Controller and Auditor-General
Tumuaki o te Mana Arotake

B.29[14a]

Inquiry into property investments by Delta Utility Services Limited at Luggate and Jacks Point

Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
Website: www.oag.govt.nz

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Inquiry into property investments by Delta Utility Services Limited at Luggate and Jacks Point

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In November 2012, I announced that my Office would carry out an inquiry into property investments by Delta Utility Services Limited (Delta), a council-controlled trading organisation of Dunedin City Council (the Council).

The property investments were at Luggate, near Wanaka, in mid-2008, and Jacks Point, near Queenstown, in mid-2009.

The Mayor of Dunedin asked for the inquiry. I was aware that some Dunedin ratepayers had alleged impropriety about the investments. There were also more widespread concerns that the investments had lost money and would reduce the Council's net worth.

My staff have reviewed:

- Delta's decisions to invest;
- how Delta managed the investments;
- the involvement of Delta's parent company, Dunedin City Holdings Limited; and
- the Council's actions.

This report sets out my Office's findings and conclusions.

The land at Luggate was sold in August 2013. Delta has sold all of the land at Jacks Point under deferred payment arrangements, with final payment due in December 2014.

Delta lost about $5.9 million on the Luggate investment and has projected a loss of about $2.8 million for Jacks Point. These losses are before tax, and Delta expects that they might yet be offset by tax credits of about $1.5 million for Luggate and about $0.8 million for Jacks Point. If so, the overall loss would be about $6.4 million.

Although Delta carried out a careful process before investing in Luggate, it is difficult, because of the size of the loss, to avoid concluding that the investment was a mistake. Delta's managers and directors who were involved have largely come to the same conclusion.

The Jacks Point investment was a better proposition than Luggate when it was made, but changes to its operations mean that Delta is unlikely to realise all of the broader benefits that were expected when the investment decision was made.

Delta directors regarded the investments as learning experiences for the company. Because of the losses involved, these proved to be expensive lessons. In my view, there was too much focus on the likely profits and not enough consideration of risks of the market slowing or an exit strategy if things went wrong. I consider that Delta should have got independent advice before investing in Luggate and Jacks Point.

My staff found no evidence of impropriety or of poorly managed conflicts of interest in relation to either investment. However, they did identify some breaches of the Local Government Act 2002 and the Companies Act 1993 and instances of Delta using artificial business structures to avoid public accountability.

The extent of the interests and involvement of one of Delta's directors in Jacks Point and how these interests and involvement were managed caused me to pause and think. These interests also concerned the members of the public who contacted my Office. In public office, having multiple roles and interests requires careful management. People with such interests need to behave with the utmost integrity and transparency to avoid real or perceived conflicts and risks to the public entities they serve. Although the overall management and disclosure of conflicts of interest was largely adequate, we identified some instances where there should have been earlier or fuller disclosure for better transparency, and one instance where the director's involvement in both sides of a venture would have been problematic had the venture proceeded.

Since 2004, Delta had sought new opportunities to expand its business, including in Central Otago. Since 2006, the Council had sought higher dividends from the Dunedin City Holdings Limited group. The holding company was told of this shortly before the Luggate investment opportunity. However, the Council had given no direction about how much risk it was willing to take on. Because most of the directors of Delta were also the directors of Dunedin City Holdings Limited, the governance regime that the Council had in place in the Council group did not provide Delta with adequate oversight of, or guidance about, the investments. For these reasons, I consider that the Council and Dunedin City Holdings Limited bear some responsibility for the investments.

Although I make no specific recommendations, this report contains lessons for all involved and for other local authorities and council-controlled organisations.

In his 2011 review of governance issues in the Council's group of companies, Warren Larsen identified many – if not all – of the governance and communication matters that we note in this report. The Council is taking appropriate steps to address those problems.

I intend to publish a separate report later this year that will explore wider governance and communication issues between council-controlled organisations and councils. In the meantime, I trust that this report will provide some useful guidance for all other local authorities – especially those with council-controlled organisations that carry out commercial activities.

I thank the current and former directors and staff of Delta, Dunedin City Holdings Limited, and the Council who helped with our inquiry.

Lyn Provost
Controller and Auditor-General

14 March 2014

Part 1
Introduction

1.1 Delta Utility Services Limited (Delta) is a council-controlled trading organisation of Dunedin City Council (the Council). It is a contracting company that provides asset management, electrical contracting, and infrastructure operations and maintenance services in the South Island.

1.2 In 2008 and 2009, Delta entered into two transactions to expand its activities into residential property development. They were:

- Luggate Park – Delta bought a 50% interest in a joint venture to develop land at Luggate near Wanaka for $5.35 million in mid-2008; and
- Jacks Point – Delta bought 9.4 hectares of land at Jacks Point near Queenstown for $8.82 million in mid-2009.

1.3 The combined cost of the investments to Delta was $14.17 million.

1.4 Delta had not previously been involved in property development. However, it expected to provide infrastructure and contracting services to both developments as part of its growth strategy in Central Otago.

1.5 There has been less demand for the residential sections than expected. In 2012, Delta wrote down the value of its interest in the Luggate Park joint venture and the Jacks Point land in its financial statements by $7.5 million (before tax).

1.6 The Mayor of Dunedin wrote to the Auditor-General on 19 October 2012 asking her to investigate Delta's decisions to invest in the residential developments. The Auditor-General also received information and concerns about the transactions from members of the public and a councillor before and after announcing her decision to conduct an inquiry. The investments have been of concern to some people in Dunedin since they became known. The reduction in the value of the investments in 2012 heightened those concerns.

1.7 The concerns and questions raised included:

- Were the investment decisions made for good reasons following appropriate processes? Or were they influenced by connections between the parties involved or tainted by conflicts of interest?
- Did the Council and its holding company, Dunedin City Holdings Limited (the holding company), know about the decisions and approve them?
- Was Delta paid for contracting work that it did for the two developments? Or did Delta acquire some of the land in lieu of being paid for work?

1.8 Many of those who contacted us did not appear to know all the facts and details of the investment decisions.

1.9 In November 2012, the Auditor-General decided that an inquiry into the way that Delta made the decisions was warranted. A thorough review of the facts would provide assurance about the financial results of the investments and what had taken place. Appendix 1 sets out the terms of reference for the inquiry. Other commitments meant that we were not able to start work until March 2013.

1.10 Separate to this work, we are carrying out a study of governance matters in council-controlled organisations. We chose the Council as one of several councils to talk to for that work. We expect that the governance aspects of the inquiry and assurance work for Delta's property investments will contribute to that broader governance study.

How we carried out our inquiry

1.11 In carrying out our inquiry, we met with:

- the directors of Delta when both investments were made (Ray Polson, Ross Liddell, Norman Evans, Michael Coburn, Paul Hudson, and Stuart McLauchlan);[1]
- staff members from Delta involved in the investments before and after they were made (the former chief executive and former chief financial officer, and the current chief executive and chief financial officer);
- the (now former) chief executive of the holding company; and
- Jim Boult, on behalf of the other companies involved in the Luggate Park joint venture.

1.12 We also met or spoke with;

- the Mayor of Dunedin, Dave Cull;
- the former Deputy Mayor, Councillor Syd Brown;
- Paul Orders (former chief executive) and Sandy Graham (group manager corporate services) Dunedin City Council;
- the former Mayor of Dunedin, Peter Chin;
- former Council officers who had some knowledge of the Delta investments (Jim Harland and Athol Stephens); and
- two Dunedin ratepayers who had contacted us with concerns and information.

1.13 We also reviewed a lot of information that Delta held about the two transactions and information that the holding company held.

1 We also met former Delta director John Gilks, who resigned as a director of Delta and the holding company at the end of May 2007 before the final decision to invest in Luggate was made. George Douglas, who resigned as a director of Delta in December 2008, was not available when we met the other directors. However, we gave him the opportunity to comment on a draft of this report.

Part 2
The context for the property investments

2.1 In this Part, we set out:

- the Council's group structure and how Delta fits into it;
- Delta's history;
- the people involved in the investment decisions;
- the context for the investment decisions;
- the need to seek new business opportunities; and
- our comments about the context for the property investments.

Summary of our findings

2.2 The property investments at Luggate Park and Jacks Point were part of Delta's broad strategy of looking for new ways of securing work in Central Otago. Delta had been looking for new opportunities from 2004. The holding company had endorsed this strategy. Senior council staff, the Mayor, and some councillors were aware of it.

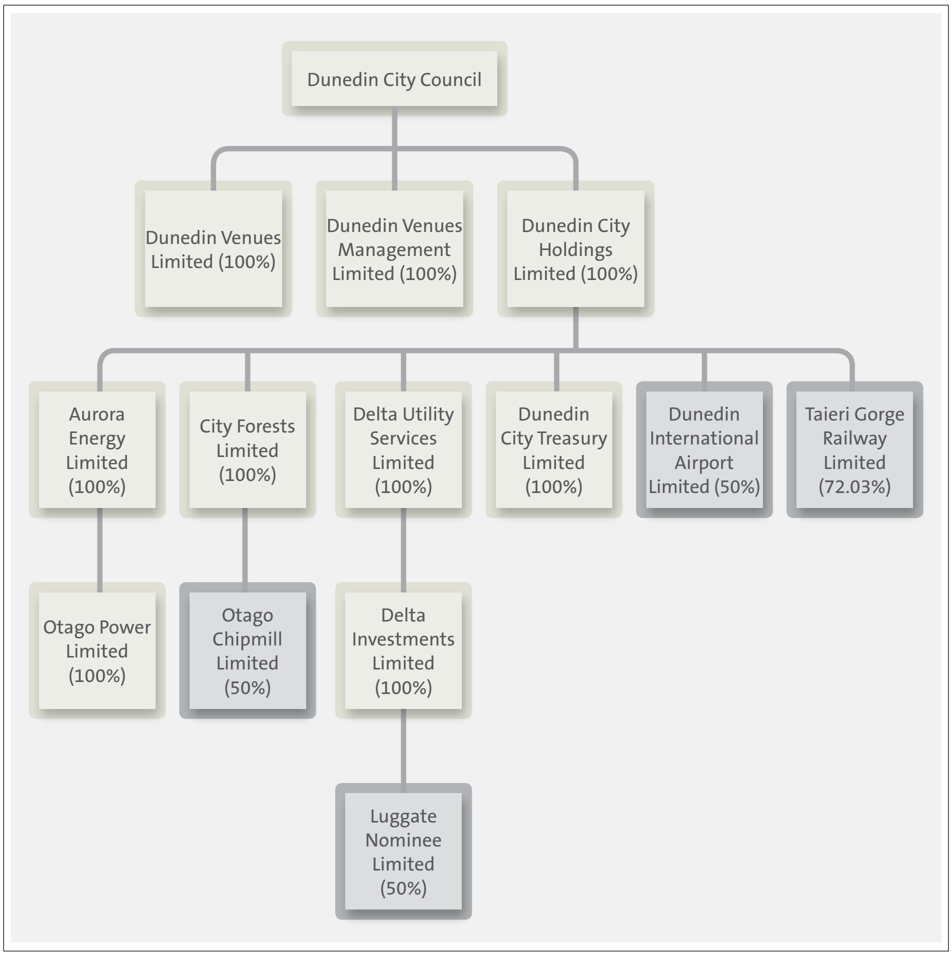
2.3 Because most of the directors of Delta were also the directors of the holding company, scrutiny by the shareholder of Delta's decisions was lacking.

2.4 Since 2006, the Council required increased returns from the holding company group. However, the Council did not give any direction about its appetite for risk.

How Delta Utility Services Limited fits into the Dunedin City Council group

2.5 Delta is one of the Council's several council-controlled organisations and is part of the Council group. Figure 1 shows the ownership structure of the Council group (companies only).

Figure 1
Ownership structure of companies in the Dunedin City Council group



2.6 Delta, Aurora Energy Limited, and City Forests Limited are council-controlled trading organisations. They are owned for investment purposes and operate to make a profit rather than to deliver Council-related services to the public.

2.7 The council-controlled trading organisations generate cash for the Council through dividend payments to the holding company. The holding company holds the investments in the council-controlled trading organisations and passes the dividend payments from them to the Council. The holding company also pays market interest to the Council on a shareholder advance provided by the Council. These payments contribute to the Council's cash flow, and it uses the dividend payments to help fund Council activities.

2.8 According to the holding company, the Council has received $178.3 million in dividends from 1994 to 30 June 2012, as well as loan repayments of $67.3 million and interest payments of $56.6 million.[2]

2.9 Figure 2 shows the dividend payments from the holding company to the Council from 2006/07 to 2012/13.[3]

Figure 2
Dividend payments from Dunedin City Holdings Limited to Dunedin City Council, from 2006/07 to 2012/13

	2006/07 $m	2007/08 $m	2008/09 $m	2009/10 $m	2010/11 $m	2011/12 $m	2012/13 $m	Total $m
Dividend	12.5	11.2	9.5	14.9	15.6	10.7	4.6	**79.0**

2.10 During the same period, Delta has paid dividends of $23.5 million to the holding company (see Figure 3).

Figure 3
Dividend payments from Delta Utility Services Limited to Dunedin City Holdings Limited, from 2006/07 to 2012/13

	2006/07 $m	2007/08 $m	2008/09 $m	2009/10 $m	2010/11 $m	2011/12 $m	2012/13 $m	Total $m
Dividend	4.5	2.5	2.5	3.5	4.0	4.5	2.0	**23.5**

Directors of Delta Utility Services Limited and Dunedin City Holdings Limited

2.11 Ray Polson was the chairman of the board of Delta when the investments were made. Mr Polson was also the chairman of the board of Aurora Energy Limited. Mr Polson ended his term as chairman of both boards on 1 November 2013.

2.12 Delta was offered the opportunity to take part in a joint venture in Luggate (called Luggate Park) in May 2006. It made its final decision to do so in early 2008. Delta considered and decided to invest at Jacks Point in the first half of 2009. The first six Delta directors shown in Figure 4 were involved in both decisions.

2.13 Figure 4 lists the directors of Delta from 2005/06 to 2012/13.

2 The interest payments began in 2001.

3 In 2011/12 and 2012/13, Dunedin City Holdings Limited also made a net-of-tax subvention payment of $5.25 million (from Aurora Energy Limited) to Dunedin Venues Limited in lieu of an additional dividend payment to the Council – Dunedin City Holdings Limited, *2011/12 Annual Report*, page 6 and *2012/13 Annual Report*, page 8.

Figure 4
Directors of Delta Utility Services Limited, as at 30 June, from 2005/06 to 2012/13

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Ray Polson (chairman)	✓	✓	✓	✓	✓	✓	✓	✓
Stuart McLauchlan		✓	✓	✓	✓	✓	✓	✓
Norman Evans	✓	✓	✓	✓	✓	✓	✓	×
Michael Coburn	✓	✓	✓	✓	✓	✓	✓	×
Ross Liddell	✓	✓	✓	✓	✓	✓	✓	×
Paul Hudson	✓	✓	✓	✓	✓	✓	×	
George Douglas	✓	✓	✓	×				
John Gilks	✓	×						
David Frow								✓
Ian Parton								✓

× Left during the financial year.

2.14 Directors McLauchlan, Evans, Coburn, Liddell, Hudson, and Gilks were also directors of the holding company. They were also directors of one or more of its other council-controlled organisations, Aurora Energy Limited, Dunedin City Treasury Limited, or City Forests Limited, when they were directors of Delta.

