

Office of the Auditor General Enquiry into Delta, a CCO of Dunedin City Council: A SUMMARY

Tabled in parliament 20 March 2014

In 2012 the Mayor of Dunedin sought an enquiry into business transactions in a Dunedin City Council CCO. The OAG has conducted an investigation, tabled in parliament today.

When the OAG agreed to carry out this inquiry, it expected that there would be lessons learned for local government as a whole. These are detailed in today's report and the OAG is conducting a further piece of work around communication between councils and CCOs.

This summary of the OAG report has been prepared by the CEO of the DCC, primarily using Chapter 7 of the OAG report, to inform and assist interested people in local government in determining which of the findings, if any, are pertinent to their own circumstances. In addition, the new LGNZ 'Centre of Excellence', launched on 13 March, will provide governance training jointly with the Institute of Directors. This will commence its rollout to councils around the country, starting on 25 March. The Mayor of Dunedin, as an LGNZ National Council member, was part of the team that approved both the strategy and the joint venture with the IoD, and has been actively involved in ensuring that Dunedin's lessons from the 2011 Larsen Report (the implementation of which means that the DCC receives no adverse recommendations from today's OAG investigation) are able to be passed on to other councils.

Background

A little over five years ago, Delta Utility Services (Delta), a Council-Controlled Organisation for Dunedin City Council, decided to make two property investments – a joint venture in Luggate near Wanaka in mid-2008 and investment in Jacks Point near Queenstown in mid-2009, for a combined investment of over \$14M. The central purpose of the investments was to create landholdings that could be turned into serviced residential lots and on-sold at a profit, whilst also giving employment certainty to the Delta workforce in providing the service utilities to the lots.

Both of the investments not only failed to realise the anticipated profits, but made (or are making) a sizeable loss for Delta - \$6.4M loss in total, \$4.4M from Luggate Park (and excluding a possible further \$2.3M if expected tax credits are not realised). Following this, there have been allegations of personal conflicts and impropriety around the investments, and there has been concern in the Dunedin community about the size of the loss and the effect of the loss on the net worth of the Council and its companies.

In 2012, the Mayor of Dunedin requested the Office of the Auditor General conduct an inquiry. The report of the OAG inquiry was tabled in Parliament on 20 March 2014, and covered Delta's decision to invest, how Delta managed the investments, and the involvement of the Council's Holding Company and actions of the Council. The report sets out Delta's decision-making process for the Luggate Park and Jacks Point investments in detail, giving an independent description of what happened and to provide assurance about the process followed. Some of the facts of the

investments were not widely known or well understood and the OAG says its report should help to correct some misinformation and fill some gaps in people's knowledge.

Below I summarise the findings of the OAG report, primarily using Chapter 7 of the OAG report as the basis of the summary, but tailored so as to distil the most relevant parts of the inquiry. For the Dunedin City Council, a review of the structure of our companies in 2011 (The Larsen Review http://www.dunedin.govt.nz/_data/assets/pdf_file/0018/208053/Larsen-Report-February-2012.pdf) has already identified many of the concerns that are highlighted in the OAG report, and substantial changes have been made in the last two or three years because of that review. Because of this, the OAG report gives no specific recommendations for the Council, the Holding Company or Delta.

However, the lessons we have learned through the Larsen Review, strongly reinforced by this OAG report, may have wider interest, especially to those in councils with CCOs who may be interested in the implications of this OAG report for their own circumstances.

The OAG's overall findings

The OAG has identified some positive aspects and some deficiencies on the part of Delta, the Holding Company, and the Council. It considers that there are lessons to be learned for all involved, and for other local authorities and their council-controlled organisations. Some of the findings of this inquiry will contribute to the Auditor-General's broader governance study, in particular because that study is considering commercial decision-making by council-controlled trading organisations.

The OAG found that the directors of Delta approached these investments cautiously and made careful decisions based on financial estimates and generally supported by good information. The directors were well supported by Delta staff in making their decisions. In turn, legal and tax advisors supported Delta staff. Governance and oversight arrangements were appropriate and worked well. The OAG found no evidence of:

- the investments being entered into for inappropriate reasons or because of personal connections with the other parties involved;
- poor management of conflicts of interest adversely affecting either investment; or
- Delta not being paid for contracting work and this being a motivation for entering the investments.

Despite these positive findings, the OAG did identify some aspects in which the activities of Delta, the Holding Company and the Council met neither good business practice nor reasonable expectations of public entities. Several of these may be of interest to other councils when considering how they and their CCOs and holding companies conduct business. Specifically:

- Delta used artificial business structures to avoid public accountability. That is, Delta appeared to set up artificial structures that gave it and its joint venture partner equal rights, but at the same time were designed to avoid accountability requirements of public entities. The joint venture structure for these investments had the joint venture partner able to appoint one more board member than Delta, but not doing so, thus avoiding being a CCO. This meant Delta had legally less than 50% interest, but in practice the arrangement functioned with two equal parties – it behaved as a CCO but avoided CCO accountability requirements such as public statements of intent, public audit etc.

