpose.

5.027 The Council should in any event agree with United Water the detail of what information:

- is required to be in the Asset Condition Report; and
- should be collected – and how it will be collected, verified, and reported to the Council – for the purpose of ensuring that the water and wastewater asset is returned to the Council in the required condition at the end of the franchise agreement.

5.028 The Council should also:

- discuss and agree with United Water a precise definition of the Auckland Average Price;
- commission an annual audit of United Water's prices; and
- make progress on the recommendations of the consultants for improved monitoring of customer service and reporting of the results.

General Lessons for All Councils

5.029 As a result of our follow-up audit, we reiterate four key requirements of any franchise agreement that should be put in place from the start of the agreement:

- an Infrastructure Condition Assessment, so that everyone is clear about the state of the infrastructure at the start;
- an Asset Management Plan;
- access to appropriate information contained within the Asset Management Plan for management and governance purposes; and
- clear standards that will provide an objective basis for managing the franchise agreement, including standards for the maintenance and enhancement of infrastructure.[3]

5.030 Monitoring responsibilities and processes also need to be determined, agreed and established at the outset. These should consider and accommodate what direct role the Council itself wishes to play in monitoring the franchise agreement.

5.031 Price controls should take account of the potential revenue stream, the initial condition of the infrastructure, and the need for future investment. Pricing mechanisms should be clear to avoid potential disagreement during the franchise term.

5.032 Councils should monitor specific measures for quality of service to customers, and the measures should be linked to any Customer Charter required of the franchisee.

3 The Appendix to our 1998 report contained a comprehensive set of model expectations covering all aspects of a franchise agreement.

Monitoring the Operation of the Franchise Agreement

5.033 We examined the Council's procedures, systems and information used in managing and monitoring the franchise agreement, under three headings:

- systems and resources;
- monitoring information; and
- communicating with United Water.

Systems and Resources

Expectations

5.034 In 1998, we expected that the Council would have:

- ***allocated suitable resources and established the necessary systems to manage and monitor United Water's performance under the franchise agreement;***
- ***created procedures for dealing with poor performance or non-performance by United Water; and***
- ***put in place procedures and performance specifications to enable the Council to monitor maintenance and renewal of, and additions to, the assets during the franchise.***

Findings

5.035 In February 1998, six months after the start of the franchise agreement, the Council invited consultant engineers Montgomery Watson New Zealand Limited (the consultants) to provide technical assistance in relation to the franchise agreement. This assistance included a review of United Water's preparation of an Initial Condition Assessment of the infrastructure.

5.036 United Water produced the Initial Condition Assessment in draft form in June 1998. The consultants completed a preliminary review of the draft in July 1998. United Water completed the final version of the Assessment, incorporating the consultants' comments on the draft, in September 1998. The Council formally agreed the final Initial Condition Assessment in October 1998 after a further review by the consultants.

5.037 In July 1998, the consultants were asked to review the Drought Contingency Plan and the Disaster Recovery Plan prepared by United Water.

5.038 In June 1999, nearly two years into the franchise, the Council instructed the consultants to carry out an analysis of the agreement and our 1998 report in order to identify appropriate issues for future monitoring, and to outline a monitoring programme. The consultants delivered their report in the same month setting out:

- United Water's obligations under the franchise agreement;
- key issues from our 1998 report; and
- those issues and activities where the Council needed to "actively audit" and those where it would be sufficient to rely on reports from United Water.

5.039 In mid-September 1999, the Council told the consultants to institute the proposed monitoring and auditing programme, which includes reviews of:

- the accuracy of wholesale charges for water and wastewater that United Water passes on to customers;
- United Water's service charges;
- whether the water distribution system meets Ministry of Health standards; and
- United Water's Asset Valuation Report.

5.040 So far, the consultant's monitoring has included reviews of wholesale water charges and the Asset Valuation Report, as well as a review of the Initial Condition Assessment.

5.041 The Council took over two years from the start of the franchise agreement to formally initiate a monitoring regime. We consider that the Council should have moved more quickly to initiate monitoring of the franchise agreement.

5.042 In its report to Council management on the results of the 1999 annual audit, Audit New Zealand said that:

- the Council *places a lot of reliance on contractors to perform and discharge their obligations under contracts of service;*
- *… Council should enhance its contract monitoring procedures to include more effective risk management in terms of identification, management and reporting;* and
- in the section on Contract Monitoring Procedures, *we identified significant reliance being placed on contractors and United Water … to perform and discharge their obligations under the contract of service ……. We believe that the development of a more robust contract monitoring system that incorporates the identification of risks to Council and formalises procedures to proactively monitor those risks, will provide greater assurance to Council…*

5.043 In our 1998 report, we pointed out the absence of a mechanism to identify poor performance or non-performance on the part of United Water. The consultants have since highlighted the same issue, but the Council has still taken no action to develop specific mechanisms for identifying and managing instances of poor performance or non-performance. The Council is accountable for monitoring United Water's performance, and needs to take an active part in monitoring the franchise.

5.044 In April 1997, the Council established a monitoring committee to monitor all of its contracts, including the water and wastewater franchise. However, we found minutes of only one meeting of the committee up to November 1998. We were told that meetings of the committee had been held informally over this period, and minutes had not been taken. As a result, we cannot say whether the committee discussed the franchise agreement.

5.045 In November 1998, the newly elected Council reviewed the monitoring committee's role, purpose and activities. As a result, the Council established a Monitoring Committee with a particular meeting agenda item "Water Franchise Watchdog" so that the Committee's elected members would take on a more active, systematic role in monitoring the franchise agreement.

5.046 Minuted meetings of the Monitoring Committee have taken place regularly since November 1998, and the meetings have considered a range of issues about the franchise agreement. We consider that this committee was in a position to have identified and addressed promptly many of the outstanding issues that we have identified in this report.

Conclusions

5.047 The Council took two years to initiate and agree the current monitoring system. It took more than a year to set up effective monitoring of the franchise agreement by the Council.

5.048 The Council still needs to establish a specific mechanism for identifying and managing poor performance and non-performance.

5.049 In our view, the Council has given insufficient priority to addressing these issues in a timely manner.

Information for Monitoring

Expectation

5.050 In 1998, we expected that the Council would have:

- ***ensured that it had access to sufficient information from United Water to allow it to assess, validate and audit the company's performance.***

Findings

5.051 United Water routinely produces the following information required under the franchise agreement:

- monthly water quality reports;
- annual report on solvency; and
- as-built plans of upgrades or modifications to the assets – which the Council is confident would be sufficient in the event that a new contractor needed to take over and manage the assets.