2.15 The boards of the holding company and the council-controlled trading organisations had the same directors for more than 10 years. After Warren Larsen's review of governance arrangements commissioned by the Council (the Larsen review),[4] the Council changed the governance structure to provide that a director could not be on the board of both the holding company and a subsidiary in the group. In October 2011, new directors were appointed to the board of the holding company (see Figure 5).[5]

4 Larsen Group (2011), *Governance Review of All Companies in Which Dunedin City Council and/or Dunedin City Holdings Limited has an equity interest of 50% or more*.

5 Further changes occurred in October 2013. Mr Baylis and Mr Shale resigned and were replaced by two new directors.

Figure 5
Directors of Dunedin City Holdings Limited, as at 30 June, from 2005/06 to 2012/13

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Stuart McLauchlan		✓	✓	✓	✓	✓	×	
Norman Evans	✓	✓	✓	✓	✓	✓	×	
Michael Coburn	✓	✓	✓	✓	✓	✓	×	
Ross Liddell	✓	✓	✓	✓	✓	✓	×	
Paul Hudson	✓	✓	✓	✓	✓	✓	×	
John Gilks	✓	×						
Bill Baylis							✓	✓
Denham Shale							✓	✓
Graham Crombie								✓
Kathleen Grant								✓

× Left during the financial year.

History of Delta Utility Services Limited

2.16 In 1990, the Council set up a company to take over part of the Council's electricity operations. The company was first called The Electric Company of Dunedin Limited and then, from March 1995 to May 1998, Delta Energy Limited. The company has operated under its current name, Delta Utility Services Limited, since May 1998.

2.17 In 2001, Delta took over the staff and activities of the Council's former Citiworks business. It expanded into civil construction, roading, drainage, landscape, and landfill management work.

2.18 Dunedin Electricity Limited owned Delta until the holding company purchased it in 2003. Delta continues to maintain and manage the electricity lines assets of its former parent, and now related, company Aurora Energy Limited.[6] Delta and Aurora Energy Limited have the same chief executive.

2.19 Delta has a wholly owned subsidiary, Delta Investments Limited, which held Delta's interest in the land at Luggate and holds Delta's interest in land at Jacks Point. Delta Investments Limited was previously called Newtons Coachways (1993) Limited (Newtons) until it changed its name with effect from July 2011.

2.20 We explain more about the role of Newtons in Part 3.

6 Called Dunedin Electricity Limited until July 2003.

Dunedin City Council's requirement for more dividends from 2006

2.21 Bevan Dodds, the chief executive of the holding company when the property investments were made, told us that, in late 2006, the board agreed "under protest" to start a series of higher annual distributions to the Council.[7]

2.22 The Council had contacted the holding company in May 2006 about this requirement. The Council believed that the after-tax profits and cash flows in the holding company group as a whole over the previous few years could support higher dividends. The Council proposed that annual dividends be increased to a minimum of 90% of the holding company's group profit after tax.[8]

2.23 In seeking the extra dividends, the Council noted Delta's and Aurora Energy Limited's increasing profits and cash flows. The Council said it did not wish them to reduce their debt or to accumulate their retained earnings. Instead, the Council wanted the ultimate shareholder (the Council) to receive any cash remaining after the companies met their day-to-day capital obligations. The Council also said that the companies should fund any expansion of their business wholly by debt.[9]

2.24 The Council and the holding company discussed this requirement during the next few months. They formed a joint working party to discuss how the holding company could meet the requirement.

2.25 In October 2006, the holding company told the Council that it would apply its best efforts to pay dividends at the higher level sought, providing it could maintain the company's sound financial position. The company also noted that, if it proceeded with planned capital expenditure, it might need to increase its debt levels to pay dividends.

Delta Utility Services Limited's need to seek new business opportunities

2.26 For some time before the Council required extra dividends in 2006, Delta directors and staff had been looking for ways to expand their business beyond Dunedin. Their broad growth plan was to extend Delta's range of services and operations in the South Island, including in growth areas such as Central Otago.

2.27 Starting in 2002, Delta acquired some roading and drainage businesses in Central Otago and Southland, including a roading company based in Alexandra. In 2007,

7 Mr Dodds gave us correspondence between the Council and the holding company that confirmed the request for higher dividends and the holding company's concerns about this.

8 The Council had formed a Financial Review Working Party in March 2006 to review the financial structure of the Council and consider the sustainability of funding arrangements. Increased dividends from the holding company group was one of the proposals considered by the Working Party.

9 Letter from Mayor Peter Chin to the holding company, 1 May 2006.

Delta acquired a Queenstown-based contracting company, Lakes Contracting Services Limited. It also acquired two smaller companies in Christchurch in 2008, one in Nelson in 2009, and another in Southland in 2010. Delta purchased these businesses to expand its workforce and operations in the South Island.

2.28 Delta's growth strategy from about 2004 focused on looking for new business opportunities in any infrastructure area, including commercial and residential property developments.

Governance culture at the time of the investments

2.29 The Council reviewed and changed the governance arrangements in the holding company group after the Larsen review. The Luggate and Jacks Point investments were made under the former governance structure of the holding company group, where largely the same directors were involved in the holding company and subsidiaries.[10]

2.30 After the Larsen review, the Council changed the structure to provide that a director could not be on the board of both the holding company and a subsidiary in the group.

2.31 We consider that some of the Larsen review's findings and observations about the former governance arrangements are relevant to the Luggate and Jacks Point investments. Those of particular relevance to our inquiry were:

- the unsatisfactory situation of the five holding company directors also being on the boards of each subsidiary and, therefore, not fulfilling a strategic and performance monitoring role for the subsidiaries;
- the related risk that too much collegiality could impede robust debate (between the boards of the holding company and Delta, because they were largely the same);
- the directors of the holding company having mainly accounting and financial skills and not skills adequately in line with the activities of the subsidiaries;[11]
- the effect on the holding company and its subsidiaries of meeting the Council's requirements for increased dividends;
- the wisdom of participating in residential land development, considering the Council's dependence on consistent cash dividends;[12]

10 Apart from Ray Polson, who was chairman of Delta and Aurora Energy Limited but who was not on the board of the holding company, and George Douglas, who was a director of Delta but who was not a director of the holding company or other subsidiaries.

11 As we explain in Part 3, this was especially problematic for the Luggate investment, because the director with the most experience was conflicted and unable to take an active role in the decision.

12 Land investments are generally illiquid, which affects the availability and timing of cash flow.

- the need to review the Council's overall investment policy for its subsidiaries and its other commercial activities to determine the Council's appetite for risk;[13]
- the need for the holding company's statement of intent to include an expectation that subsidiary companies would focus on core business, unless the holding company agreed to a change in strategy by way of an accepted business case (as opposed to the more simple financial thresholds that applied when the Luggate and Jacks Point investments were made); and
- a need for improved communication within the Council and between councillors, council staff, and the subsidiaries, and a need for improved formal reporting and communication structures and procedures.

Our comments about the context for the property investments

2.32 Delta's decisions to invest in the land at Luggate and Jacks Point need to be assessed in the context of Delta's operations, the expectations of the holding company and the Council, and the governance culture in the Council group at that time.

2.33 The investments were part of Delta's broad strategy of looking for new ways of securing work in Central Otago, which was, at that time, considered a growth area.

2.34 Delta's broad strategy had been endorsed by its shareholder, the holding company. The strategy was consistent with statements of intent of Delta and the holding company, and pre-dated but fitted with the Council's requiring increased distributions from the group from 2006.

2.35 The Council needed increased cash from dividends, which suggests that the holding company's board should have encouraged the subsidiaries to enter into ventures that would earn more cash rather than ventures that might lock up cash (such as property development). However, it is not quite that simple. As a contracting company, Delta's way of earning cash was through making a profit on its contracting activities. Delta was looking for new ways of getting contracting work to generate more cash, including by investing in property.

2.36 The holding company's records from late 2006 show that senior council staff and the Mayor would have known about Delta's growth strategy of moving into other South Island markets, particularly in Christchurch and Central Otago. The Mayor and senior council staff were attending board meetings of the holding company,

13 Without clear direction from either the Council or Dunedin City Holdings Limited, this was essentially a matter for the subsidiaries' judgement.

and, at that time, the Council and the holding company regularly discussed the Council's requirement for extra dividends.[14]

2.37 Neither the holding company nor the Council discouraged Delta from seeking growth opportunities, including in residential property developments in Central Otago.

2.38 There were no formal discussions between the Council, the holding company, and Delta about Delta's growth strategy and approach to managing risks. Without any clear direction from either the Council or the holding company, the appetite for risk was essentially a matter for judgement by Delta. Council officers involved at the time saw this as the responsibility of the holding company rather than the Council. The officers said that it was not realistic to expect councillors to articulate to company boards their appetite for commercial risk except in the most general way.

2.39 We agree that the holding company had responsibility for commercial governance of its subsidiaries under the Council's governance structure. However, local authorities are required to consider and express their views on risk management from time to time in their investment policy[15] and those with council-controlled trading organisations need to have an effective governance regime to manage their risks, including through the statement of intent process. This is part of prudent financial management, which is a Council responsibility. If councils lack the required capability in that area, they need to get advice from staff or external support.

2.40 We will consider how other local authorities approach this matter in our study on council-controlled organisations.

14 Minutes of the holding company's board meetings in September and October 2006 refer to Delta looking at developments in Wanaka and the Queenstown Lakes district, and its efforts to move into the Christchurch and Central Otago markets as much as possible.

15 A local authority's investment policy must state the local authority's policies for investments, including how risks associated with investments are assessed and managed (section 105 of the Local Government Act 2002). Council-controlled trading organisations are usually regarded as a form of investment.

Part 3
Investing in the Luggate Park development

3.1 In this Part, we discuss:

- Delta's intention to look for growth opportunities in residential property development before investing in Luggate;
- the Luggate Park development and the opportunity to invest in it;
- how Delta considered the opportunity and the risks;
- negotiation of the terms of a joint venture to develop land at Luggate Park;
- the structure of the joint venture to develop land at Luggate Park;
- how the value of the land was determined; and
- the final approval for the joint venture.

3.2 We then comment on Delta investing in the Luggate Park development.

Summary of our findings

3.3 In our view, Delta went through a careful and reasonable process when getting into property development at Luggate. Delta approached the investment cautiously and sought legal and tax advice. The land value was agreed after a negotiation process and was based on an independent valuer's report.

3.4 We found no evidence that any inappropriate motivation influenced Delta when it entered into the joint venture at Luggate.

3.5 Delta managers and Mr Coburn identified risks to the project at key decision-making points, including when the approval of all Delta directors was sought. Delta's joint venture subcommittee told directors that all those risks had been considered. However, we did not see any real consideration or analysis of the risk of the market slowing or that there could be less demand for sections than estimated.

3.6 Delta's tax advisors had strongly recommended that Delta get expert advice about the financial projections for the development. In our view, it is unfortunate that Delta did not do so. The director with the most property development experience could not be involved because of a perceived conflict of interest. This was even more reason to get expert advice before committing to the joint venture.

3.7 We found instances of Delta choosing artificial structures for carrying out its business activities. These structures involved legally unequal ownership or governance arrangements, but the parties had no intention that they would operate unequally in practice. From the material we have reviewed, the purpose of these structures was to avoid the accountability requirements of council-controlled organisations. In our view, such a move is inappropriate for a public entity.

Delta Utility Services Limited's search for opportunities in residential property development

3.8 Delta's growth strategy for 2004 to 2006 included looking for new ways of working. In 2004, Delta and an infrastructure design company formed a new joint venture company, Fulcrum Partners Limited (Fulcrum). The joint venture's purpose was to look for opportunities in the South Island to build and operate infrastructure in residential subdivision developments of more than 500 lots. Fulcrum would either manage the construction of the infrastructure assets or buy them from the developer if they had already been built. Fulcrum would then maintain and operate the assets and charge home-owners a fee for doing so.

3.9 The parties referred to this as the "Fulcrum concept". The concept needed the relevant local authority to agree to Fulcrum maintaining and operating the infrastructure assets. The more common model is for the developer to build the infrastructure assets, then to vest them in the local authority to maintain and operate.

3.10 The joint venture company was structured so that the private sector partner owned one share more than Delta and had the right to appoint one more director.[16] This arrangement was deliberate. It meant that Fulcrum was not a council-controlled organisation, so it was not publicly accountable.

3.11 In early 2004, Fulcrum identified developments at Jacks Point (near Queenstown) and Pegasus (near Christchurch) as potential opportunities. However, the developers of those sites did not proceed with Fulcrum's proposal. Fulcrum identified several other possibilities in Central Otago and Canterbury, including a residential subdivision project at Luggate, known as Luggate Park.

The Luggate Park development

3.12 Luggate is a small settlement between Wanaka and Cromwell. It is about 10 kilometres east of Wanaka on State Highway 6 and has a population of about 400 people.

3.13 Luggate Park is about 77 hectares and surrounds part of the existing Luggate township. At the time of the proposed development, the land was subject to four different zonings under the Queenstown Lakes District Council's district plan – township, residential, rural residential, and rural general.

3.14 In February 2004, Luggate Holdings Limited bought the land to develop a subdivision.

16 Delta appointed three of its board members as directors of Fulcrum (Ray Polson, Ross Liddell, and George Douglas). The private sector partner also appointed three directors but never exercised its right to appoint a fourth.

3.15 Luggate Holdings Limited bought the land from Luggate Village Holdings Limited, a company in which Delta director Mike Coburn had a 50% interest. Luggate Village Holdings Limited had owned the land from July 2003 to February 2004.[17] The land transfer records show that two mortgages were put in place when Luggate Holdings Limited bought the Luggate land. One was to a bank, and the other was to Mr Coburn's company as a vendor mortgage. These were both discharged in February 2005, when a mortgage was arranged with a different bank.

3.16 The planned subdivision development at Luggate Park was for 255 lots, to be developed in two main stages. Stage 1 involved residential lots next to the existing township, and stage 2 would develop more lots in areas zoned residential, rural residential, and rural general. The different areas of the development were known as 1A and 1B (stage 1), and K, 2A, and 2B (stage 2).

3.17 Construction[18] of the Luggate Park subdivision began in 2004 after stage 1 received resource consent. Property titles were issued for 83 lots in areas 1A and 1B.

3.18 Stage 2 of the Luggate Park subdivision involved about 56 hectares of:

- 24 larger lots on an elevated plateau that overlooked the rest of the development on one side and the Clutha River on the other (stage 2B);
- 10 lots zoned "rural residential" (stage K); and
- 138 smaller lots on a large bit of flat land (stage 2A).

How the Luggate opportunity arose

3.19 Luggate Holdings Limited, the owner of the Luggate Park land, was a company in which Mr Boult and other beneficial shareholders had interests.[19] Mr Boult was one of two directors of Luggate Holdings Limited when that company bought the Luggate Park land. As we explain later in this Part, the joint venture structure that was eventually negotiated involved several companies and was reasonably complex.[20] However, it is clear from the documents we reviewed and from our interviews that, although there were other beneficial shareholders and another director, in practice Delta was primarily negotiating with Mr Boult about entering into the joint venture. Where appropriate, we refer to the interests of Mr Boult and the other beneficial shareholders in the Luggate land as "the Luggate interests". However, in most circumstances, we have simply referred to Mr Boult.

17 Mr Coburn told us that he and a financial partner owned the land briefly but did not intend to develop it.

18 By construction, we mean providing infrastructure services such as roading, water, wastewater, communications, and power for the developed residential lots in the subdivision.

19 Companies Office records show that Mr Boult and Neil Macdonald jointly hold the 100 shares in Luggate Holdings Limited. The joint ownership indicates that the shares are held under a trust arrangement. Mr Boult confirmed this, and said that, in total, six people had varying interests in the company.