- There was a lack of strategic and performance monitoring of the investments by the holding company because of the common directors. That is, the Delta board and the Holding Company board were largely the same people at the time holding company approval was sought. This resulted in limiting robust independent holding company shareholder-challenge of the decision-making of the Delta board.
- In addition, the Holding Company board was largely made up of people with accounting and financial skills, not skills adequately aligned with the activities of the companies.
- Delta and the holding company did not communicate effectively with the Council about the Luggate Park investment and the Holding Company did not communicate effectively with the Council when the Jacks Point investment breached the company's \$10 million spending authority.
- The Council had written to the Holding Company in 2006 saying that it wanted higher dividend flow from the Holding Company subsidiaries, and that the companies should fund business expansion by debt. However, this was not accompanied by putting adequate governance and oversight arrangements in place to support that demand. Furthermore, the Council had not made clear how much risk the Council was willing to take on in its pursuit of greater dividends, and, in this case, the appetite for risk as it departed from its core business was left as a matter for Delta. The Holding Company did not make it clear that departing from core business required a business case to be approved by the Holding Company.
- There were inadequate formal structures in place for effective communication between Delta, the holding company and the Council. Simply having a Councillor appointed to the Holding Company and Delta boards did not assist communication, as that Councillor said he did not see himself as a conduit of information to the Council about the Holding Company group. There are no records of formal Council briefings around Luggate, for example, although informal briefings of the then Mayor and senior DCC staff at that time did take place.

In addition, the OAG found other issues that may be more specific to this particular case or time, and decisions made by the Delta and Holding Company board:

- In a finding that the OAG highlights as a particular failing, Delta failed to engage appropriate expertise to consider the Luggate Park investment despite a recommendation from its tax advisor to do so. This was particularly important because this was a new area for Delta and its most experienced director in property development was perceived to have a conflict of interest and therefore unable to participate in decision-making. Delta's main manager advising the board had an acknowledged lack of expertise in the area. Because of the money involved, it would have been useful to seek an independent view of the price sought for the Jacks Point land and the financial projections for the project: this wasn't done.
- In general, Delta focused too much on the potential benefits and not enough on what might go wrong.
- Delta paid for unconsented as well as consented land at Luggate at the start of the joint venture, despite being clear at the outset that the joint venture would only pay for consented land.
- One of the subsidiary companies used in the transactions met the requirements of being a CCO, but this was not realised by Delta which meant its directors breached the Local Government Act by making decisions without a statement of intent.

- Delta's directors did not meet all the requirements of the Companies Act for the consultancy arrangement with one of their own board members for project management work at Jacks Point. The directors did not resolve that the arrangement was fair to the company or disclose the details of the arrangement in the company's interests register.

Lessons for councils and council-controlled organisations

The OAG finishes its report by commenting on more general lessons for the Council and for local government about risks and confidentiality, as follows.

Being clear about risk

Delta made the investments at a time that the Council required more dividends from the Holding Company group. Had the investments succeeded, they could have helped to meet that requirement when profits were realised.

The OAG considers that the Council bears some responsibility for the investments. The governance regime it had in place failed to provide any guidance or oversight to the Holding Company or Delta for the investments, and the Council had not specified its risk appetite for the activities of its trading organisations. Its main focus at the time seems to have been on how much money it could get from its trading organisations and not so much on what they were doing.

As governors of a public entity, Delta's directors were responsible for prudent stewardship of Delta's assets and funds but were also trying to expand the business to generate more profits for the shareholder. The inevitable tension between careful stewardship and shareholder requirements for more money was not helped by the absence of guidance from the Council or the Holding Company on risk.

Local authorities with commercial entities should actively consider their risk appetite from time to time, and be explicit about this with those entities. The annual statement of intent process should provide a basis for those discussions. If a local authority gives primary responsibility for governance of council-controlled organisations and other commercial entities to a holding company, the holding company should seek the council's agreement to its approach to managing risks.

Confidentiality

For council-controlled trading organisations, there can be a tension between open communication and commercial sensitivity. There will often be a good reason for a council-controlled organisation to protect or withhold information during commercial negotiations, including when the council-controlled organisation considers that there is a risk of leaking confidential information that might affect those negotiations.

However, when decisions have been made, confidentiality considerations should become less important, and council-controlled organisations need to decide then how best to communicate with their shareholding councils. Private sector entities dealing with council-controlled organisations should be aware of this, and that the situation is more complex when dealing with a public entity.

The OAG will be exploring governance and communication matters between council-controlled organisations and councils in more detail in another study that it is undertaking. In the meantime, this report will provide some useful guidance for all other local authorities – especially those with council-controlled trading organisations.

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