5.052 The franchise agreement also requires United Water to provide the Council with any information it may require to establish compliance with the pricing mechanism. United Water has provided such information when requested.

5.053 The first five-year report on the condition of the asset (the Asset Condition Report) will be due in 2002. We consider that this report should provide essential information to enable the Council to ensure the satisfactory stewardship of the asset and to review United Water's performance.

Conclusions

5.054 United Water is complying with the information requirements of the franchise agreement by providing information to enable the Council to monitor some aspects of the company's performance.

5.055 The Asset Condition Report due in 2002 (and every five years after that) should provide essential information on the asset and on United Water's performance. It is important that the contents of the Asset Condition Report are specified and agreed in advance so that United Water can collect the necessary data.

Communicating with United Water

Expectation

5.056 In 1998, we expected that the Council would have:

- ***put in place procedures for regular communication with United Water.***

Findings

5.057 When we reported in 1998, the Council had not established formal procedures for regular communication with United Water. Communication arrangements remain much as they were in 1998, involving both formal and informal contacts such as:

- exchanges of letters;
- meetings on key issues; and
- day-to-day contact with staff and senior management on various issues.

5.058 The majority of communications between the Council and United Water have not reflected systematic management of the franchise. Rather, they have been prompted by the need to resolve particular problems.

5.059 There is no regular, direct contact between the Council's Monitoring Committee and United Water.

5.060 The consultants have direct communication with United Water as part of their monitoring role.

Conclusions

5.061 The Council's appointment of the consultants to provide a programme of technical monitoring and information gathering was a positive step in making available to the Council the information that it needed in its governance role. However, we understand that some members of the Council's Monitoring Committee have been frustrated by the information available to them to conduct the Committee's monitoring activities.

5.062 Concerns about the availability of monitoring information need to be addressed to enable the Council to play its part as a full partner to the franchise agreement.

5.063 The Council should also:

- conduct an active, ongoing dialogue with both its own consultants and United Water in order to properly manage the franchise and protect the long-term interests of the public of Papakura; and
- take the lead in ensuring that the outstanding issues highlighted in this report are resolved.

Measuring United Water's Performance

5.064 The Council needs to be able to measure the following key elements of United Water's performance under the franchise agreement:

- **Price Control** – whether United Water's prices are within the terms and conditions of the agreement;
- **Water Quality** – the quality of water delivered to consumers;
- **Customer Service** – the quality of United Water's customer service; and
- **Asset Management and Development** – whether United Water is adequately maintaining and enhancing the pipes, buildings and machinery that make up the water and wastewater system.

Price Control

Expectations

5.065 Given the monopolistic nature of a public utility franchise, controls are required to prevent unreasonable price increases for customers and unreasonable profit by a monopoly supplier. In 1998, we expected that the Council would have:

- ***objectives (for the franchise) that would protect the long-term interests of ratepayers and water users; and***
- ***ensured that the franchise agreement included a mechanism for regulating the prices charged to customers.***

Findings

5.066 The franchise agreement meant a change to a direct "user pays" system for water use, and for that purpose all properties are metered. The agreement contains two pricing mechanisms, one for water supply and one for wastewater disposal.

5.067 United Water is required to pass the costs charged by Watercare for the bulk water supply and wastewater removal directly to consumers, without making additional charges. In May 2000, the consultants reviewed information on the charges for bulk water supply and wastewater removal and found that United Water was complying with the requirements of the franchise agreement.

5.068 The franchise agreement fixed United Water's service charges for both water supply and wastewater removal for the first two years and that obligation was met. From July 1999, United Water could increase the service charges, but the charges are required to remain lower than the Auckland Average Prices (see the Appendix on pages 159-160).

5.069 United Water has increased its service charges on two occasions since July 1999 (see Figure 5.1 on page 150):

- In July 1999, the charge for water supply rose from 37.125 to 44 cents a thousand litres (18.5%), and the charge for wastewater removal rose from 22 to 28 cents a thousand litres (27.3%).
- In July 2000, the water charge increased by 8 cents a thousand litres (18.2%) and the wastewater charge by 5 cents a thousand litres (17.9%).

Figure 5.1
Components of Water and Wastewater Charges to Consumers

	1 July 1997 $	1 July 1998 $	1 July 1999 $	1 July 2000 $
Water Supply (Watercare charge)	0.46850	0.47875	0.48000	0.49000
Water Service (United Water charge)	0.37125	0.37125	0.44000	0.52000
Water /1000 litres Total	**0.83975**	**0.85000**	**0.92000**	**1.01000**
Wastewater Treatment (Watercare charge)	1.31630	1.52000	1.64000	1.86000
Wastewater Service (United Water charge)	0.22000	0.22000	0.28000	0.33000
Wastewater /1000 litres Total	**1.53630**	**1.74000**	**1.92000**	**2.19000**

United Water cannot directly influence the charges set by Watercare, but must do whatever is necessary to ensure that the costs of bulk water are minimised, e.g. by reducing water loss through leaks.

The United Water charge for the wastewater service is based on 80% of metered water supplied.

5.070 The Council compared the increased prices to the Auckland Average Prices by requesting information about water and wastewater charges from other Councils in the Auckland region – deriving the information in Figure 5.2 on the next page that was presented to the Council's Monitoring Committee in October 1999. Using those charges, and the equivalent figures for the following year, the Council determined that both increases in United Water's prices to consumers remained below the Auckland Average Prices.

5.071 The Council instructed its consultants to audit United Water's service charges as part of the 1999-2000 monitoring work programme. Until this has been completed, the Council has no assurance that charges are being correctly applied.

Figure 5.2
Comparative Prices for Water Supply and Wastewater Removal

Council	Water $/1000 litres (inc GST)	Wastewater $ average annual charge (inc GST)
Auckland	1.2246	454.31
North Shore	1.18	329.39
Waitakere	1.41	Not used[4]
Manukau	0.99	481.00
Average	***1.2011***	***421.57***
United Water	0.92*	368.64*
Difference	***0.2811(30.6%)***	***52.93(14.4%)***

* Based on the 1/7/99 data from previous table. United Water wastewater charge calculated as 0.80 x 240 x $1.92 = $368.64 (80% of consumption x average household consumption x the 7/99 price per 1000 litres).