20 Later in this report, we sometimes refer to "the Luggate companies" to describe the other joint venture partner.

3.20 Delta had talked with Mr Boult about the Fulcrum concept in 2004 and 2005. They had agreed that the Luggate Park development would be a good candidate. However, they could not get the Queenstown Lakes District Council's support so decided not to proceed with the Fulcrum concept there.

3.21 In May 2006, in response to interest from Delta in such a venture, Mr Boult on behalf of the Luggate interests offered Delta the opportunity to buy into the Luggate Park subdivision development. Before this, Delta had done some contracting work at Luggate Park during stages 1A and 1B of the development, and Aurora Energy Limited had entered into capital works agreements for electricity assets at the subdivision.

3.22 The option of buying into a residential subdivision development was a different sort of business opportunity than Delta had previously considered. It was a departure from Delta's core business at that time. However, Delta was looking for new opportunities and was interested in investing in property development with an experienced partner. The option to buy into Luggate arose a few weeks after the Council first advised the holding company of its requirement for extra dividends.

3.23 In his May 2006 letter, Mr Boult:

- referred to his previous discussions with the chief executive about property development in Central Otago and various other developments he was involved in.
- advised that stage 2 of the Luggate Park development was the best prospect for a joint venture with Delta.
- said that stage 1A had been completed with titles issued and that all but one of the lots had sold. Work was under way on stage 1B, and 35 of 37 lots in this stage[21] had been sold and were due to settle in late 2006.
- suggested that there was the opportunity to look at stage 2 of the development (the undeveloped and yet to be consented land) as a standalone project that might suit a joint venture.
- noted that there were three parts to stage 2 – 2A, 2B, and K – involving a total of 172 lots. The lots were a mixture of "high end" lots that looked out over the Clutha River, rural residential lots, and a significant number of smaller and cheaper residential lots.
- noted that stage 2 would be one of the last subdivisions to qualify for cheaper local authority development contributions for roading, water, and other infrastructure, which should make the sections cheaper than those on offer in the area in the future.

21 Later information referred to seven lots in stage 1B that remained unsold, so not all of these planned sales eventuated.

- said that stage 2 was subject to resource consent but that the outcome should be known by late 2006 or early 2007.

3.24 On behalf of Luggate Holdings Limited, Mr Boult provided a financial model for stage 2. He said that the model was reasonably conservative but a basis for discussion. He estimated that the gross sales value of the stage 2 lots would be $30.3 million and that the development should yield a return of about $7.5 million (about 33% of total expenditure). For the purposes of the model, Mr Boult valued the land at $10.75 million. However, he said that Luggate Holdings Limited would be happy to sell the land at valuation. He noted that the model assumed that the land would be sold to the joint venture when resource consents had been issued. He also noted that the joint venture would own the land free of debt but borrow development costs.

3.25 Mr Boult also noted that the proposal could ensure development work for Delta for the subdivision, subject to a transparent arrangement for that work.

How Delta Utility Services Limited considered the opportunity and the risks

3.26 Delta managers considered Mr Boult's proposal. In July 2006, they recommended that the Delta directors:

- agree in principle to forming a joint venture to develop stage 2 of the Luggate Park subdivision after resource consents had been issued; and
- determine which of the directors would work with management and Mr Boult to finalise the joint venture.

3.27 Delta managers said that a joint venture company would be formed to oversee development and construction of stage 2 of the subdivision. Delta would have one less share than the Luggate interests but equal board representation. The parties later decided to use an unincorporated joint venture rather than a company and agreed that each party would have a 50% interest in the joint venture but there would be unequal board representation.[22]

3.28 Delta managers gave the directors Luggate Holdings Limited's financial projections for the property development. They noted that the projections would require testing, and said that this would be the initial and ongoing responsibility of the joint venture board that would be established.

3.29 Managers identified the following risks to the joint venture partners:

- *Disputes*
- *Market slowing*
- *Liabilities – professional, construction, regulatory*

22 As with the structure of Fulcrum, the ownership structure was to avoid the joint venture being a council-controlled organisation.

- *Termination/exit arrangements*
- *Negative reaction by others, limiting individual opportunities for the parties. This risk is assessed to be small in regard to the Luggate opportunity, but larger as/if the JV moves to subsequent opportunities.*

3.30 Most of these identified risks eventuated to some degree, and the venture was drastically affected by the lack of market interest. We comment on Delta's approach to considering risks at the end of this Part.

3.31 Managers summarised the proposal as follows:

> *… this proposed* [joint venture] *represents an opportunity for DELTA to become involved in the marketing and development of a specific parcel of land. This will assist DELTA to decide its final appetite for such activity. In return DELTA offers Mr Boult "partnership" with a very capable development construction company. While DELTA will benefit from the opportunity to price construction work to a related party, the scale of the target development is such as to limit this benefit at the outset. Accordingly, the proposal is more in the nature of a learning opportunity.*

3.32 At this time, Mr Coburn told managers that he used to own the land and that he understood that there were major planning problems with stage 2 of the development.[23] Managers responded that Mr Boult was working through those matters. They also noted that Delta would not enter the joint venture until the land had been consented.[24]

3.33 A report to Delta directors in early 2008 summarised why Delta had wanted to get into property development in 2006. The 2008 report noted that Delta directors agreed in 2006 that Delta should explore involvement with land development:

- as a means of developing wider knowledge of a market that was important to its civil and electrical contracting businesses;
- to gain access on preferential terms to work for its civil and electrical businesses; and
- as a means of improving profitability by "diversifying along the development chain".

3.34 A Delta manager explained this last point to us. In its contracting role, Delta had to compete for work and saw itself at the bottom of the development chain rather than as a decision-maker. It thought that becoming involved in property

23 Email from Mr Coburn to Delta's chief executive on 26 July 2006, after being sent the board paper proposing the joint venture with Mr Boult's companies.

24 As we discuss later in this Part, Delta did enter into the joint venture before all the land had been consented. Stage 2B was under appeal to the Environment Court when the joint venture agreement was finalised and payment made.

development as an owner/decision-maker as well as a contractor would move it higher up the development chain and improve profitability.

Negotiating the terms of the joint venture

3.35 In July 2006, Delta agreed in principle to form a joint venture with Mr Boult[25] for stage 2 of Luggate Park.

3.36 Delta directors and management told us that they were aware that Fulton Hogan had bought land for property development ventures and had found this a good way of keeping its workforce busy in quiet periods. Delta directors and management were open to the idea of Delta taking part in these sorts of ventures as part of Delta's growth strategy and because a competitor had succeeded in doing so.

3.37 Delta formed a joint venture subcommittee to further develop the proposal. It appointed three of its directors (Mr Polson, Mr Liddell, and Dr Evans) as members of the new subcommittee. Delta's chief executive and chief financial officer were also members.[26] Delta was also considering another joint venture opportunity at this time (at Jacks Point), so the subcommittee was formed to consider both proposals.[27]

3.38 Figure 6 shows the members of the joint venture subcommittee from 2005/06 to 2009/10.[28]

Figure 6
Members of the joint venture subcommittee, from 2005/06 to 2009/10

	2005/06	2006/07	2007/08	2008/09	2009/10
Ray Polson (chairman)	✓	✓	✓	✓	✓
Norman Evans	✓	✓	✓	✓	✓
Ross Liddell	✓	✓	✓	✓	✓
Stephen Wilson	✓	✓	✓	✓	✓
John Walsh	✓	✓	✓	×	

× Left during the financial year.

3.39 For the rest of 2006 and throughout 2007, Delta worked with Mr Boult on the structure of the joint venture agreement. The joint venture subcommittee oversaw that work. Both parties were supported by legal and tax advisors who worked on a draft joint venture agreement.

25 Although the joint venture structure that was later agreed involved several companies, at this stage Delta simply referred to the joint venture as being with Mr Boult.

26 John Walsh and Stephen Wilson.

27 Delta Utility Services Limited, minutes, 26 July 2006.

28 The joint venture effectively ceased to operate from mid-2009 when Newtons began to manage the investments.

3.40 Matters that needed to be agreed included:

- the land that would be subject to the joint venture agreement;
- how and when the price of the land would be determined (a December 2005 valuation needed to be updated, and Delta needed to decide whether it wished to get its own valuation);
- what would happen if resource consent was granted in stages;
- the legal structure for the joint venture;
- how Delta would buy into the venture (for example, by using equity or debt);
- the tax effects on the Council group of Delta becoming involved in property development;
- standard aspects of joint ventures, such as how disputes would be resolved and exit arrangements;
- how the venture would be governed and managed;
- how profits would be shared; and
- accountability arrangements, including financial reporting and audit arrangements.

3.41 In December 2006, Delta managers reported to the joint venture subcommittee on the draft joint venture agreement and the above matters. Delta managers advised that:

- Delta should enter into the transaction through a subsidiary (based on tax advice).
- The agreement contained an "out clause" for Delta if resource consent had not been granted by 30 June 2008.
- The joint venture would not proceed if the land value was not within a specified range.
- One of Mr Boult's companies, Armada Holdings Limited (Armada), would manage the project and report to an owner board that would be established. The joint venture was to pay Armada all costs it incurred in managing the business, including a monthly fee to cover Mr Boult's time.

3.42 Managers recommended that the subcommittee seek the Delta board's agreement in principle for the more detailed joint venture arrangements outlined in paragraph 3.41, subject to a satisfactory business plan. The business plan was to be provided when the valuation for the land was available. The Delta board agreed to this.

3.43 In March 2007, Mr Boult updated the financial projections for the Luggate joint venture for the Delta board's consideration. He provided three versions of the financial model:

- "likely" (the expected outcome if they were to do the subdivision then);
- "break-even" (showing that property prices would have to drop by 27% before the joint venture lost money); and
- "optimistic" (the effect of a 10% increase in property prices).

3.44 In our view, this is an example of the parties' tendency to focus on the potential benefits of the joint venture project rather than the risks and worst-case scenario. We comment on this at the end of this Part.

3.45 The parties negotiated the terms of the joint venture agreement further in the first few months of 2007, including the important matter of how the land would be valued. The joint venture subcommittee met in May 2007 to consider the assumptions that would determine the land value, the progress with the resource consent process (noting that a significant condition of the joint venture was for the land to be fully consented), and the financial projections for the development.

3.46 For the financial projections, Delta managers told directors that better information about the likely sale proceeds, development costs, and how long it would take to sell the lots would be available when the land was valued after consents had been issued.

Getting shareholder approval

3.47 On 2 May 2007, Delta directors resolved to proceed with the Luggate joint venture, subject to approval from the holding company and to the joint venture agreement including a clause that tied the land value to a gross profit expectation of 30%.

3.48 On 10 May 2007, Delta sought the holding company's approval to proceed with the joint venture. This approval was needed because Delta's statement of intent required shareholder approval for Delta to acquire shares in a company or organisation, or assets exceeding a total investment of $1 million.

3.49 Delta's summary of the proposal at that time included that:

- Delta and Luggate Holdings Limited would become 50:50 partners in a property development joint venture to develop 172 residential sections for resale at Luggate.
- Delta's participation would be through a fully owned subsidiary, which would hold Delta's share of the joint venture.
- Delta would provide a secured interest-free advance for 50% of the land value.

- Development work would be funded by joint venture bank debt.
- Delta's advance would be repaid in full 20 months after the start of the project and would have a peak of less than $6.0 million.

3.50 Figure 7 shows how Delta managers summarised the financial expectations of the development.

Figure 7
How the managers of Delta Utility Services Limited summarised their financial expectations of the development at Luggate Park

	$million
Sales value of developed lots	30.387
Marketing and selling costs	(1.693)
Development costs	(9.676)
Overheads and funding costs	(0.601)
Land value	(10.750)
Surplus before tax	**7.667**

3.51 Delta managers also noted that:

- The financial projections would be finalised when resource consents were issued and the land valued.
- The agreement entitled Delta to carry out that part of the $9.7 million development work that it had the capacity to do.

3.52 On 15 May 2007, the holding company's board agreed to Delta's proposed involvement in the joint venture and to Delta lending the joint venture $5 million as a secured loan. All of the members of the holding company's board were also directors of Delta (Mr Coburn, Dr Evans, Mr Hudson, Mr Gilks, and Mr Liddell).

3.53 At its meeting on 13 June 2007, the holding company's board noted that Delta was looking at two developments: the joint venture property development in Luggate and expanding into Queenstown with a proposed purchase of a small company. The minutes note that:

- The required capital injection was less than $10 million (and so within the holding company's spending authority from the Council).
- The chairman (Mr Hudson) said that he could brief the Council.
- Three Council officers and the Mayor (Peter Chin) were present for the discussion.

3.54 We have not seen any evidence that the holding company board scrutinised or tested the Luggate investment proposal. It appears that approval was a formality.

Communicating with Dunedin City Council

3.55 At the time of the Luggate investment, governance and communication arrangements between the Council and the holding company were as follows:

- A liaison committee comprised the Mayor, the chief executive of the Council, the chairman of the Council's Finance and Strategy Committee (Councillor Syd Brown), and the chairman of the holding company. The purpose of the liaison committee was to brief the Council on large transactions. Meetings were informal, and minutes were not taken.[29]
- Quarterly meetings arranged by the holding company briefed councillors on holding company matters.
- The Council's former general manager of finance and corporate support, Mr Stephens, was the company secretary of the holding company and attended board meetings. The Mayor and the chief executive were also invited to attend the first part of holding company board meetings for a general update. At times, other senior Council staff attended.

3.56 We asked the Council for records of any specific communication from Delta or the holding company about the Luggate investment. The Council has not found any such records. Senior Council staff and the Mayor would have had some, but not detailed, knowledge of the investment from attending a holding company board meeting in June 2007. More information was provided about Jacks Point, which we cover in Part 5.

3.57 Because the Council has not found any records, we have not seen any evidence from mid-2007 that the chairman of the holding company (Mr Hudson) formally briefed the Council on Delta matters, including Luggate Park. Mr Hudson was a director of the holding company and of Delta when both the Luggate Park and Jacks Point investments were made. He was also a councillor. However, Mr Hudson told us that he did not see himself as a conduit for information to the Council about companies in the holding company group.

3.58 Delta did not publicise the Luggate Park joint venture investment. However, Delta answered questions about it when contacted by the *Otago Daily Times* in September 2008. The investment does not seem to have been known about publicly before then.

29 The Larsen review report stated that, despite best intent, the liaison committee was ad hoc and operated informally. The review considered that the liaison committee needed to be disbanded and replaced with a more formal structure.

Why Newtons Coachways (1993) Limited was involved

3.59 Delta's tax advisors had recommended using a subsidiary to advance funds to the joint venture. Delta arranged to purchase Newtons from the Council and to establish it as a subsidiary of Delta. This was because it was more convenient for Delta to buy Newtons from the Council than to form a new subsidiary.

3.60 The Council had previously established Newtons as a name protection company. However, the Council no longer needed Newtons for that purpose. Newtons was a council-controlled organisation[30] and remained so after it was purchased by Delta. Delta did not appear to realise that Newtons was a council-controlled organisation or think about accountability requirements, such as the need to prepare a statement of intent, when it first purchased the company.

3.61 Delta initially appointed Mr Polson, Dr Evans, and Mr Liddell as directors of Newtons. Mr McLauchlan, Grady Cameron, and Mr Coburn were later appointed as directors in July 2009.

3.62 Figure 8 shows the directors of Newtons from 2005/06 to 2012/13. Newtons was re-named Delta Investments Limited from July 2011.

Figure 8
Directors of Newtons Coachways (1993) Limited/Delta Investments Limited, from 2005/06 to 2012/13

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Ray Polson (chairman)		✓	✓	✓	✓	✓	✓	✓
Norman Evans		✓	✓	✓	×			
Ross Liddell		✓	✓	✓	×			
Stuart McLauchlan					✓	✓	✓	✓
Grady Cameron					✓	✓	✓	×
Michael Coburn					✓	✓	✓	×
Jim Harland	✓	×						
David Frow								✓
Ian Parton								✓

× Left during the financial year.

30 Newtons had no role other than name protection. It did not meet the accountability requirements in the Local Government Act 2002 for council-controlled organisations in the period it was owned by the Council.

Structure of the joint venture to develop land at Luggate Park

3.63 In mid-2007, Delta entered into an unincorporated joint venture to develop and sell the land at Luggate Park for profit. Delta's tax advisors said that an unincorporated joint venture was an appropriate legal structure for the development and would enable the joint venture parties to claim any tax losses.

3.64 Figure 9 sets out the five parties to the Luggate Park joint venture and their roles.

Figure 9
Parties in the joint venture to develop property at Luggate Park

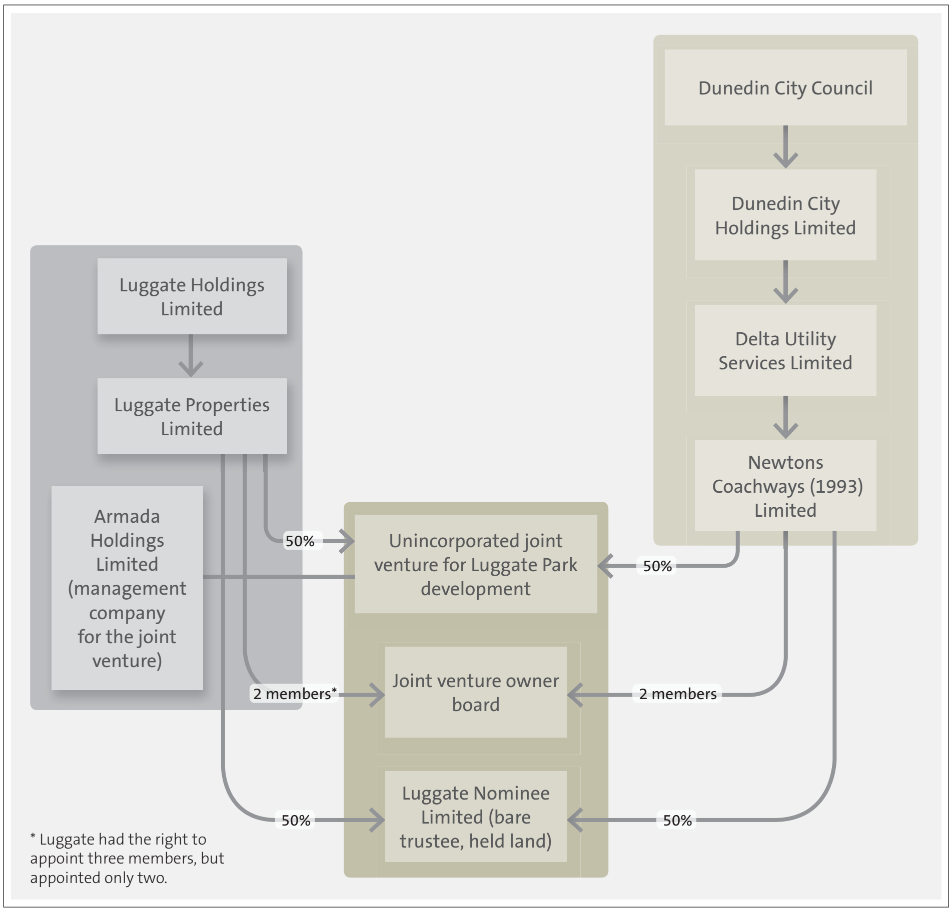
Joint venture party	Main role
Luggate Holdings Limited*	Owner of the land but required to transfer the land to Luggate Properties Limited
Luggate Properties Limited,** a wholly owned subsidiary of Luggate Holdings Limited	Formed for the purpose of the transaction to be the registered proprietor of the land
Newtons Coachways (1993) Limited (a wholly owned subsidiary of Delta Utility Services Limited)	Acquired from Dunedin City Council for the purpose of the transaction Required to advance Delta's funding for the venture to Luggate Properties Limited
Delta Utility Services Limited	Construction company for the joint venture
Armada Holdings Limited, a company owned by Mr Boult and his family	Management company for the joint venture

* Luggate Holdings Limited was incorporated on 23 September 2003. Neil Macdonald was a director from 23 September 2003 until 22 June 2012. David Stock was a director from 10 September 2007 until 27 August 2008. Mr Boult is the only current director and was appointed on 23 September 2003. The 100 shares are held jointly by Mr Boult and Mr Macdonald.

** Luggate Properties Limited was incorporated on 29 May 2007, and was removed from the Companies Register on 25 February 2014. Mr Boult was a director from 29 May 2007 to 25 February 2014. Mr Macdonald was a director from 29 May 2007 to 22 June 2012. Mr Stock was a director from 6 May 2008 to 27 August 2008.

3.65 Figure 10 shows the structure of the Luggate Park joint venture.

Figure 10
Structure of the joint venture to develop land at Luggate Park



3.66 Delta and Luggate Holdings Limited used new subsidiaries for the transaction. The joint venture agreement required one of the new subsidiaries, Luggate Properties Limited, to have no activities other than its functions under the joint venture agreement. This was to ensure that it was a "clean" company that was not subject to any other business obligations.

3.67 The subsidiaries were the active parties (the participants) in the joint venture once it was established. The joint venture agreement required them to form a new company to hold the land as a trustee for their interests in the joint venture and to sell the individual lots after they had been developed. The company was named Luggate Nominee Limited. Each joint venture party owned a 50% share in it and appointed one director.[31]

31 Luggate Nominee Limited was incorporated on 25 January 2008. There are two shares, one owned by Luggate Holdings Limited and one owned by Newtons (now called Delta Investments Limited). Mr Boult and Mr Polson are directors.

3.68 Luggate Nominee Limited held the land as trustee as follows:

- It held the interest of Luggate Properties Limited in the *unimproved land* solely for that company.
- It held the interest of the joint venture in the *improvements to the land* carried out under the development for the joint venture.

3.69 We describe funding, governance, and management arrangements in the next Part.

Working out the value of the land

3.70 The land subject to the joint venture was the undeveloped land in stage 2 (about 56 hectares) and unsold lots in stage 1. Luggate Holdings Limited had applied for consent to subdivide the land in stage 2 of Luggate Park.

3.71 The joint venture agreement was to have full effect when resource consents were issued. Either party could withdraw if this had not happened by 30 June 2008. However, the joint venture agreement provided that the arrangement could be restructured if consents were issued in phases, provided the parties considered that it was economic to proceed.

3.72 In mid-2006, Mr Coburn had said that he understood that there were some planning issues with the land. He raised this again in late 2007, when Delta managers sought approval from directors to proceed with the joint venture. In mid-2006, Delta managers had been clear that the agreement would proceed only if the desired land use was consented. Mr Boult had said the same in his communications at that time.

3.73 Consents were issued for the proposed subdivision of stage 2A of the land in September 2007. However, they were declined for stage 2B. Luggate Holdings Limited appealed that decision to the Environment Court, and consent for stage 2B was eventually granted in October 2009.

3.74 The parties amended the joint venture agreement in early 2008 to state that, despite the delay with consent, the stage 2B land would be developed on the same terms that applied to the land that consent had been granted for.

3.75 The joint venture agreement provided that:

- the land would be independently valued;
- for the purposes of working out the value of the land, only the consented land would be valued;
- the valuer had to take account of the parties' expectation to make a net profit of 30% on the sale of each lot, after deducting development costs; and

- if the land value was below a specified amount, Luggate Holdings Limited could withdraw and, if it was above a specified amount, Delta could withdraw.

3.76 When the joint venture agreement was amended in 2008 (because of the delay with resource consent for stage 2B), the parties did not amend the clause that said that only consented land would be valued for the purpose of determining the land value.

Valuation reports

3.77 The parties used a valuer who had previously valued the land for Luggate Holdings Limited. The valuer reported to the parties in October 2007, valuing the consented and unconsented components of the Luggate Park subdivision at $14.42 million. This was the stage 2 land known as 2A, 2B, and K, and the unsold lots in stages 1A and 1B.

3.78 The valuer's report discussed growth and property sales in Queenstown, Wanaka, and Cromwell. It noted that, although the rate of growth in Wanaka had slowed in 2006 and 2007, affordable land in the district was in demand. Developments in Luggate and nearby Albert Town could meet that demand. The report's main conclusions were that:

- There would be a significant reduction in sale rates in the short term, based on the current status of the market and competing subdivisions in the Southern Lakes region.
- The township of Luggate would maintain reasonable demand in the short term. Sales would be at the market level, but there would not be speculation for investment purposes.
- It would take longer to sell sections, in line with the general market activity in the region.

3.79 The land was valued for mortgage-lending purposes using a method of discounted cash flows and a hypothetical subdivision, taking into account the estimated costs of developing each lot. Based on development costs for stages 1A and 1B and industry averages, the report assumed that it would cost $55,000 to develop each lot.

3.80 The valuer updated the estimated land value several days later after reducing the number of lots on the upper plateau in stage 2B by 15. This was in keeping with revised plans for that part of the development and because resource consent had been delayed. This led to a revised value of $13.46 million.

3.81 The overall land value in the valuation report included the value of the unconsented land and the likely sales values of that land. The parties considered that the unconsented stage 2B land had a value of $1.5 million. They appear to have included the value of that land because they considered it likely that consent would be issued, rather than determining the value after consent had been granted. This was contrary to the original intention of the parties, as stated in the joint venture agreement, that only consented land would be included when determining the land value.

Reaching agreement to proceed

3.82 Delta's joint venture subcommittee considered the valuation report in November 2007. One of Delta's directors on the joint venture subcommittee, Mr Liddell, had concerns about the quality of the valuation report. His concerns included that the expected sales value of the developed lots was too high and the estimated development costs were too low. He also thought the unconsented land should be excluded. Mr Liddell said:

> *All in all, I think we have to be really careful, even though we want some contracting work.*

3.83 Delta managers carried out financial analysis to test Luggate Holdings Limited's financial projections and the assumptions in the valuer's report. This analysis looked in particular at development costs, likely sales values, and profit margins. In early December 2007, Delta managers recommended that the joint venture subcommittee proceed with a land purchase price of slightly less than the amount Luggate Holdings Limited was seeking. That price was about $1.4 million less than the revised valuation report.

3.84 The joint venture subcommittee met on 6 December 2007 to discuss the recommendation. Mr Liddell said that he thought the land was worth nearer $10 million than $13 million. However, the subcommittee agreed to advise Mr Boult that Delta would go ahead with the joint venture at a land cost of $12 million, after Delta staff had reviewed the estimated development costs for the consented lots and confirmed that they would not exceed the $8.07 million included in the valuation.

3.85 Mr Boult then proposed to take nine developed lots out of the joint venture that were ready to be sold, with the effect of reducing the land value to $10.715 million. Mr Boult sought Delta's agreement to share in the costs of undergrounding overhead power lines that crossed part of the development. Delta agreed to these changes.

3.86 Delta staff had reviewed the estimated development costs and considered them higher than forecast by the valuer and Luggate Holdings Limited. Delta staff wanted to decrease the land value by the difference (from $10.715 to $10.461

million). Delta's records note that Mr Boult verbally agreed to this amount at that time. The parties later agreed to a slightly increased amount of $10.7 million after further changes to the land included in the joint venture.[32]

3.87 Figure 11 summarises the process used to determine the agreed land value of $10.7 million.

Figure 11
Process used by Delta Utility Services Limited to determine the land value at Luggate Park

Event and timing	$million
October 2007 valuation report – consented and unconsented land; stages 2A, 2B, and K; and unsold lots in stages 1A and 1B	14.420
October/November 2007 – valuation report amended to reduce the number of lots in stage 2B by 15 lots	13.460
December 2007 – value is reduced when nine developed lots ready for sale are taken out	10.715
December 2007/January 2008 – value reduced at Delta's request to reflect development costs that are higher than forecast	10.461
April 2008 – parties agree to increase in land value after one developed lot is removed and three added	10.700

3.88 The joint venture subcommittee agreed on 19 December 2007 to recommend that the Delta board go ahead with the proposal, subject to confirmation that Delta, through Newtons, would have an equal say in all joint venture decisions. Managers confirmed this.[33]

3.89 On 20 December 2007, Delta staff, on behalf of the Delta directors on the joint venture subcommittee (Mr Polson, Mr Liddell, and Dr Evans), sought approval from the other Delta directors (Mr McLauchlan, Mr Hudson, Mr Douglas, and Mr Coburn) to proceed with the joint venture development.

3.90 In seeking approval, Delta staff set out the background to the proposal in some detail. The background included revised financial projections and stated that the development was expected to take 27 to 36 months. Delta staff noted that the joint venture would acquire the unconsented land as part of the arrangement.

32 In April 2008, the parties agreed to increase the land value to $10.7 million after the Luggate companies withdrew one of the developed lots from the joint venture but added three more. The joint venture agreement was amended by deed to reflect the increased land value.

33 Although the joint venture agreement provided for Luggate Properties Limited to have an extra representative on the joint venture owner board, Mr Boult had told Delta in May 2007 that the company would not exercise that right.

Final approval of the joint venture

3.91 There has been speculation about, and interest in, which directors voted to support the Luggate investment. Their approval was sought by email. Each director replied by email on 21 December 2007, copying all concerned. We note their responses in the sequence that they were given.

3.92 Mr McLauchlan, who was appointed to the board in July 2007, said:

> *I have not been aware of the detail of this deal until reading this email. We have a subcommittee of the board who have been working on this deal and if they are in agreement... I will vote in favour. I would like to know* [Mike Coburn's] *thoughts on this as he has a lot of experience in this area.*

3.93 Mr Hudson said:

> *I agree to support the subcommittee's recommendation but with a degree of nervousness.*

3.94 Mr Douglas said:

> *I have been keeping in touch with developments on Luggate and although I do not have the detail that the subcommittee has and the venture is not as good as first envisaged I consider the venture is still worthwhile. Delta should learn a lot from the experience.*

3.95 These three directors were relying on the work of the joint venture subcommittee, made up of three of their fellow directors and two Delta managers. The directors and managers were particularly keen to hear Mr Coburn's views. Mr Coburn gave a longer response:

> *Everyone is aware because of a perceived conflict of interest I've had little or no information on the project, nor have I had any input into any of the discussions but based on my knowledge as a developer of substantial subdivisions in the Queenstown Lakes District Council, I comment as follows, not in any way criticising the process that has taken place, only to ensure that all directors are aware of the risk in a project such as this, bearing in mind I am a director/shareholder of the company that sold this parcel of land to JB's company in the first place.*

3.96 Having declared his previous interest in the land and his perceived conflict of interest, Mr Coburn then raised questions and concerns about:

- the development costs, which he thought were too low and should be nearer $10 million;

- whether all contributions payable to the Queenstown Lakes District Council had been taken into account;
- the forecast gross revenue of $28.5 million from sales of the developed sections, which suggested an average sale price of $217,000 for each lot – he thought an average sale price in the range of $150,000 to $170,000 was more realistic;
- the land (stage 2B) not having been consented – because this consent could be difficult to obtain, he would allocate no value to that land;
- the ambitious timeline to develop and sell lots – 40 to 48 months was more realistic;
- profit – profit for such developments was usually in the last 25% of sales;
- interest costs, which were likely to remain high; and
- the significant effort and risk to secure $5.3 million of work for Delta.