5.072 In May 1999, the consultants pointed out that the franchise agreement contains no specific, agreed method for calculating Auckland Average Prices. This lack could in future give rise to potential disagreement between the Council and United Water – particularly if the Auckland Average Prices and United Water's prices were to move closer together. Differences over how the Auckland Average Prices are calculated could put at risk compliance with the requirement of the franchise agreement that United Water's prices are not to exceed Auckland Average Prices.

Conclusions

5.073 United Water has complied with the price requirements of the franchise agreement.

5.074 How the Auckland Average Prices are calculated needs to be precisely defined in order to avoid disagreement between the Council and United Water.

4 Waitakere City Council supplied its Annual Plan budget of $13,084,000 for 1999-2000, which could not readily be applied.

5.075 The Council needs to ensure that the audit of United Water's own prices (planned as part of the 1999-2000 monitoring programme) is completed. Until the audit is completed, the Council has no assurance that United Water is correctly applying the charges to its customers.

Water Quality

Expectations

5.076 In 1998, we expected that the Council would have:

- ***developed objectives (for the franchise) that would protect the long-term interests of ratepayers and water users; and***
- ***ensured that the franchise agreement requires the franchisee to meet all legal or third party water and wastewater quality standards.***

Findings

5.077 Water quality is an important aspect of customer service, and can provide an indicator of the condition of the water and wastewater infrastructure. The franchise agreement requires that the infrastructure assets be maintained to achieve a minimum of a grade 'B' Ministry of Health standard for water quality.

5.078 Water quality results are regularly monitored and reported to the Council. Apart from one occasion (when a technical error in the administration of the tests produced a poor quality reading), water quality has been maintained at the required level or higher. Since 1998, United Water has achieved an 'A' grade for the majority of the system, and three 'A' grades for the entire district for the year 2000.

Conclusion

5.079 United Water has achieved a water quality standard that complies with or is better than the standard required by the franchise agreement.

Customer Service

Expectation

5.080 In 1998, we expected that the Council would have:

- ***put in place procedures to enable it to monitor customer service and quality assurance performance during the franchise.***

Findings

5.081 The franchise agreement sets out some performance standards for notifying customers of planned interruptions to the water supply. Other standards in the agreement deal with:

- unplanned interruptions to the water supply and customer complaints and enquiries;
- wastewater spills, overflows, and unplanned interruptions to the supply of wastewater reticulation services; and
- planned interruptions to the supply of wastewater reticulation services.

5.082 At the time of our 1998 audit, the Council had put no arrangements in place to monitor these performance standards. This remains the case.

5.083 The Council told us that during the first year of the franchise agreement it received a number of complaints about the agreement. Many of the complaints were about the new billing system. The number of complaints has fallen, with virtually none now reaching the Council.

5.084 The Council suggested that customers are now addressing their complaints to United Water. But the company is not required to provide information on complaints and any response taken to address them, although it began collecting and analysing information about complaints in August 2000.

5.085 Under the franchise agreement, United Water has to *operate … so that Customers serviced by the Infrastructural Assets, and paying for such services, may expect a level of service and quality of suppy in accordance with accepted industry standards prevailing at the relevant time in the Auckland Area*. In line with the agreement, and in consultation with community groups, United Water has developed a Customer Contract and a Customer Service Charter covering a wide range of issues from service difficulties, emergencies, and account enquiries, to environmental matters.

5.086 The Council receives no reports of United Water's performance under its Customer Contract or Customer Service Charter.

5.087 The Council has its own wider survey of customer satisfaction about Council activities, which it contracted to the National Research Bureau in February 2000. The Council intends to repeat the survey every three years.

5.088 The results of the February 2000 survey indicated a general level of satisfaction with the water and wastewater services of about 60%. The Council was consulted on the choice of questions to be asked in the survey.

5.089 United Water suggested to us that the survey was of limited use. In its view the survey provided only a very general level of comfort, without any specific information on what aspects of the services customers were unhappy with and wished to see improved.

5.090 The Council approved additional work on customer service performance monitoring during 1999-2000. This will make use of United Water's internal management reporting systems to assess performance against the Customer Charter – both at specific dates and over time. The work was not completed at the time of our follow-up audit.

Conclusion

5.091 The Council still has no arrangements to monitor customer satisfaction with the operation of the franchise agreement – except through its own survey of all Council services. United Water's Customer Service Charter provides an

opportunity for the company to share with the Council monitoring information – that the company will in any case be producing for its own management purposes – to show how it is performing against the charter.

Asset Management and Development

Expectations

5.092 In 1998, we expected that the Council would have:

- ***completed an Asset Management Plan for the water and wastewater networks, or put in place processes to ensure that an Asset Management Plan would be produced; and***
- ***ensured that the franchise agreement sets up specific performance measures for maintenance and renewal of, and additions to, the water and wastewater networks.***

Findings

5.093 The development and implementation of an appropriate Asset Management Plan is fundamental to:

- safeguarding significant public assets;
- the protection of the interests of ratepayers and users; and
- the success of the franchise agreement.

5.094 The Council needs to have confidence that both the assets and the level of service are being maintained and enhanced over time. Key issues of equity, environmental protection, and water conservation are dependent upon United Water maintaining the networks to the required standard.

5.095 The franchise agreement clearly stipulates that an Initial Condition Assessment had to be developed and produced by June 1998. United Water produced a draft Assessment in June 1998 and a final version in September 1998 (see paragraph 5.010).

5.096 In its tender for the franchise, United Water provided comprehensive details of its proposed Asset Management Strategy and the methodology that it intended to follow. These details were subsequently bound into the franchise agreement as part of Schedule III, but were not referred to in the body of the franchise agreement. The Council and the consultants are both of the view that this was sufficient to require United Water to produce an Asset Management Plan.

5.097 However, United Water takes a different view – believing that it is required to produce only the Initial Condition Assessment, stipulated in the franchise agreement; not an Asset Management Plan, which is not referred to in the body of the agreement.

5.098 The difference of view over the requirements of the franchise agreement was not "tested" or clarified, because United Water in any event produced an Asset Management Plan in August 1999 for its own purposes. The company considered that the Plan was essential to properly manage the asset and conduct its business.

5.099 United Water considers that it has proprietary rights to the Asset Management Plan, and that the information it contains is commercially sensitive. The company believes that the franchise agreement does not provide for access to the Plan by either the Council or its consultants.

5.100 However, United Water has cooperated with Audit New Zealand (on behalf of the Audit Office) as the Council's external auditor and with the consultants to supply sufficient information from the Plan to allow them to carry out specific tasks. For example, Audit New Zealand reviewed the Asset Management Plan in order to establish a clear linkage between the physical data for the assets in the Plan and disclosures in the Council's financial statements with respect to funding for depreciation.

5.101 The franchise agreement requires United Water to maintain the infrastructure to an overall standard better than its initial condition and in good operational order. On the expiry or earlier termination of the agreement, the infrastructure is intended to be in better condition than it was at the start.

5.102 As there was no measure of the condition of the infrastructure at the start of the franchise in July 1997, the earliest benchmarks to measure performance are the Initial Condition Assessment completed in September 1998 and an Infrastructure Asset Valuation of November 1999. However, the franchise agreement contains very few specific performance indicators for the maintenance and improvement of the water and wastewater infrastructural assets that could be used to support a performance assessment.

5.103 The franchise agreement requires United Water to produce a report on the condition of the assets within six months after 1 July 2002 and every fifth anniversary thereafter. It will be important, before this report is produced, for United Water, the consultants and the Council to agree on:

- how the condition of the infrastructure will be measured; and
- the process for periodic monitoring and how the results will be reported to the Council.

5.104 United Water believes that the five-yearly Asset Condition Report is the main measure by which its long-term performance should be assessed. Through this report, the company intends to make available to the Council and the consultants information from the Asset Management Plan.

5.105 In our view, the Asset Condition Report will be an essential report that must provide assurance to the Council on the condition of the assets, the future service levels that will be provided, and the performance of United Water. This report assumes greater significance given the lack of direct access by the Council and the consultants to the Asset Management Plan.

5.106 Measuring and monitoring asset condition will be particularly important for the end of the franchise agreement, after which the assets must be returned to the Council at an overall better standard than their initial condition and in good operational order. The Council will need sound procedures throughout the period of the franchise to assess whether this important requirement will be achieved.

Conclusions

5.107 The omission from the franchise agreement of a clearly understood, specific requirement to produce an Asset Management Plan was a significant oversight. In addition, lack of access to the contents and information in the Plan has the potential to adversely affect the Council's ability to monitor and manage the franchise agreement, and to protect what is a significant public asset over the long term.

5.108 The Asset Condition Report, due in 2002, will provide essential information for the Council to assure itself that the water and wastewater infrastructure is being properly maintained and enhanced.

5.109 More specific performance measures, standards, and methodologies than are in place at the moment are needed to support this assessment. We expect the Council to continue to work with its consultants and United Water to develop appropriate measures and standards now – so that by the time the Asset Condition Report is due, United Water will be able to provide the information required from its Asset Management Plan. The measures and standards should be used as a basis for developing a method to assess the condition of the assets upon their return to the Council at the end of the franchise.

Appendix

Extracts from the Franchise Agreement on Pricing

Definitions:

Auckland Water Supply Average Price (or AWSAP) *means the average price per m^3 at which potable water is supplied, during any given period, to retail customers in the Auckland Area, calculated by dividing the aggregate of all amounts charged for such supplies (which amount shall be adjusted for the purposes of this definition so as to remove all subsidies of any type which have been incorporated into the setting of such retail charges) by the total number of m^3 of potable water so supplied.*

Auckland Wastewater Disposal Average Price (or AWDAP) *means the average price per m^3 at which Wastewater is received, during any given period, from retail customers for reticulation and treatment in the Auckland Area, calculated by dividing the aggregate of all amounts charged to such retail customers for the reticulation and treatment of Wastewater (which amounts shall be adjusted for the purposes of this definition so as to remove all subsidies of any type which have been incorporated into the setting of such retail charges) by the total number of m^3 of Wastewater so received.*

Clause 6.2(b):

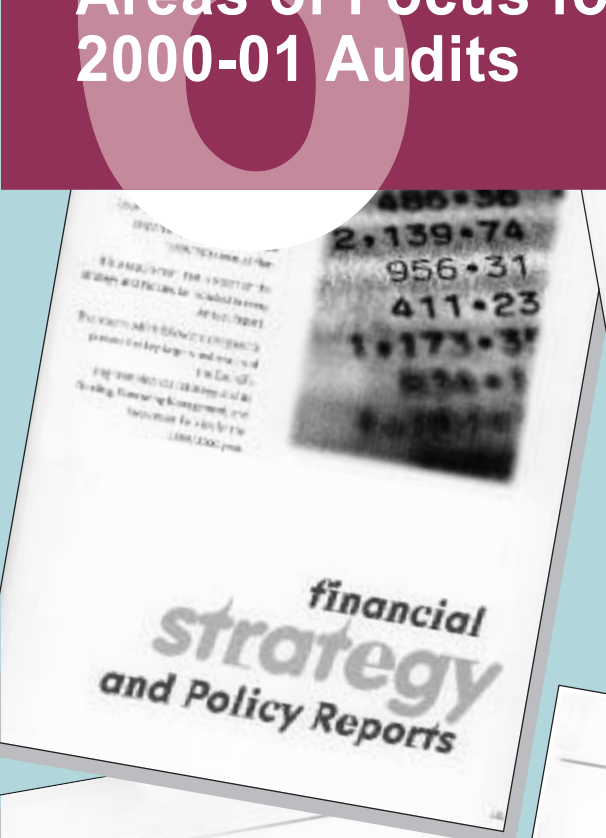
The Supplier [United Water] *warrants that, during the Term, the average potable water charge during any given period shall not be more than AWSAP during that period. The Supplier shall, no less frequently than once every 12 months during the Term, provide to PDC such information as PDC may reasonably require to establish the extent to which the Supplier has complied with this warranty during the proceeding 12 months (or such lesser period, where the Supplier provides such information more frequently than annually). For the purposes of this clause, the "average potable water charge" shall be an amount, stated as the average price per m^3 at which potable water is supplied by the Supplier to Customers during that period, being the aggregate of the following charges: …*

Clause 6.5 – General Wastewater Reception and Treatment Charging Provisions:

(a) *The Supplier warrants that during the Term, the average residential Wastewater reception and treatment charge during any given period shall be not more than AWDAP during that period. The Supplier shall, no less frequently than once every 12 months during the Term, provide to PDC such information as PDC may reasonably require to establish the extent to which the Supplier has complied with this warranty during the proceeding 12 months (or such lesser period, where the Supplier provides such information more frequently than annually). For the purposes of this clause, the "average residential Wastewater reception and treatment charge" shall be an amount, stated as the average price per m^3 which is charged by the Supplier to Customers pursuant to this Agreement during that period, being the aggregate of the following charges: …*

Six

Areas of Focus for the 2000-01 Audits



The pages reproduced on the previous page are from the Porirua City Council's 1999/2000 Annual Report.