3.97 Mr Coburn ended his remarks with:

> *Just a few comments for consideration based on little information. I am sure the subcommittee have considered all the risks in making their recommendation. I wish to abstain from voting for obvious reasons.*

3.98 Mr Polson responded to his fellow directors, saying that he had asked managers to draft a response to Mr Coburn's comments. Mr Polson said:

> *Suffice to say the subcommittee canvassed all those risks and were satisfied on balance. Naturally there are development risks – we need to take those or not get involved in property development at all. There will be lessons learned for sure.*

3.99 Later that day, the Delta staff member who had been the most closely involved with the project emailed directors in response to Mr Coburn's comments. The staff member began with:

> *For the avoidance of any doubt I do not profess to have any expertise in this field and the comments* [given below] *relate to the discussions that have occurred inside the JV committee ...*

3.100 The staff member noted that managers had confidence in the value of the construction work that Delta would get from the joint venture. However, the underlying problem had always been working out the likely sales value of the developed sections and when sales would take place. The joint venture subcommittee had noted that a 25% reduction in sale prices would still leave the venture in a positive position, and Delta would still profit on the expected construction work by about $1 million. The staff member then provided detailed responses to each of the issues Mr Coburn had raised, based on work by the joint venture subcommittee.

3.101 In response to Mr Coburn's comment that he would allocate no value to the unconsented land, the staff member noted that the financial assumptions for the development gave this part of the land a value of $1.5 million, and Mr Boult was optimistic that consent would be granted. However, if consent was not given to develop it into smaller lots, it could be sold as two 10-hectare lifestyle blocks. Even if that land had no value, the profit margin on the whole deal would reduce by only 2%, from 30% to 28%.

3.102 Managers contacted Mr Boult later that day, confirming that Delta had agreed to proceed. The joint venture agreement was amended to reflect the agreement on the value of the land and some related matters (such as agreement to share the cost of having underground power cables). The agreement was also amended to reflect that resource consent had not yet been issued for the stage 2B land, but that land would be developed on the same basis as the consented land when consent was given.

3.103 In late December 2007, on behalf of the Luggate companies, Mr Boult signalled that the joint venture agreement should be further amended to reflect that the joint venture parties would negotiate in good faith an additional payment above the agreed $1.5 million value of the stage 2B land for any added value that land would have when consent was granted. Delta's initial response was not positive. It considered that any gains from the rezoning of the stage 2B land once consent was given should benefit the joint venture. It appears that Mr Boult did not pursue this matter further.

Immediate attempts to change the agreement

3.104 In early January 2008, immediately after Delta directors had agreed to proceed with the joint venture at the agreed land value, Mr Boult sought to change the funding structure. He proposed that the joint venture borrow $4 million from the bank up front. This would have raised an extra $2 million for Luggate Holdings Limited at the start of the joint venture.

3.105 Although this would have reduced the amount of Delta's advance to the joint venture (through Newtons) by $2 million, it would have meant that Newtons owed $2 million of the bank debt, and the bank would have a mortgage with priority over Newtons' mortgage. This would have reduced the priority of repayment of Delta's funding and increased Delta's risk.

3.106 Delta managers sought guidance from the joint venture subcommittee. In doing so, managers referred to Mr Polson's view that the market was tightening and risks rising. Managers noted that "his view is the deal is either as it has been agreed or there is no deal". The joint venture subcommittee was concerned about the attempt to change the deal so soon after it had been agreed. The subcommittee did not think that this boded well for the project. It said that the agreed funding arrangement was not negotiable. The Delta board endorsed this decision.

3.107 For a short time, it looked like the venture might not proceed. In early February 2008, Mr Boult proposed some other funding options to get the venture "back on track". These options included Delta lending an additional $2 million to the venture or taking a bigger share of about 70% or even 100% in the venture. However, Mr Boult proposed that he still manage the project under a profit-sharing arrangement.

3.108 Delta was concerned about these requests to change the funding basis. In early February 2008, managers and directors were ready to walk away from the deal. However, they were reluctant to do so because of the time and effort they had put into it.

3.109 On 27 February 2008, several Delta directors discussed the deal with Mr Boult at a Delta client function in Queenstown. Mr Boult proposed another variation on the deal to Delta managers the next day. He noted that some directors were keener to proceed than others.

3.110 In late February 2008, Delta told Mr Boult that the directors were not prepared to depart from the previously agreed funding arrangements. However, they were willing to proceed with the previously agreed arrangements or to end the agreement if Mr Boult wished to go ahead with another party.

3.111 In early March 2008, on behalf of the Luggate companies, Mr Boult agreed to proceed with the deal as previously agreed.

Our comments on the decision-making process

3.112 We have assessed Delta's decision to enter the joint venture against relevant requirements of the Local Government Act 2002 and the Companies Act 1993.

Local Government Act 2002

3.113 As a council-controlled trading organisation, Delta is subject to the requirements of the Local Government Act 2002.

3.114 The statutory objectives of a council-controlled organisation include:

- achieving the objectives of its shareholders, both commercial and non-commercial, as specified in its statement of intent; and
- carrying out its affairs in accordance with sound business practice (if the council-controlled organisation is a council-controlled trading organisation).

3.115 The second of these objectives is most relevant to how Delta made decisions about Luggate Park.

Did Delta make decisions in accordance with sound business practice?

3.116 Delta went through a careful and reasonable process to consider the opportunities presented by getting into property development, including finding a partner to work with. Mr Boult had property development experience, and Delta had worked with him before (including at Luggate Park).

3.117 Delta did not rush into the decision. It took the decision in stages, from agreement in principle to forming a joint venture subcommittee to work on the detail, to detailed negotiations about the legal structure, to a final decision. The process took just under two years.

3.118 Delta managers and directors approached the investment cautiously. The managers got legal and tax advice to support their advice to directors, where necessary. Delta's board questioned and tested the financial projections (including the estimated development costs, the likely sales proceeds, and the land value). The land value was agreed after negotiation, using the independent valuer's estimate as a starting point.

3.119 The business case for the project was essentially the financial projections and the expectation that Delta would profit when properties sold and from the construction work. This would contribute to Delta's growth strategy and ensure work for Delta's staff in Central Otago. The Delta directors we spoke to were clear that they had to keep their staff in work after expanding Delta's operations in the South Island.

3.120 Delta managers and Mr Coburn identified risks to the project at the main decision-making points, and the joint venture subcommittee said that it had considered all of those risks. However, we did not see any real consideration or analysis of the risk of the market slowing or that there might be less demand for sections than estimated.

3.121 The joint venture partners expected profits of 30% of the value of the venture or about $7.5 million. Delta expected to make a further $1 million profit from the contracting work. Managers said that, even with a 25% fall in property prices, the project was viable, and Delta would get the benefit of the contracting work.

3.122 The risk assessment was more focused on the financial model and the accuracy of its assumptions, such as development costs, and when Delta could expect to make the profit, not on what might happen if some or all of the lots failed to sell.

3.123 Operating a business and having a growth strategy for the business involves a certain element of risk-taking. In this instance, the directors were looking for new ways of generating income and dividends. The directors understood that getting into property development was higher risk than their contracting business. However, they regarded the Luggate opportunity as a “learning exercise” for their business. They expected the company to learn and benefit from working with an experienced property developer and had a reasonable expectation that sales would result from the property developer’s marketing expertise.

3.124 A significant risk to property development is timing, because market changes can delay profits. The estimated time of 27 to 36 months for sales and profit proved to be optimistic. Delta did not appear to consider how long it might need to wait for returns and how this might affect the rest of its operations.

3.125 The likely development costs being higher than first estimated – despite Delta having carefully considered these costs – affected the project’s viability. Because of the estimates’ significance to the venture’s success, Delta could have had the estimates independently reviewed.

3.126 Delta’s tax advisors had strongly recommended that Delta get expert advice about the financial projections for the development before committing to the joint venture. In our view, it is unfortunate that Delta did not do so. Delta has noted that it is always easier to judge the outcome of a business investment retrospectively than to assess risks to growth opportunities in advance. The directors did not predict the change in the property market or the duration of its effects. They do not consider that seeking any further advice at the time would have changed that.

Did Delta pay too much for the land?

3.127 From the start, the parties intended the joint venture would start when resource consents were granted. However, as negotiations progressed, the parties decided to include the unconsented stage 2B land in the land value and, therefore, in the price Delta paid to enter into the venture. They agreed that the unconsented land had a value of $1.5 million, so the extra cost to Delta at that time was $750,000.

3.128 The joint venture agreement was amended in January 2008 to state that the stage 2B land would be developed on the same basis as the land that had received resource consent. However, this amendment did not address the fact that the joint venture agreement provided that only consented land would be included when determining the land value.

3.129 Mr Coburn had raised a concern in late December 2007 about the unconsented land and whether it had any value. Delta managers said that, even if the unconsented land had no value, Delta's profit would reduce only slightly. They made it clear to directors that the price included the unconsented land, but not that this was contrary to the original intention or the joint venture agreement. It is not clear that the parties or their advisors turned their minds to this at the time.

3.130 Delta proceeded on the basis of Mr Boult's confidence that consent would be granted. They did this against their original intention and despite Mr Coburn's comment that he would allocate no value to the unconsented land. This raises the issue of whether Delta paid too much for the land or whether it was just a timing matter, because consent was eventually granted. In our view, the fact that consent had not been given for part of the land was reason for caution, and Delta should not have paid for the value of the unconsented land when entering the joint venture.

3.131 Delta's loss might have been less if the parties had kept to their original intention. Delta notes that the judgement that consent would be granted proved to be right. However, a more cautious approach would have been to reconsider whether it was economic to proceed with stage 2B (and pay for a share of that land) when consent was granted, considering the sales of the consented and developed sections and the market at that time.

Compliance with other accountability requirements in the Local Government Act

3.132 The Local Government Act states that decisions must be made by, or under the authority of, the board of the council-controlled organisation and in accordance with its statement of intent and (for a company) with its constitution.

3.133 The statement of intent is an important accountability and authority mechanism for a council-controlled organisation, because it ensures that the council-controlled organisation operates within broad parameters approved by the shareholder.

3.134 Delta's statements of intent for the relevant periods contained general objectives about expanding its business to provide returns to its shareholder. These objectives included growing the company into a leading business, further diversifying and expanding the company's activities in operating and managing utility assets, and maximising financial returns and the value added by the company and its financial strength.

3.135 The Delta directors' decision to enter into the Luggate joint venture was in keeping with Delta's growth strategy at that time. Its shareholder, the holding company, approved that decision. We would not expect a statement of intent to specifically authorise a particular transaction, such as the Luggate joint venture. However, we would expect any such investment to be within the broad parameters of the statement of intent – and it was.

3.136 Newtons did not have a statement of intent when the investment was made. We comment on this in the next Part.

Legal structures and accountability arrangements

3.137 The Fulcrum company and the Luggate joint venture had unusual legal structures. These structures were designed to give Delta a slightly smaller interest than the private sector partner and, therefore, to ensure that neither entity was a council-controlled organisation.[34] However, both entities operated on an equal basis in practice, because neither private sector partner exercised its right to appoint an additional board member.

3.138 At a significant point in the decision to proceed, Delta directors sought assurance from managers that they would have an equal say in all matters concerning the Luggate joint venture, and managers gave this assurance. This was not entirely consistent with the joint venture agreement, but it did operate that way. Delta knew from an early point in negotiations that the other joint venture partner did not intend to exercise its right to appoint an extra representative to the joint venture owner board.[35]

3.139 The result of the unequal structures was that the entities were not subsidiaries or council-controlled organisations. The accountability framework set out in the Local Government Act therefore did not cover them. That framework includes public statements of intent, annual reports, and public audit. For subsidiaries, it also includes consolidation and reporting in Delta's group financial statements.

3.140 It is open to a commercial entity such as Delta to choose other legal structures for carrying out its business. However, in this instance, the entities were structured in an artificial way – the parties were legally unequal but had no intention of operating unequally. From the material we have reviewed, this was done to avoid the accountability requirements of council-controlled organisations.[36]

3.141 In our view, using the accountability framework for council-controlled organisations would have meant greater accountability for the entities and

34 A proposed joint venture between Delta and Jacks Point Limited for a construction company under discussion in 2006 was intended to have a similar unequal structure. We describe this proposal in Part 5.

35 Email from the Delta manager most closely involved in the negotiations to Delta's legal advisor 10 May 2007 "… not to be formally recorded … Luggate have advised they will only be appointing 2 directors to the owner board …".

36 For example, the legal advice to Delta at the time assumes that this was the intention.

would have provided better and earlier information to the Council and the public. Delta notes that the structures were partly used to simplify financial reporting requirements, but, more importantly, they were used to avoid drawing private sector parties into a disclosure regime that did not apply to them and that could be expected to discourage private sector participation.

3.142 We do not consider that Delta's use of artificial structures to avoid accountability arrangements is appropriate for a public entity. We can understand the perspective of private sector partners, but increased accountability through mechanisms such as the statement of intent process and broader reporting requirements is one of the effects of doing business with publicly owned entities. Enhanced reporting and the opportunity to engage in the statement of intent process should be of value to the private sector partner as well.

Companies Act 1993

3.143 The Companies Act acknowledges that directors will sometimes have interests in other parties that the company does business with. It defines the circumstances in which a company director will be considered to be "interested" in such transactions. These circumstances include that the director will or might receive a material benefit from the transaction, or if the director is a director, officer, or trustee of a party to the transaction.

Managing conflicts of interest

3.144 If a director is interested in a transaction, they must disclose that interest to the board of the company and enter it in the company's interests register. A director can enter a "general notice" in the interests register and disclose to the board their interests in other entities and that they are to be regarded as interested in any transaction that the company might enter into with any of those entities. This is enough disclosure of interest for any future transactions between the company and those entities.[37]

3.145 Delta managers and directors applied a cautious approach to managing conflicts of interest in the Luggate decision. Delta records show that Mr Coburn was perceived to have a conflict of interest with the Luggate land. The reason for this is not clear from the records. Mr Coburn does not appear to have been "interested" in Luggate Park in Companies Act terms, because the vendor mortgage from Mr Coburn's company to Luggate Holdings Limited had been discharged.

3.146 We did not get a clear sense of the perceived conflict from those we interviewed, but it appears that Mr Coburn was considered to have a conflict of interest as a previous owner of the Luggate land. Mr Coburn said that another reason might have been that he was a property developer in Central Otago, so he was in the

37 Sections 139 and 140 of the Companies Act 1993.

same business as Mr Boult. There might have been a risk that Mr Coburn would have got information about the Luggate development as a Delta director that could have been useful to him in his other property ventures, so it would be preferable if he was not involved in making initial decisions.

3.147 We doubt that being a previous land owner would be enough, in itself, to be a conflict of interest. However, it is clear that Mr Coburn's property development activities needed to be carefully managed at times.

3.148 We do not criticise Delta for taking a conservative view on Mr Coburn's conflict of interest. Managing conflicts requires those closely involved to make judgements based on facts. That said, it was unfortunate that the Delta director who was an experienced property developer could not be actively involved, especially because Mr Coburn raised concerns about the proposal that proved to be valid.

3.149 The Delta directors on the joint venture subcommittee undoubtedly had considerable business and financial experience. However, they lacked significant experience in property development, as did the Delta managers who advised them.

3.150 In our view, the fact that the board member with the most experience could not be involved and the acknowledged lack of expertise in property development by Delta managers was even more reason to get expert advice before committing to the joint venture, as Delta's tax advisors had recommended.

Shareholder approval was a formality rather than independent scrutiny

3.151 Delta obtained necessary approvals from its shareholder, the holding company. However, the directors on the holding company's board who approved the transaction were also directors of Delta at the time of the approval, so this was a formality rather than independent scrutiny.