6.1 Impact of the Public Audit Act 2001

6.101 The Public Audit Act 2001 (the Act) comes into force on 1 July 2001. The Act reforms and restates the law relating to the auditing of public sector organisations – including local authorities and related entities.

6.102 The Act does not change fundamentally the Auditor-General's role in the local government sector. But some provisions will have significant effects on entities in the sector. They are:

- the extended definition of "public entity";
- the new expression of the Auditor-General's mandate; and
- two new reporting procedures in respect of local authorities – one of which replaces the former power of surcharge and imposes personal liability for a loss on members of a local authority.

6.103 This article discusses each of those points in turn.

Definition of "public entity"

6.104 The Auditor-General's portfolio and, accordingly, the scope of the public audit system, turn on the definition of "public entity" in section 5 of the Act. Section 5(1) and (2) says:

> *(1) In this Act, **public entity** means each of the following entities:*
>
> *(a) the Crown:*
>
> *(b) each office of Parliament, except where another auditor has been appointed for that office under section 40(b) of the Public Finance Act 1989:*

(c) an entity of a class described in Schedule 1:

(d) an entity listed in Schedule 2:

(e) an entity in respect of which the Auditor-General is the auditor under any other enactment (other than section 19):

(f) an entity which is controlled by 1 or more entities of the kinds referred to in paragraphs (a) to (e).

(2) For the purposes of subsection (1)(f), an entity is controlled by 1 or more other entities if –

(a) the entity is a subsidiary of any of those other entities; or

(b) the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or

(c) the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).

6.105 Schedule 1 of the Act includes all the classes of entity (for example, local authorities and LATEs) of which the Audit Office is currently the auditor under the Local Government Act 1974. To this extent, the definition of "public entity" reflects the present position.

6.106 However, the test of "control" in section 5(2) will significantly broaden the application of the Auditor-General's mandate to related entities. The test has particular implications for:

- entities and sub-entities which exist under the umbrella of a local authority or another public entity;
- ventures or entities which are established or operated under section 247C of the Local Government Act 1974 – many of which were previously outside the Auditor-General's mandate; and
- entities in which a number of local authorities – or other public entities – together have a controlling interest (even though no single public entity holds a controlling interest).

Transitional Position

6.107 The Act makes the Auditor-General the auditor of all "public entities" from 1 July 2001. However, for those entities that were not previously within the Auditor-General's portfolio, the obligation to audit only arises in respect of balance dates occurring after that date.

6.108 Our policy is that we will not become involved in audits for balance dates before 1 July 2001 unless:

- there are unaudited financial statements for a financial year which ended before the Act came into force; and
- there is no existing auditor to do the audit.

A Consistent Auditing Mandate

6.109 One of the most important achievements of the Act is that it brings the whole of the Auditor-General's auditing portfolio into a single statute, and applies the auditing mandate consistently across the portfolio.[1] This contrasts with the previous situation, where:

- the Auditor-General's full auditing mandate (including "effectiveness and efficiency" audits) applied to some entities – for example, local authorities and LATEs – but not others; and
- the nature of the financial auditing mandate appeared to differ as between those entities which were companies (for example, energy companies and port companies) and those which were not.

6.110 Part 3 of the Act sets out the Auditor-General's mandate in clear terms. Parliament has appointed the Auditor-General to be the auditor[2] of each public entity – a function which is inclusive of, but not limited to, any of the following specific functions (section 14):

1 The only exceptions being in respect of the Reserve Bank of New Zealand and any public entities which are registered banks under the Reserve Bank of New Zealand Act 1989. These bodies will be exempt from effectiveness and efficiency audits under section 16(1)(a).

2 Note, however, that the Auditor-General's practice of appointing individual auditors to audit entities on his behalf may continue.

- the financial report audit – the Auditor-General must audit those financial or other accountability documents which a public entity is required to produce for audit (section 15);
- the performance audit – the Auditor-General may at any time examine issues of effectiveness and efficiency, legislative compliance, waste, probity, or financial prudence in one or more public entities (section 16); and
- the power to inquire into any matter concerning a public entity's use of its resources (section 18).

6.111 The Auditor-General will now be able to exercise all of these functions throughout the local government sector.

New Reporting Procedures

General Powers to Report

6.112 The Auditor-General's powers to report are central to the public auditing system and his role as an Officer of Parliament. The Act has three main reporting provisions:

- Section 20 retains the Auditor-General's power to report to the House of Representatives.
- Section 21 confers a comprehensive power to report to *a Minister, a committee of the House of Representatives, a public entity, or any person* on anything the Auditor-General considers it desirable to report on.
- Section 22 contains a new procedure for reports relating to an entity which is covered by the Local Government Official Information and Meetings Act 1987. It enables the Auditor-General to direct the entity to table the report at its next publicly open meeting.

6.113 The procedure under section 22 acknowledges the interests of a local authority's electors – as opposed to taxpayers generally – in receiving information about the authority's affairs.

Special Reporting Procedure for Financial Losses

6.114 The Act also introduces a special reporting procedure, which replaces the Auditor-General's power to apply financial surcharges on persons responsible for financial losses. The power was unsatisfactory for many reasons – not least its "judge and jury" aspects. The courts, not the Auditor-General, should determine questions of liability for financial losses.

6.115 The new procedure applies only to local authorities and, consequently, is to be included in the Local Government Act 1974.[3] It applies whenever a local authority has incurred a "loss", as that term is defined.[4] Under the procedure:

- the Auditor-General may make a report on the loss to the local authority, with recommendations for recovery;
- the local authority must respond to the report within a defined time;[5]
- the report and the authority's response are sent to the Minister of Local Government and made public;
- the members of the authority are personally liable for the loss – subject to certain defences;[6] and
- if the amount of the loss is not recovered within a reasonable time, the Crown may take court action to recover the loss as a debt on the local authority's behalf.