3.152 A Delta manager commented that the previous governance structure for the Council's council-controlled organisations, of having largely the same directors on the holding company and its subsidiaries, lacked the "commercial tension" usually seen in a group company structure. One of the directors said he was always clear that he fulfilled a different role when sitting on the board of the holding company than when on the Delta board. However, Delta managers told us this was not always clear to them.

3.153 The chief executive of the holding company confirmed to us that, because Delta had directors largely in common with the holding company, all decisions about Delta were discussed only within the Delta environment. The holding company had few records of those matters.[38] The chief executive said that the holding company's role was to pass appropriate resolutions to ensure that the holding company group operated within its delegated authority from the Council and to pass on information to the Council.

No evidence that personal connections influenced the decision

3.154 Some of the people who contacted us raised the concern that personal associations between one or more of Delta's directors or managers and Mr Boult had inappropriately influenced Delta's decision to enter into the Luggate joint venture.

3.155 We were told that some of the directors knew Mr Boult through previous business dealings and that Delta managers knew him through his involvement in an Aurora Energy Limited scholarship scheme. However, these were standard dealings in the ordinary course of the directors' and Delta's activities.

3.156 We found no evidence that personal associations or inappropriate motivation influenced Delta to enter the joint venture with companies in which Mr Boult had interests.

3.157 Rather, the parties negotiated robustly about the terms of the joint venture agreement, supported by their legal and tax advisors. At several points, Delta would not agree to proposed changes to the agreement. At times, it was ready to withdraw from the agreement. We see this as evidence of a genuine commercial relationship between the parties, with both trying to protect their interests as is typical of business negotiations and arrangements.

38 In responding to our request to the holding company for information about consideration of the Luggate and Jacks Point investments at holding company board meetings, the chief executive of the holding company gave us minutes of only two meetings (in June 2007 and April 2009).

Part 4
The early operation of the Luggate joint venture

4.1 In this Part, we outline how the joint venture operated and its financial arrangements. We discuss:

- the contracting work for Delta;
- the financial arrangements for the joint venture;
- how Delta funded its contribution;
- funding the developments costs for the joint venture; and
- the governance and management of the joint venture.

4.2 We then make some overall comments about the early operation of the Luggate joint venture.

Summary of our findings

4.3 Delta had priority for contracting work at the site and expected to make a profit of about $1 million from doing this work for the joint venture. Both Delta and Aurora Energy Limited did some work at Luggate Park and were paid for that work. However, because the development did not proceed as planned, Delta did not get the revenue or profit from the work that it expected.

4.4 The structure of the joint venture and related financial arrangements were reasonably complex, and were influenced by tax considerations. The arrangements were based on success and did not address what would happen if the sections did not sell as planned. There was not enough focus on the risks or the exit strategy.

4.5 The joint venture parties borrowed the costs of the development work at Luggate Park from a bank. They increased the amount borrowed from time to time. However, they became reluctant to borrow more because of the lack of demand for the Luggate Park lots. Had the parties borrowed more, the final loss would have been greater.

4.6 In our view, the parties were prudent in putting the development on hold and containing costs while waiting for the market to improve. The governance and project management arrangements operated effectively for a venture of this kind. However, aspects of Newtons' involvement in the Luggate transaction did not meet the accountability requirements of the Local Government Act.

4.7 Delta directors agreed to a request from Luggate Holdings Limited to use the joint venture land as security to raise funds for unrelated purposes, after negotiating an arrangement that did not weaken Delta's position.

Contracting work for Delta Utility Services Limited

4.8 The joint venture agreement provided that Delta would get priority for physical contracting work in the Luggate Park property development. There was a process for testing Delta's pricing if the joint venture thought that necessary.

4.9 In seeking the Delta board's approval for the joint venture, the value of the contracting work was estimated to be $5.3 million. Part of the appeal for Delta was that it considered this work would have a better profit margin than most of its other work. Delta expected to make a profit of about $1 million. We were told that work at Luggate Park did not involve some of the seasonal problems associated with other locations, so the work could continue year-round.

4.10 Delta had done work for Luggate Holdings Limited during stage 1 of the Luggate Park development and on some other developments that Mr Boult was involved with.[39]

4.11 The joint venture development did not proceed as planned because of the market slowdown, so revenue that Delta earned for the work and any corresponding profit was less than estimated.

4.12 Delta gave us information showing that the combined revenue from work by Delta and Aurora Energy Limited at Luggate Park from 1 January 2008 was $1.415 million (including $160,000 of maintenance and remedial works). The joint venture paid Delta and Aurora Energy Limited for this work. The joint venture funded these payments from the loan from the bank for development costs.

Financial arrangements for the joint venture

4.13 The initial proposal was that the parties would form a joint venture company to carry out the development. However, in August 2006, near the start of discussions, Mr Boult said, after a discussion with Luggate Holdings Limited's legal and tax advisors, "to avoid a significant tax issue from our end, we would like to suggest a different way of structuring this". The different structure proposed at that time was essentially the joint venture structure that was later agreed.

4.14 Delta managers noted that the proposed structure offered a "tax timing benefit for Luggate", which should be reflected in the price. Delta managers told Mr Boult that they would seek the views of the joint venture subcommittee. They cautioned that the directors might not have an appetite for a more complex structure. However, a few days later, managers told Mr Boult that the proposal was generally acceptable to Delta's directors.

39 Delta gave us information showing that the revenue from work by Delta and Aurora Energy Limited on stage 1 of Luggate Park before December 2007 (the date the Delta board agreed to enter into the joint venture for stage 2) was $5.5 million.

4.15 In March 2007, when they were negotiating the terms of the joint venture agreement, the legal advisor for Luggate Holdings Limited made the company's position clear to Delta's legal advisor, saying:

> *My understanding of the proposal is for the land to be held by a custodian company as a 'bare trustee' …. It is not my understanding that the land would be sold to that company as this destroys the structure that has been carefully agreed between the parties for the purposes of entering into the joint venture. Luggate cannot proceed with the proposal if the terms of the agreement provide for the land to be sold outside the Luggate group immediately as that will give rise to an immediate tax liability that will be payable on the realisation of the land and there would be no cash flow to support the payment of tax.*

4.16 To achieve the outcome sought the joint venture agreement provided that Luggate Holdings Limited would provide the land to the joint venture by advancing half of the agreed land value to Luggate Properties Limited, and Delta (through Newtons) would lend Luggate Properties Limited its half of the agreed value of the land in cash. This meant that each party's investment in the venture would be equal. It also meant that the land would be transferred to the joint venture for the development without a sale taking place. We understand that such a structure is not unusual for bringing a partner into a property joint venture.

4.17 Luggate Properties Limited had to use the money that Newtons advanced to discharge any mortgages over the land. This was so the land would be unencumbered and could be mortgaged in keeping with the joint venture agreement.

4.18 The advance from Newtons was subject to a deed of acknowledgement of debt between Luggate Properties Limited, Newtons, and Luggate Nominee Limited (entered into on 14 May 2008). Under this deed, Luggate Nominee Limited agreed to grant a mortgage over the land to Newtons to secure repayment by Luggate Properties Limited of the advance from Newtons. The advance of Luggate Holdings Limited's share of the value of the land to Luggate Properties Limited was unsecured.[40] However, it was also covered by a deed of acknowledgment of debt.

4.19 The contributions of both joint venture parties, representing half each of the agreed land value of $10.7 million, were to be repaid from subsequent sales. The joint venture agreement provided that, each time a section was sold, the parties would each receive half of the:

- unimproved value of the section[41] – this would repay their advances of cash (Newtons) and land (Luggate Holdings Limited); and
- value of the improvements (the infrastructure services that would be provided for each lot).

40 This changed in mid-2009, as outlined later in this Part.

41 Being the proportionate value of the section sold to the overall value of the joint venture land.

4.20 If the land value increased, the parties would also share any surplus after expenses had been met.

How Delta Utility Services Limited funded its contribution

4.21 Delta funded its share of the joint venture by borrowing $5.35 million from Dunedin City Treasury Limited to acquire shares in Newtons.[42]

4.22 The Newtons board met for the first time on 22 April 2008. Mr Polson was appointed as chairman and to represent Newtons and Delta on the board of Luggate Nominee Limited. Delta appointed Mr Liddell and Dr Evans as the other directors of Newtons.

4.23 The Newtons directors resolved on 30 April 2008 to issue 5,350,000 shares to Delta Utility Services Limited for $1 for each share ($5.35 million).

4.24 Dunedin City Treasury Limited advanced these funds to Delta for payment to Newtons. Newtons then advanced the funds to Luggate Properties Limited as an interest-free loan on 17 July 2008. This was the settlement date for the transaction, which was slightly later than planned.

4.25 After resolving to issue shares to Delta and advancing the loan funds to the joint venture, the Newtons board did not meet again until July 2009. Newtons was not actively involved in governing the joint venture in that initial period (April 2008 to July 2009). At that time, it was merely the means to lend funds to the joint venture.

4.26 Newtons became more actively involved in governing the joint venture from mid-2009, after it acquired the Jacks Point land.

Funding the development costs for the joint venture

4.27 The joint venture partners had agreed to borrow from a bank to fund the development costs of stage 2 of the Luggate subdivision. Each party was liable for half the amount owing. Repayment of this debt to the bank would be secured by a mortgage over the joint venture land.

4.28 In July 2008, the joint venture entered into a loan agreement with a bank to borrow up to $500,000 to fund the initial development costs for the venture, for a term of 12 months, with an ability to capitalise interest costs up to a maximum of $45,000. The bank required a first mortgage over the land in return for the loan.

42 The chief executive of the holding company told us that Delta did not go to Dunedin City Treasury Limited for each project. Instead, it would add any expected projects into Delta's annual budget and submit that budget to the Dunedin City Treasury Limited board as justification for an annual borrowing limit. Dunedin City Treasury Limited would not ask for information on particular projects that had already been agreed by the subsidiary and the holding company.

4.29 During the period of the Luggate joint venture project, the bank loan was increased several times to meet the joint venture costs, such as buying a section and building a house on it to sell as a package, and necessary upgrades to the sewerage treatment system and the costs of undergrounding overhead power lines.

4.30 The joint venture did not make interest payments, so the interest costs were capitalised (added to the principal).

The bank's funding had priority for repayment over Newtons' advance

4.31 The joint venture parties entered into a deed of priority with the bank to agree that the bank's development funding would have priority for repayment over the contributions of the joint venture partners.

4.32 The deed of priority was amended each time the bank loan was increased to increase the "priority amount" of the bank's lending over the contributions of the joint venture partners.

4.33 The bank's priority amount had increased to $1.935 million by August 2010.

4.34 The effect of the arrangement with the bank was that Newtons' mortgage had second priority to the bank's mortgage. As sections were sold, Newtons and Luggate Properties Limited would be repaid after the bank debt had been paid.

4.35 In mid-2009, at Mr Boult's request and with Newtons agreement, after several months of negotiations and legal advice, a third mortgage was granted over the joint venture land. The third mortgage secured Luggate Holdings Limited's $5.35 million contribution of land to the joint venture.[43] It was to be used as a collateral security for business ventures unrelated to the joint venture.

4.36 Newtons directors were not keen on the third mortgage arrangement in the form first proposed because they considered it weakened their security. They were also concerned that the proposed lender (a finance company) could get rights over the joint venture land, including the right to sell it if there was a repayment default. However, Mr Boult had said in early 2008[44] that the Luggate companies would seek an arrangement of this kind, so the directors considered that they needed to find a way to make it work.

4.37 The directors eventually agreed to a restructured proposal, involving a third mortgage over the joint venture land granted by Luggate Nominee Limited to Luggate Holdings Limited, which then submortgaged it to the same bank that had

43 When the parties entered into the joint venture, they agreed that repayment of the Newtons advance of $5.35 million would be secured by a mortgage, but repayment of Luggate Holdings' contribution of $5.35 million in land value would not be.

44 During the discussions about funding referred to in paragraphs 3.104 to 3.111.

lent the joint venture the development funds. The submortgage was a collateral security for obligations of another company related to Luggate Holdings Limited but not involved in the joint venture.

4.38 The Newtons directors saw this arrangement with the bank as preferable to the proposed involvement of the finance company. They had legal advice that the restructured arrangement would not give the bank the right to sell the joint venture land if the other company that was not involved in the joint venture defaulted.

4.39 The effect of the arrangement was that the new third-ranking mortgage had the same priority for repayment as Newtons' loan under its second-ranking mortgage. This was because the joint venture agreement provided that the joint venture partners would get an equal share of the land value of each lot from the proceeds when any lot was sold. This overrode the rankings of the security interests of the parties. The deed of priority of securities reflected this. It recorded the nominated amounts held by the security holders and their rankings as:

- first security holder (bank) – $1.545 million (in August 2010, this was increased to $1.935 million);
- second security holder (Newtons) – $5.5 million; and
- third security holder (Luggate Holdings Limited) – $5.5 million.[45]

4.40 As it turned out, the relative priorities of the second and third mortgages were not relevant because of the lack of sales.

4.41 The negotiations over the arrangement further illustrate the robust commercial relationship between the joint venture partners, and also Delta's efforts to maintain a good working relationship in the interests of the success of the joint venture.

Governance and management

4.42 Under the joint venture agreement, the parties agreed to form an owner board to govern the joint venture. Luggate Properties Limited had the right to appoint up to three members, and Newtons had the right to appoint up to two members. Luggate Properties Limited never exercised its right to have one extra member on the owner board. As noted in paragraph 3.138, it told Delta early in the negotiations that it would not do so.

4.43 Mr Boult and Mr Macdonald represented Luggate Properties Limited on the owner board. Newtons' representatives were Mr Polson and Mr Liddell.[46] Mr Polson was appointed chairman of the owner board.

45 As with the contribution from Newtons, this nominated amount was slightly more than the actual contribution.

46 Until mid-2009, when Mr Coburn replaced Mr Liddell as Delta's representative.

4.44 The owner board first met in April 2008, then regularly until the end of March 2009. In March 2009, the Luggate Park development was put on hold because of market inactivity.

4.45 The owner board was responsible for preparing policies and procedures for managing the development and considering the annual budget. It had to approve all joint venture expenses.

Managing the joint venture

4.46 The joint venture agreement required the parties to enter into a management agreement with Armada Holdings Limited (Armada) as the management company for the venture. Armada, based in Queenstown, was owned by Mr Boult and his family.

4.47 The parties entered into the management agreement in early 2008. Armada's responsibilities included preparing an annual budget and annual financial statements, and regular reports to the owner board. Mr Boult acted as the project manager for an agreed monthly fee of $5,000, and an Armada staff member provided administrative support. Armada was also able to recover its costs for providing administrative and management services from the joint venture.

4.48 The joint venture agreement did not require the joint venture's financial statements to be audited, but Delta could require its auditor to audit them at its expense.[47]

4.49 The joint venture did not pay Delta for time that Delta staff spent on the Luggate project.

4.50 Luggate Holdings Limited had hired a company, Signal Management Group Limited (Signal), to help with stage 2 of the development, including offering advice on development costs for each stage and related matters. Signal wrote a series of reports on the project from January 2008 to February 2010.

4.51 It was agreed that the owner board would manage the project, but a project co-ordination group of Mr Boult, Signal, and a Delta staff member would talk about operational matters weekly.

The state of the market in the middle of 2008

4.52 At the owner board's first meeting in April 2008, Mr Boult proposed initially developing 43 of the stage 2A lots, rather than all 138 lots. The stage 2A land was separated by Dead Horse Creek. The 43 lots on the west side of Dead Horse Creek were referred to as stage 2A1 of the development.

47 In practice, Audit New Zealand has considered the joint venture financial statements during the annual financial audits of Newtons and Delta.