6.116 The old surcharge provisions had not been applied for many years before they were abolished. However, we (and some local authority lawyers) found them useful from time to time to remind local authority members and staff about the potential consequences of losses being incurred, and encourage authority members to act in accordance with the law. The new provisions are also designed with that objective.

3 New sections 706A to 706C. See section 50 of the Public Audit Act.

4 In section 706A(1).

5 Members may also respond individually.

6 The defences are set out in section 706C(4).

6.2
Reviews of Legislation Affecting Local Government

6.201 Some of the significant reviews involving legislation affecting local government that are under way include:

- the Local Government Act 1974;
- the Public Works Act 1981;
- the Funding Powers Review encompassing the Rating Powers Act 1988;
- the Land Transport Policy Review – including amendments to the Transit New Zealand Act 1989, Part II of the Transport Services Licensing Act 1989, the Transport (Vehicle and Driver Registration and Licensing) Act 1986, and the Transport Act 1962; and
- proposed amendments to the Health Act 1956 to strengthen the regimes for managing drinking water standards.

6.202 The interest of the Audit Office in the reviews is to ensure that key elements of the legislative framework are provided for so that the best outcomes for communities, districts and the environment can be achieved.

6.203 In our view, those key elements require that:

- the role and purposes of local government are clear, and local authorities' powers and responsibilities are appropriate to their functions – particularly in relation to regulation setting, administering and enforcement;
- local authorities (as representative democracies) are responsive to their communities, and encourage participation through the use of open and transparent decision-making processes – so that communities can hold them to account;

- local authorities exercise their ownership and stewardship roles for community assets and resources accountably, prudently, effectively and efficiently in the interests of the ratepayers, residents, and the district;
- funding tools are suitable to local authorities' functions, and the use of such tools is appropriate – particularly coercive taxing powers; and, finally
- an appropriate structural balance is found that reflects considerations such as communities of interest, economies of scale, and the activities required to be undertaken.

6.204 Participating in the reviews is likely to be demanding for the Office. However, we are hopeful that the reviews will address a number of the long-standing issues and concerns that we have raised in the past about the operation and effect of a number of legislative provisions affecting local government.

6.205 As a result of the range and the possible extensiveness of legislative change resulting from the reviews, we are concerned that best practice guidance is available to local authorities to help them prepare for the new requirements before the changes come into force.

6.206 We are aware that departments such as the Department of Internal Affairs and the Ministry for the Environment recognise the value of best practice guidance. Their experience in introducing significant new legislation – such as the Resource Management Act 1991 and Part VIIA of the Local Government Act in 1996 – suggests that best practice guidance can smooth the transition between old and new regimes and result in more effective implementation.

6.3 Accounting for Environmental Obligations

Introduction

6.301 We have been raising awareness for a number of years about the potential difficulties local authorities will face in identifying environmental obligations and accounting for them correctly.

6.302 Last year, we reported on emerging guidance on accounting for environmental obligations and the results of a survey by our auditors of local authorities.[7] The survey indicated that local authorities have many actual and potential environmental obligations, but few authorities were accounting for the obligations in accordance with the emerging guidance.

6.303 In this article, we report on a new financial reporting standard and examine some of the potential impacts on local authorities of complying with the standard.

FRS-15: *Provisions, Contingent Liabilities and Contingent Assets*

6.304 FRS-15: *Provisions, Contingent Liabilities and Contingent Assets* was issued as an approved financial reporting standard in November 2000, and is based on exposure draft ED-86 (the key requirements of which we provided information on last year). FRS-15 applies to reporting periods ending on or after 31 October 2001 and, therefore, will first apply to local authorities for their financial year ending 30 June 2002.

7 *Second Report for 2000*, parliamentary paper B.29[00b], pages 43-51.

6.305 FRS-15 is particularly relevant to environmental obligations (landfills, contaminated sites, etc.) which are subject to the standard.

6.306 Two aspects of FRS-15 particularly relevant to local authorities are:

- The need to recognise a provision (i.e. a liability) in the statement of financial position when –
  - an entity has a present obligation (i.e. legal or constructive) as a result of a past event;
  - it is probable (i.e. more likely than not) that an outflow of resources will be required to settle the obligation; and
  - a reliable estimate can be made of the amount of the obligation.
- The need to disclose information about contingent liabilities in the notes to the financial statements.

Impact on Local Authorities

6.307 FRS-15 will have a significant impact on local authorities, especially in accounting for environmental obligations. We expect to see a significant increase in the number of provisions for environmental restoration obligations recognised in local authority financial statements.

6.308 In the remainder of this article we examine some of the issues that, in our view, are likely to provide challenges in implementing FRS-15.

Legal or Constructive Obligation

6.309 An environmental obligation can be either a legal obligation or a constructive obligation.

6.310 A ***legal obligation*** may derive from a contract (explicitly or implicitly), legislation, or other operation of law. Examples of legal obligations are penalties or clean-up costs imposed under the Resource Management Act 1991 (RMA) for unauthorised discharge of contaminants to land or water,

causing environmental damage.[8] Also under the RMA, landfill operators have an obligation to avoid, remedy, or mitigate the environmental effects of their landfills.[9]

6.311 Assessing whether a legal obligation exists will be difficult in some circumstances. We expect that local authorities will in many cases need to seek legal advice to establish whether they have a legal obligation to remedy environmental damage.

6.312 A ***constructive obligation*** arises when an entity creates valid expectations in other parties that it will discharge an obligation.[10]

6.313 Assessing whether a constructive obligation exists is likely to prove equally complex for many local authorities. It will require the use of judgement, and may require legal advice in some cases. For example, it may be difficult to ascertain the extent of a local authority's obligations in relation to a historically contaminated site (such as a closed landfill) that was contaminated before the introduction of the RMA but is not currently breaching the RMA.

6.314 A constructive obligation may exist where the local authority has created a valid expectation that it will rectify damage, regardless of whether the local authority owns the site. The expectation could have been created as a result of:

- published policies of the local authority;
- the local authority rectifying damage under similar circumstances in the past; or
- statements by officers or elected representatives of the local authority.

8 Sections 15 and 338, Resource Management Act 1991.

9 Section 17, Resource Management Act 1991.

10 Valid expectations are created where an entity has indicated to other parties it will accept responsibility based on an established pattern of past practice, published policies or a sufficiently specific current statement (paragraph 4.1(a), FRS-15).

Measuring the Obligation

6.315 Provisions for environmental obligations must:

- be able to be reliably measured before they can be recognised in the financial statements; and
- be measured at the best estimate of the amount required to settle the obligation for remedial action or restoration at balance date.

6.316 FRS-15 makes clear that it will be **very rare** for a provision not to be recognised because a reliable estimate cannot be made.

6.317 Local authorities will have to make assumptions in measuring some environmental obligations – such as landfill closure and post-closure care costs, for which cash outflows can occur 20-30 years into the future. Having to make assumptions and estimates will not be an acceptable reason for not recognising a provision.

6.318 In the case of landfills, the provision for closure and post-closure care costs will need to be assessed for each landfill site. The amount of the provision will depend on the conditions imposed by the resource consent and the specific management requirements of the site.

6.319 Another requirement of FRS-15 is that provisions are to be discounted where the effect of the time value of money is considered to be material. We expect that a provision for closure and post-closure care costs of a landfill site will typically be discounted, since the cash outflows can occur many years in the future. The discount rate used should be appropriate and reliable.[11]

Funding Implications

6.320 The application of FRS-15 will have funding implications for local authorities. Section 122C(1)(f) of the Local Government Act 1974 specifies that operating revenues in any financial year are to be set at a level adequate to cover all projected operating expenses.

11 FRS-15 requires the use of a pre-tax rate(s) that reflects current market assessments of the time value of money and risks specific to the liability, but which must not reflect the risks for which future cash flow estimates have been adjusted (paragraph 6.12).

6.321 The funding implications for local authorities differ depending on whether a provision (in the Annual Plan) is to be appropriately expensed or capitalised.[12] If the provision is to be charged as an expense, it would be an "operating expense" under section 122C(1)(f), which must be funded. If the provision is to result in an equivalent increase in the value of an asset, the "operating expense" would arise in the form of the depreciation charge on the asset each subsequent year, which must also be funded.

6.322 Another funding implication arises from the discounting requirements of FRS-15. The discounted amount of a provision will increase each reporting period due to the passage of time. This increase will be recorded as an interest expense (part of "operating expenses") in the statement of financial performance. The effect of changes in discount rate and cash flow estimates will also be recorded in the statement of financial performance.

6.323 It is important to note that FRS-15 has a transitional provision for local authorities which change an accounting policy to comply with the standard for the first time. These local authorities will be allowed to recognise any revenue or expense from the change in the statement of movements in equity as an adjustment against opening equity. As a result, the funding implications will largely be felt after the initial year of application of FRS-15.

Annual Plans

6.324 FRS-15 also has implications for the preparation of Annual Plans by local authorities. The 2001-02 Annual Plan should (ideally) be prepared in accordance with FRS-15, so that reporting at the end of the year is on the same basis as the plan.

6.325 However, because of the potential difficulties in identifying environmental obligations and collating the information required to account for them correctly, we expect that local authorities will struggle to meet that ideal. We have accepted that, in most cases, 2001-02 Annual Plans will not be prepared in accordance with FRS-15.

12 Guidance is provided in FRS-3 *Property, Plant and Equipment* and the *Statement of Concepts for General Purpose Financial Reporting*.

6.326 Nevertheless, we expect local authorities to include explanation in their 2001-02 Annual Reports for any major variations from the Annual Plan – such as new provisions for environmental obligations. From the 2002-03 financial year, all Annual Plans must be prepared with proper recognition of FRS-15.

Conclusion

6.327 FRS-15 will have a significant impact on the financial statements of local authorities, especially as regards environmental obligations. The impacts of the standard will need to be considered and managed carefully. As we signalled last year, we will continue to assist local authorities and our auditors by providing guidance on the subject. We intend to issue guidance for our auditors on accounting for environmental obligations by August 2001.

6.328 Other guidance on the subject is also forthcoming. The Society of Local Government Managers' Financial Management Working Group is expecting to issue guidelines to local authorities on accounting for environmental obligations in the near future. We have provided assistance to this group. We also understand that the Ministry for the Environment intends to review and modify its existing *Landfill Full Costing Guide*[13] later this year to provide guidance to local authorities and others on the pricing of waste disposal that covers the full cost of a landfill's operation.

13 *Landfill Full Costing Guide: A Guide for Landfill Managers to Help in Assessing the Full Costs of Developing and Running a Landfill*, June 1996.

6.4 Regulatory Functions – Integrity of Procedures

6.401 Of all the types of functions carried out by local authorities, regulatory functions are probably the most 'sensitive' because:

- the public and personal impact of regulatory decisions can be high; and
- the high-profile nature of some regulatory decisions can lead to greater public scrutiny in the event of something going wrong.

6.402 Regulatory functions also differ from other functions because they:

- involve matters of legal compliance; and
- for the most part, do not provide the recipient with any tangible good or service (such as a supply of water or the ability to borrow library books).

What Is a Regulatory Function?

6.403 The Local Government Act 1974 and other statutes confer a wide range of functions on local authorities. That Act uses the term *regulatory function* to describe some of these functions, although it does not define which ones they are. We understand the term to mean a function under which a local authority controls, governs, or directs activity (whether by individuals or by businesses) in its district.

6.404 Regulatory functions can take a number of forms, and can have a number of different components. For example:

- developing policies and rules – such as the district plan;
- compiling and maintaining registers – such as of dogs;

- issuing consents and permits in accordance with some statutory criteria – such as health and liquor licences and resource consents; and
- enforcing the conditions applicable to a permitted activity – such as by compliance inspection, enforcement and abatement procedures, and prosecution for offences.

The Potential for Risk

6.405 Carrying out regulatory functions carries the potential for risk to the local authority that a particular decision or action is challenged for want of being taken properly. The grounds for possible challenge include:

- failure to comply with statutory requirements;
- failure to observe due process;
- failure to apply adequate skill and care;
- bias in the execution; and
- improper behaviour on the part of an employee.

6.406 Many regulatory decisions and actions have consequences for the local authority. Most consequences will be capable of anticipation – such as enforcement of consent conditions – but some may not – such as the nature of the liability of the authority for a negligent act in making the decision or taking the action.

Minimising the Risk

6.407 A local authority can minimise the risk of challenge to regulatory decisions and actions, and the risk of unanticipated consequences, by putting in place the appropriate measures to ensure the integrity of the procedures by which those decisions and actions are taken.