4.53 In a report to the owner board for its August 2008 meeting, Mr Boult set out the sales that would be needed to justify starting the 43 stage 2A1 lots. Mr Boult noted that the property market was "less than buoyant". At that time, the owner board planned to start developing stage 2A1 in December 2008.

4.54 Signal prepared a concept plan for developing the 43 stage 2A1 lots. It began estimating the development costs of those lots. Delta had the first right to do this work.

4.55 Signal estimated that the development costs of the stage 2A1 lots would be about $102,000 for each lot. This was about $40,000 more than the estimates from when the parties entered into the joint venture. Mr Boult suggested that this was partly because of Delta's pricing and that it was difficult not being able to go to the market to test that pricing. Also, stage 2A had a significant amount of "front end" costs involving storm water and the sewage treatment plant that were actually for the whole development. However, these costs made the development costs for the stage 2A lots higher than they would be for the rest of stage 2.

4.56 In October 2008, Mr Boult told the owner board that the property market was in a period of uncertainty and general confusion and that it was unclear how this would pan out. He recommended proceeding with the plan for stage 2A1 and launch to market. If the parties could get 10 pre-sales, they could proceed. However, if they could not, the joint venture would need to reconsider its strategy.

4.57 Mr Boult also noted that some property owners in the already developed part of Luggate Park in stage 1A wanted to sell their sections and that this might affect sales of stage 2A1 lots. Mr Boult suggested that the joint venture buy a couple of the stage 1A sections and build houses on them to sell as house-and-land packages. The owner board agreed to buy one of those sections and build a house on it. In December 2008, the bank agreed to extend the joint venture loan to fund this.

4.58 In December 2008, the joint venture commissioned some material promoting house-and-land packages at Luggate. Delta asked for its details to be removed from the material, because it preferred to keep its involvement low profile at that time.

Efforts to market and sell residential lots at Luggate Park

4.59 Efforts to market the Luggate land in 2008 and 2009 included:

- entering an agreement with a United Kingdom-based company for it to market the Luggate development in jurisdictions other than New Zealand and Australia for a commission – the joint venture paid $10,000 for the costs of a

representative from that company to visit New Zealand and also met the costs for Mr Boult to visit the company in the United Kingdom;
- getting various real estate firms and other marketing experts to advise on strategies to sell lots in stage 2A and receiving regular market updates from those agents and experts;
- promoting the idea of a dairy/café business at Luggate township;
- considering marketing house-and-land packages, rather than just the developed lots, as a way to get sales in a difficult market, and discussing this with suppliers of various housing products, such as pre-designed homes; and
- building a "spec house" on one of the lots.

4.60 Despite these efforts, there were no sales in the period from July 2008,[48] the formal start of the joint venture, to April 2010, when the joint venture's "spec house" sold. There were only four further sales at Luggate Park from April 2010 to September 2012. The joint venture did not spend significant amounts on these marketing efforts, apart from travel costs for pursuing the arrangement with the United Kingdom-based company. However, that company did not make any sales.

Deciding to put the project on hold

4.61 At the end of March 2009, the owner board discussed the quiet state of the market. It agreed to put the development on hold for six to nine months and to review this in September 2009. The owner board agreed to keep the project running at a bare minimum, by completing work to put the overhead power lines underground, completing a necessary upgrade to the sewage system to comply with discharge consents, and finishing the "spec house" development.

4.62 Mr Boult offered to reduce Armada's monthly management fee while the project was on hold to $3,000 a month. Delta offered to take over the project management role from Signal, using the same team that it was using for the Jacks Point project then under way. Signal produced its last report on the project in February 2010.

48 There was one sale just before this, and the parties split the proceeds.

Luggate Park development remained on hold for the rest of 2009

4.63 There was little activity at Luggate Park for the rest of 2009 after the owner board put the development on hold at the end of March 2009.

4.64 The most significant development was a favourable decision from the Environment Court on the stage 2B resource consent in October 2009.

4.65 Mr Boult had become chief executive of Christchurch International Airport in February 2009 but remained involved in the Luggate project.

4.66 The owner board met in November 2009 for the first time since July 2009. At the November meeting, Mr Boult assessed the market as showing a general improvement and recommended re-launching Luggate Park with a new campaign focused on affordable house-and-land packages. The owner board also considered marketing the high-end lots on the elevated plateau (stage 2B) now that resource consent had been granted.

The Luggate market was "dead" when Delta decided to buy into Jacks Point

4.67 On 1 April 2009, when advising the Delta board of the decision to put Luggate Park on hold for six months, Mr Polson described the Luggate market as "dead". At the time, Delta was considering buying into the Jacks Point property development.

Our comments on how the joint venture operated

4.68 The project to develop and sell residential sections at Luggate Park never progressed as planned because of a lack of market interest, which those involved attribute to the global economic crisis and its effect on the property market in Central Otago.

4.69 There is no doubt that the economic situation affected the success of the venture. Part of the business proposition for Luggate Park was that it would meet a need for affordable land for housing in a reasonable location near Wanaka. This should have met a need for such land in the Queenstown Lakes District Council area and is consistent with government policy to encourage affordable housing. However, the Luggate site did not appeal to purchasers as hoped, and demand for affordable land for housing in the area was not as strong as the parties expected.

4.70 Having realised soon after they entered into the joint venture that the market was slower than expected, the parties proceeded cautiously. They first planned to progress part of stage 2A only (stage 2A1) and then only if they could get enough pre-sales to justify starting construction. However, the pre-sales did not take place and the development costs were considerably higher than forecast, so this made even stage 2A1 uneconomic.

4.71 The parties considered other options to generate sales, and got marketing advice from various real estate firms. None of the strategies employed were successful.

4.72 The market did not improve, but the parties were cautious and contained costs to the minimum necessary rather than putting more money in. The loss would have been greater if they had continued to spend money developing the land in the absence of market interest.

4.73 The value of the contracting work to Delta and corresponding profit was far less than estimated, but the development was never going to be large enough to be a major source of profit for Delta from construction work. The value of the construction work was not a major consideration for Delta entering into the project.

4.74 The joint venture parties borrowed from the bank for some development costs, including for necessary upgrade work to the sewerage treatment plant and undergrounding of overhead power lines, and also to buy a section and build a house on it as a way of generating sales. They increased the amount borrowed from time to time, and did not make any interest payments, so interest costs were capitalised.

4.75 The parties reached a point where they were reluctant to borrow further from the bank because of the lack of demand. Had they borrowed more, the final loss would have been greater. In our view, the parties were prudent in putting the development on hold and containing costs while waiting for the market to improve.

Funding arrangements

4.76 Delta received tax advice that an unincorporated joint venture was an appropriate legal structure for the Luggate development because it would enable the parties to access any tax losses. Delta also received tax advice on other aspects of the transaction and potential effects on Delta and the holding company group. It is appropriate for a public entity to carefully consider the tax effects of its activities, and Delta did so.

4.77 When Delta entered into the Luggate joint venture, it had a first-ranking mortgage to secure repayment of the advance from Newtons of $5.35 million. The parties agreed that the joint venture land had a value of $10.7 million as a development site. If the development had progressed and lots had been sold, there would have been plenty of cover for repayment of Delta's advance. However, the value of

Delta's security decreased each time the joint venture borrowed more from the bank because the bank had priority for repayment. Also, under the joint venture agreement, Delta's advance:

- was repayable only when the sections were sold;[49] and
- ended up with the same priority for repayment as the additional funds that Luggate Holdings Limited borrowed for other purposes during the term of the joint venture.

4.78 The funding arrangements were based on success and did not address what would happen in the event of market failure. The arrangements would have worked if the land had been developed and the sections sold at the expected prices, but there was too much focus on the possibilities that the joint venture offered and not enough on the risks or the exit strategy.

4.79 Delta directors agreed to Luggate Holdings Limited using the joint venture land as security to raise funds for a purpose unrelated to the joint venture, but negotiated a way of doing this that did not weaken Delta's security or position. We see those negotiations as further evidence of the robust commercial relationship between the parties, and also of Delta's efforts to make the joint venture relationship work.

Governance and management

4.80 The governance and project management arrangements operated effectively for a venture of this kind.

4.81 The owner board met regularly until the venture was put on hold, and then as required, and received good support from staff from Armada and Delta. The board also received detailed reporting and advice from Signal to inform important decisions, such as whether to proceed with stage 2A bearing in mind the higher than estimated development costs. Mr Boult also provided a report to each owner board meeting on significant activities and strategy. The owner board provided active oversight and financial management. Each representative brought expertise to the project and took an appropriately strategic (rather than managerial) role.

Local Government Act requirements and Newtons

4.82 Delta used Newtons to fund the Luggate transaction. To give effect to the joint venture arrangement, the directors of Newtons resolved to issue shares to Delta in return for $5.35 million and later advanced those funds to Luggate Properties Limited.

49 In 2011, Delta described the advance as more in the nature of "quasi equity" in advice to directors on whether the value of the investment should be treated as impaired at that time.

4.83 Newtons did not have a statement of intent in place when the directors made these decisions, and Delta's statement of intent did not cover the activities of subsidiaries. This means that Newtons' involvement in the Luggate transaction did not meet the requirements of the Local Government Act.[50]

4.84 Newtons also made decisions about the Jacks Point investment in 2009 that were not covered by a statement of intent.

50 The Local Government Act 2002 states that decisions must be made by or under the authority of the board of the council-controlled organisation, and in keeping with the statement of intent (and, for a company, with its constitution).

Part 5
Buying the Jacks Point land

5.1 In this Part, we describe how and why Delta decided to acquire 98 land lots at Jacks Point for property development in 2009. We include Delta's consideration of risks, as well as Delta's previous dealings at Jacks Point from 2006.

5.2 We discuss:

- the Jacks Point residential development and the companies involved;
- Mr Coburn's interests at Jacks Point;
- Delta's previous dealings with Jacks Point Limited from 2006;
- how Delta assessed the opportunity to acquire land at Jacks Point;
- how Delta negotiated and finalised the arrangements;
- Mr Coburn's advisory role; and
- Delta's communication with the holding company and the Council.

5.3 We then include some overall comments about how Delta bought the Jacks Point land.

Summary of our findings

5.4 The 2009 investment decision was made more quickly and was considerably less complex than the Luggate Park investment.

5.5 In 2006, Delta considered entering into a joint venture with Jacks Point Limited to form a construction company to develop residential subdivisions in Central Otago. Mr Coburn was a director of Jacks Point Limited at that time. Mr Coburn and Delta managed Mr Coburn's conflict of interest adequately, but, in our view, Mr Coburn's involvement in both parties to the proposed joint venture would have been problematic had the venture proceeded.

5.6 In 2009, Delta (through Newtons) purchased the land at Jacks Point as part of its growth strategy but when a similar investment at Luggate Park was not delivering the expected benefits. The directors of Delta saw Jacks Point as a quite different, and longer-term, opportunity than Luggate Park. Mr Coburn proposed the purchase to Delta. Mr Coburn was no longer a director of Jacks Point Limited when he proposed the purchase, and disclosed his other interests at Jacks Point. Companies Act requirements for disclosing interests were met. We saw no evidence that Delta bought land at Jacks Point in lieu of payment for unpaid contracting work, as some complainants alleged.

5.7 Because of the size of the investment, we consider that it would have been prudent to get an independent review of the financial projections to ensure that $8.82 million was a reasonable price to pay for the land.

5.8 As a council-controlled organisation, Newtons did not comply with some of the requirements of the Local Government Act. In our view, it was an oversight rather than intentional avoidance. Delta and the holding company gave explicit authority for the investments and transactions.

5.9 On the whole, the various conflicts of interest were disclosed and managed appropriately. However, in our view, Mr Coburn should have disclosed that he is a shareholder as well as a director of Ruboc Holdings Limited and disclosed his interest in that company earlier than he did.

5.10 There was a breach of requirements in the Companies Act about the payment of consultancy fees to Mr Coburn. The directors did not take the steps required to certify that the consultancy arrangement was fair to the company or disclose details of the arrangement in the interests register, and the parties have been unable to find a signed copy of the contract for the work. We saw no advice from Delta staff about the need to meet these Companies Act requirements, but we were surprised at this omission by experienced company directors.

The Jacks Point residential development

5.11 Jacks Point is a 1200-hectare settlement in the Wakatipu Basin, about 15 minutes' drive from Queenstown on State Highway 6, on the edge of Lake Wakatipu. It has some housing, some vacant developed lots that are for sale, a golf course and lake, and some undeveloped land. Plans for the development include more than 1300 houses, a lakeside village with accommodation, restaurants, shops, and a luxury lodge. Only a small percentage of the land available is to be built on, with about 95% of the site being open space.

5.12 The property owners – not Queenstown Lakes District Council – own the infrastructure facilities at Jacks Point. Property owners become members of the Jacks Point Residents and Owners Association (JPROA) and get shared ownership of communal facilities such as the road network, the water supply and wastewater systems, and amenities (including reserves, farmed open space, walkways, and a trail network). The JPROA operates like a local authority, and levies its members for the cost of maintaining and operating the communal facilities.

5.13 The development land is divided into a series of neighbourhoods. There were 680 residential lots in the initial development of Jacks Point. When Delta bought 98 lots in 2009, the other lots had already been developed and sold to various parties.

5.14 The neighbouring, undeveloped Henley Downs has capacity for about 700 lots.

Jacks Point Limited

5.15 Delta, through Newtons, purchased its lots from Jacks Point Limited, which was then the management company for the Jacks Point development.

5.16 At the time of the purchase, the directors of Jacks Point Limited were John Darby, George Kerr, and Richard Hanson.

Michael Coburn's interests at Jacks Point

5.17 Mr Coburn was a director of Delta from October 2003 to October 2012. Mr Coburn had interests at Jacks Point before and after Delta purchased land at the development. Mr Coburn and Delta needed to manage those interests throughout Delta's dealings with Jacks Point Limited.

5.18 The interests relevant[51] to this report were:

- Mr Coburn had an ownership interest in the Jacks Point land from 30 May 2005 to 16 October 2006, when his company Ruboc Holdings Limited bought a 15% shareholding in Jacks Point Equities Limited, which owned Jacks Point Limited,[52] which owned land at Jacks Point;
- Mr Coburn's family interests purchased 11 lots at Jacks Point in that period;[53]
- Mr Coburn was a director of Jacks Point Equities Limited from 8 July 2004 to 22 August 2008;
- Mr Coburn is the sole shareholder and director of Ruboc Holdings Limited, which entered into a consultancy arrangement in 2009 with Newtons for Mr Coburn to provide project director services to Newtons for the Jacks Point contract work;
- Mr Coburn was a director of Jacks Point Limited (now called Coneburn Land Holdings Limited)[54] from 6 May 2004 to 11 December 2008, and was executive director of that company from early 2005 until his resignation in December 2008;
- Mr Coburn was a director of Arith Holdings Limited (the company that owned the Henley Downs land next to Jacks Point) from January 2007 to August 2008;

51 Mr Coburn is a director of Jack Tewa Foundation Appointer Limited, which appoints trustees to other entities that own infrastructure assets at Jacks Point. Mr Coburn was previously a director of Jacks Point Land Holdings Limited (from June 2004 to December 2006) and Jacks Point Land Limited (April 2006 to December 2008). Mr Coburn told us that those companies held the land for the lodge site and golf course respectively. These companies do not appear to be significant to this inquiry.

52 Jacks Point Equities Limited held shares in Jacks Point Limited from 6 September 2004 to 19 November 2010.

53 Mr Coburn told us that his family interests still own five vacant lots, that a residence has been built on one of the other lots, and that the other five lots have been sold.