6.408 We have assembled information on what we consider to be the avenues of risk, and have structured this information as a set of nine risk factors:

- absence of documented policies and procedures;
- absence of a policy governing conflicts of interest;

- too much autonomy given to regulatory staff;
- absence of clear delegations;
- absence of accountability where regulatory staff have high levels of discretion;
- regulatory staff identifying too closely with an industry;
- absence of policies on regulatory staff taking secondary employment or engaging in subsequent employment;
- absence of a policy on the use of confidential information; and
- use of improper or unlawful compliance methods.[14]

6.409 Our auditors will be discussing these risk factors and associated prevention strategies with local authorities. The purpose is to raise the authorities' awareness of where they will be at risk in carrying out their regulatory functions if they do not have appropriate measures in place to ensure the integrity of the procedures.

Why We Are Looking at the Subject

6.410 Our decision to look at this subject now was influenced by a growing number of enquiries from ratepayers and others that raise issues about the discharge of regulatory functions, particularly under the Resource Management Act 1991.

6.411 In addition, our inquiry into how the Auckland City Council managed its statutory responsibilities in the Hauraki Gulf drew a number of complaints about the Council's conduct of regulatory functions.[15] We identified the lack of a customer- and solution-focused culture in the way in which the Council carried out its role on the Islands of the Gulf.

14 These risk factors, and the associated prevention strategies, have been drawn from the publication of the Independent Commission Against Corruption of New South Wales *Strategies for Preventing Corruption in Government Regulatory Functions* (March 1999).

15 See pages 88-94 of this report.

B.29[01a]

6.412 We stress that we have no reason to believe that local authorities are carrying out regulatory functions poorly or improperly, or that there is any significant amount of corruption among regulatory staff.

6.413 Given the purpose of raising the subject we will not be reporting any detailed findings. However, in next year's report to Parliament we intend to provide a brief outline of any major issues that our auditors identified.

6.5 Sustainability of Essential Services

6.501 Our *Second Report for 2000*[16] emphasised the importance of the new financial management regime for local authorities. Before the advent of the plans now required by Part VIIA of the local Government Act, most local authorities operated on a relatively short-term planning horizon – generally determining their planned activities by reference to annual cash requirements.

6.502 A particular expectation of the new planning regimes was that local authorities would be better equipped to provide for the ongoing and sustainable supply of services that their communities see as important to them. The need for local authorities to recognise the serious implications of maintaining essential services was seen as important in 1996 when Part VIIA was enacted because many authorities were facing significant costs for infrastructure upgrading needs.

6.503 Two of the particular characteristics of local government that appear to lend it naturally to a long-term planning horizon are:

- its involvement in the delivery and purchase of services that have very long life-spans and lead times for change; and
- its responsibility for safeguarding vital environmental and community resources that once lost can be difficult and expensive, if not sometimes impossible, to recover.

6.504 By July 2001, most local authorities should have completed reviewing and adopting their second Long-term Financial Strategy (LTFS). Issues such as those outlined on valuation and useful lives (paragraphs 1.121-1.129 on pages 16-17)

16 Parliamentary Paper B.29[00b], pages 7-9.

mean that there will always be limitations on the accuracy of Asset Management Plans and LTFSs. Nevertheless, we had hoped that the second LTFSs would represent a more comprehensive picture of future requirements for essential services than their predecessors.

6.505 However, the results of our projects during 1999-2000 on auditing LTFSs, and the reviews of LTFSs and Funding Policies by the Early Nine (paragraphs 3.201-3.251 on pages 67-80), raise the possibility that the LTFS regime may not achieve its intended objective because:

- LTFSs may not yet be sufficiently soundly based to provide reasonable indications to local authority members and communities about the sustainability of key services and emerging issues affecting those services; and
- reviews of LTFSs which involve no more than adjusting estimates for such things as price rises – rather than revisiting the key assumptions, objectives and strategies underlying the LTFS – may result in failure to identify or address emerging issues or changing community preferences.

6.506 Our aim in 2000-01 is therefore to focus on aspects of sustainability of essential services, and to explore whether local authorities are giving effect to the LTFS regime so as to achieve the legislative intent of promoting prudent financial management.

6.507 To that end we will be seeking to answer three key questions:

- How well did each local authority review its LTFS in terms of the environment within which it provides services, and did the authority align its objectives with policy and budgets?
- How well has each local authority implemented its LTFS?
- How is each local authority using its LTFS to identify and prepare for changes and emerging issues that are likely to affect the sustainability of services? For example, as a result of changes in population demographics, or increasing environmental standards, or new legislative requirements.

6.508 As a first step, our auditors will assess the answer to each of those questions from their knowledge of the local authorities. We will use this information to:

- build a high-level picture about the sustainability of essential services and whether the planning regimes are helping to improve long-term planning for these services; and
- identify common issues and trends in how local authorities are engaging their communities and exploring options to manage change.

6.6 Anticipating Future Rates Increases to Fund Depreciation

6.601 Last year we reported that a number of local authorities, in order to deal with the impact of funding the depreciation expense, had adopted the practice of phasing in the necessary rates increase over time – for example, over five years.[17] (See also paragraphs 1.201-1.208 on pages 18-19 of this report.)

6.602 Phasing in the rates increase means that deficits will be incurred in the early years, to be made up by surpluses in the later years. The consequence is that ratepayers in, say, four or five years' time will be faced with paying for the shortfall in rates levied in the preceding years.

6.603 The practice has been adopted despite the statutory transition already provided – whereby local authorities did not have to recognise depreciation as a cost until 1998-99, compared to 1997-98 for the other requirements of Part VIIA of the Local Government Act.

6.604 Some local authorities have advanced the argument that they are complying with the Act and are using the exemption under section 122J of the Act that allows the anticipation of future surpluses. We have already indicated (both to local authorities and Parliament) our view that the use of that section 122J exemption could be imprudent and contrary to the intentions of the Act.[18] A local authority ought not to raise less revenue than is necessary to maintain its core assets and services, thus accumulating deficits to be financed by future ratepayers.

17 *Second Report for 2000*, parliamentary paper B.29[00b], pages 23-24.

18 Ibid.

6.605 In our 2000-01 audits we will monitor the local authorities that have adopted the practice. We will look to see whether the Annual Plan for 2001-02 provides for the planned rates increases to occur, and whether future increases are still reflected in the Long-term Financial Strategy and Funding Policy.