54 The name change happened on 24 April 2012.

- Mr Coburn was a committee member of the JPROA and a director of Coneburn Water Company Limited, which is a company controlled by the JPROA that owns and manages the water supply system at Jacks Point; and
- Mr Coburn is a trustee of a trust that holds shares in Locations Realty Limited and Locations Realty Queenstown Limited.[55]

5.19 We cover Mr Coburn's disclosures of his interests and Delta's knowledge and management of those interests throughout this Part.

Previous dealings between Delta Utility Services Limited and Jacks Point Limited

5.20 Delta had a working relationship with the company that managed the land at Jacks Point, Jacks Point Limited, from construction work it had done for the company at the Jacks Point site from 2005.[56] Delta had also had contact with Jacks Point representatives when it was promoting the Fulcrum concept to developers in 2004 and 2005.[57]

5.21 Delta also did contracting work for Arith Holdings Limited in 2007 and 2008.[58]

5.22 In September 2006, Delta put in a bid for work at Jacks Point in a tender to develop 249 lots over an 18-month period. The work involved earthworks, road construction, and utility installation for three of the neighbourhood areas of Jacks Point.

5.23 Jacks Point Limited ran the tender process. Mr Coburn was the Executive Director of that company at that time. In October 2006, Jacks Point Limited accepted Delta's bid for the work, but subject to Delta's agreement to transfer the balance of the term of the contract to a joint venture to be formed between Delta and Jacks Point Limited if such a joint venture were formed before the contract work had been completed.

5.24 The October 2006 letter from Jacks Point Limited, which set out the conditional acceptance of Delta's bid for the work, was signed by Mr Coburn as Executive Director of Jacks Point Limited. Mr Coburn was also a Delta director at that time. Delta managers sent a memorandum to directors about the condition sought by Jacks Point Limited, but did not send it to Mr Coburn because of "his clear conflict of interest".

55 Mr Coburn has told us that he has no beneficial interest in the companies.

56 Delta's annual reports from 2006 to 2009 contain related-party disclosures noting that Mr Coburn was a director of Jacks Point Limited and the amount of payments from that company to Delta for contracting services.

57 We describe the Fulcrum concept in Part 3.

58 Delta's annual reports for 2007 and 2008 contain related-party disclosures noting that Mr Coburn was a director of Arith Holdings Limited and the amount of payments from that company to Delta for contracting services.

5.25 We wanted to better understand these events, which raised the possibility of Mr Coburn using his knowledge of Delta's business and strategy for personal gain, because he was then a director of Jacks Point Limited and had an ownership interest in land at Jacks Point. In paragraphs 5.26 to 5.40, we set out what happened.

5.26 Delta managers had some concerns with the condition that Jacks Point Limited wanted to impose. They noted that:

- the work had been tendered before discussions between Delta and Jacks Point Limited about a possible joint venture had progressed far, and they had not taken the possible joint venture into account when pricing the work and planning how to resource it; and
- unless Mr Coburn was excluded from future board reports on the work, Jacks Point Limited would get knowledge of how profitable the work proved to be before deciding whether to include it in a joint venture.

5.27 Delta managers said that the condition sought by Jacks Point Limited needed clear approval from Delta's board before proceeding.

5.28 The discussions between Delta and Jacks Point Limited about a possible joint venture that Delta referred to in October 2006 had begun in mid-2006. Minutes of a Delta board meeting on 26 July 2006 refer to two joint venture opportunities being on the agenda. The minutes record that: "Mr Coburn spoke to the one he was involved with then withdrew from the meeting due to a conflict of interest."[59]

5.29 The two opportunities were the Luggate joint venture (first proposed in May 2006) and a proposed joint venture with Jacks Point Limited. It appears from later documents that Mr Coburn raised the possibility of a "project management" joint venture between Delta and Jacks Point Limited at this meeting. Delta managers noted that the proposal arose during a board discussion about Delta "moving up the value chain", by investing in specific subdivision opportunities rather than working just as a contractor.[60]

5.30 Delta formed its joint venture subcommittee to consider these joint venture opportunities at the 26 July 2006 meeting, with Mr Polson, Mr Liddell, and Dr Evans as members and supported by two of Delta's managers. On 2 August 2006, Delta's chief executive met Mr Coburn and Mr Darby from Jacks Point Limited. After those discussions, the chief executive told Mr Polson that Mr Coburn and Mr Darby had proposed forming a joint venture company with Delta for construction work (as opposed to previous discussions about a project management joint venture) and that:

- their concept was not limited to the Wakatipu Basin or civil construction;

59 Because of his declared conflict, Mr Coburn would have withdrawn from the Luggate discussions.

60 We referred to this in Part 3 when describing the reasons for the Luggate investment.

- they believed that they could provide $100 million of construction work at Jacks Point and at the adjacent Henley Downs, which would generate $10 million of profit, and they would like to benefit from delivering the opportunity; and
- Delta would get the opportunity to share $5 million of that profit by giving Jacks Point Limited equity in a construction joint-venture company that would do the work.

5.31 Delta's notes of the meeting refer to Mr Coburn:

- expressing the view that the proposed joint venture would ideally involve both civil and electrical construction activity to maximise growth opportunities; and
- agreeing to discuss the proposal with Mr Polson to gauge his support.

5.32 In September 2006, the Delta board agreed in principle to form a joint venture company along the lines proposed, initially restricted to non-electrical activities in the Wakatipu Basin but subject to further expansion on a basis yet to be defined.

5.33 In November 2006, Mr Polson and Mr Liddell met with Mr Coburn and Mr Darby to discuss the proposed joint venture in more detail. They discussed aligning the interests of Jacks Point Limited and Delta, first at the Jacks Point development but later elsewhere in Central Otago. They noted that infrastructure assets offered two possibilities – construction and management/maintenance, and that Queenstown Lakes District Council was open to handing these responsibilities over to others.[61]

5.34 Mr Coburn represented Jacks Point Limited's interests in the discussions, and Delta excluded him from advice sent to the joint venture subcommittee on the proposal. Delta worked on a shareholders agreement and constitution for the joint venture company and discussed these with Mr Coburn as a representative of Jacks Point Limited.

5.35 The proposal was that Delta would have one less share (but an option to buy one more share if it wanted to) and one less director than the other party. This is another example of Delta intentionally avoiding the accountability requirements of a council-controlled organisation that would have applied if the shareholdings and rights to appoint directors were equal.

5.36 When the Delta board discussed the proposal at a meeting on 29 November 2006, the minutes record that:

> *Mr Coburn advised that he had a general notice of interest noted in the interests register on all matters associated with Jacks Point and that it covered this issue.*

5.37 The minutes also record that:

- Mr Coburn took part in the discussion;

61 These discussions were much like the Fulcrum concept that Delta and another partner had been pursuing with developers from 2004 as part of Delta's growth strategy.

- Mr Gilks, Mr Douglas, Mr Hudson, and Dr Evans had concerns about the proposal;
- Mr Hudson suggested that Council approval should be sought, and was asked to discuss it with the chief executive of the holding company;
- Delta managers said that a detailed business case was being prepared for consideration; and
- the meeting agreed that the proposal would "lie on the table" until the business case could be considered.

5.38 The parties did more work on the proposal between November 2006 and January 2007. Jacks Point Limited proposed to use a new company to enter the joint venture with Delta. The directors and shareholders were to include Mr Darby, Mr Coburn, and Mr Kerr, and they would also have been appointed as directors of the proposed joint venture company to represent the Jacks Point interests. Delta engaged Deloitte to prepare the business case and financial forecasts.

5.39 Delta considered the draft business case and financial forecasts at its January 2007 board meeting. The minutes of this meeting record Mr Coburn's disclosure of interest in all matters concerning Jacks Point, and that he did not participate in the discussion of the business case. The minutes record that the joint venture subcommittee had reviewed the business case and other information and now recommended that the joint venture not proceed in the form proposed. Rather, the joint venture subcommittee recommended that Delta and Jacks Point Limited work together on a project basis instead. This was agreed.

5.40 Because Delta did not agree to the proposed joint venture, Jacks Point Limited did not pursue the idea that the 2006 contract for construction work at Jacks Point could be transferred to a joint venture between the parties.

Payments to Delta from Jacks Point Limited for work at Jacks Point

5.41 Delta told us that:

- the value of the civil works by Delta for Jacks Point Limited before 2009 was about $7.4 million (plus GST);
- Delta carried out about $410,000 of electrical works for Jacks Point Limited before 31 December 2008;
- Delta completed additional civil works to the value of about $800,000 (plus GST) for Jacks Point Limited after 1 January 2009; and
- Delta also provided electrical contracting services to Aurora Energy Limited for the electricity network at Jacks Point.

5.42 Some of the complaints to us have raised a concern that Delta purchased land at Jacks Point in lieu of payment for unpaid contracting work. We have seen no evidence of that.

How the Jacks Point opportunity arose

5.43 In January 2009, Mr Coburn suggested that Delta buy a block of land at Jacks Point for property development. He had resigned as a director of Jacks Point Limited in December 2008.

5.44 On 29 January 2009, Mr Polson contacted the joint venture subcommittee members to say:

> *A second issue also for discussion by our JV group. Mike Coburn has suggested we look at purchasing a block of undeveloped lots (maybe 100) at Jacks Point on a deferred payment basis with the quid pro quo that Delta would be given a contract to manage and maintain all the roading, grounds and infrastructure on a long term contract. This would provide a base work load for us in Queenstown (maybe $700,000 to $1m per annum) and we would develop the lots in smaller parcels as we needed work or the market improves. Obviously a lot of detail to be worked through but at least worth considering as part of our strategy. We would also be able to shift all our operational base to JP.*

5.45 The proposal was broader than simply land purchase, and that appealed to Delta as long as it could get the sections at a good price and be confident of selling them for a profit. Delta saw it as an opportunity to get involved in a "flagship" site in the Wakatipu Basin, which was a significant part of its strategy to grow the business. It was also an opportunity to provide a base and foundation for Delta's workforce under a long-term contract.

5.46 Mr Cameron had joined Delta as chief executive in January 2009, so was responsible for advising the joint venture subcommittee and the Delta board on the Jacks Point proposal. Delta managers met with Mr Coburn and Mr Darby in February 2009 to discuss the terms of a possible deal. They then prepared advice for the joint venture subcommittee, in consultation with Mr Coburn, and reported to the subcommittee on 12 March 2009 outlining how to progress the proposal.

The market was already slowing

5.47 When the proposal was received, the Luggate development was already under way. The global financial crisis had begun to have an effect, and the market for the land at Luggate was reported to be flattening considerably.

How Delta Utilities Services Limited negotiated and finalised the arrangements

The initial proposal

5.48 The initial proposal was that Delta would purchase 98 lots of land at the Jacks Point site at a cost of $8.82 million. The lots were under the control of a bank, and this was the amount owing by the land owner. Delta understood that the bank was prepared to sell at that price to recover the amount owing.

5.49 Jacks Point Limited was acting as an intermediary between the bank and Delta. The proposal was that Jacks Point Limited would be the vendor, having made arrangements with the bank, so that Jacks Point Limited could sell the land to Delta and deliver clear title.

5.50 Delta understood at that time that Jacks Point Limited did not have an ownership interest in other land at Jacks Point but was the management company for the development, and that Mr Coburn was no longer a director of Jacks Point Limited (having recently resigned).

5.51 The land available for sale to Delta had a total land area of 9.22 hectares. It was made up of two separate and neighbouring areas, known as Neighbourhood 2B (49 lots) and Neighbourhood 3 (49 lots).

5.52 In return for purchasing the land, Delta was to receive:

- development work for its workforce, the cost of which would be recovered when the plots were sold (the work was estimated at $6 million, from which Delta would also get a profit margin);
- a three-year contract for asset management, landscape management for the whole of Jacks Point and, at a later stage, neighbouring Henley Downs (with an automatic right of renewal for a further three years);
- a lease for a permanent depot on site; and
- "preferred contractor" status for any infrastructure development at neighbouring Henley Downs when development began.

How did Delta evaluate the proposal?

5.53 After the initial briefing to the joint venture subcommittee, Delta managers worked with advisers and Mr Coburn to consider the details of the proposal and how it could work. The business case was essentially the financial projections for the gain on sale of the developed land, the broader benefits of the proposal in terms of the depot site and the access to work, and the fit with Delta's growth strategy.

5.54 Delta did not get an independent valuation to confirm that the proposed purchase price of $8.82 million was reasonable.

5.55 Delta's board was satisfied with the purchase price of the undeveloped land in the context of the wider benefits that would accrue to Delta. The board considered that getting a registered valuation was unlikely to add anything to the decision-making process.

5.56 Delta's experience with Luggate Park, where directors considered the valuation to have been optimistic and of little use, had influenced the views of managers and of board members about the benefits of getting a valuation and its relevance to the decision it needed to make. Delta decided to do its own research on land sales because it was confident that the board had access to better information and knowledge of Queenstown market values at the time.

5.57 The financial model was reasonably simple. At face value, the purchase price of $8.82 million divided by 98 lots gave a cost of $90,000 for each lot. The development costs were estimated to be $60,000 for each lot. The economic prospects were thought to be favourable as long as the lots could be sold for more than $225,000 (net) or a profit of about $75,000 for each lot.[62] From its understanding of the Queenstown market at that time, Delta considered that the land price of $8.82 million offered a significant opportunity to profit from developing and selling the lots.

5.58 A point of difference for the Delta lots was that they would be smaller and cheaper than the lots for sale elsewhere at Jacks Point, which had an average sale price then of about $275,000. It was also intended that Delta would do the construction work on the lots then sell them back to Jacks Point Limited, which would market them.

5.59 At this early stage, it was also evident that an advantage of the proposed arrangement was that Delta would have a "flag ship" site in an area that it had targeted explicitly for growth.

5.60 On 12 March 2009, the joint venture subcommittee approved in-principle for managers negotiating with Jacks Point Limited to reach an agreement, but wanted to:

- secure a longer involvement at the site by seeking a five-plus-five-year contract rather than the proposed three-plus-three-year contract; and
- consult the Council on the proposed arrangement.

62 After payment of any real estate agent selling fees and other expenses.

5.61 The joint venture subcommittee identified two particular aspects to consider further:

- the degree of confidence about development costs for each lot, given that Delta would carry out this work and development costs at Luggate Park had been significantly more than forecast; and
- the risk to achieving an average sale price of $225,000 (net) for each of the 98 lots during the following four years.

5.62 Delta did some more work on these matters and engaged legal advisors to consider the terms and wording of the various legal agreements.

5.63 On 24 March 2009, Delta told the chief executive of Dunedin City Treasury Limited in confidence about the proposed funding arrangements and sought confirmation that those arrangements did not breach any group funding or security arrangements.

Delta board agreed in principle to proceed

5.64 When it met in April 2009, the Delta board considered progress, noting that its joint venture subcommittee had recommended that the project proceed as quickly as possible, and that the subcommittee was working on finalising the documents and detail. Mr Coburn had helped Delta staff finalise the proposal to Delta directors and had taken part in the discussion at the Delta board meeting.

5.65 The main considerations for the Delta board included:

- Although the board would need to monitor financial risks with the project, operational risks were lower because Delta could decide when to do the development work and could delay or stage this work as needed (based on market conditions and other demands on its workforce).
- It was confirmed that the project would operate through Newtons.
- Because managing and containing development costs was important, it was recommended that a Delta board member (Mr Coburn) be appointed as a consultant to represent Newtons in managing the delivery of the first phase of the development work for 49 lots.
- The maintenance agreement was extended to a five-year agreement, with a right of renewal for a further five years.

5.66 Delta then did some work on the risk of volatility in price that might arise from "fire sales" by other owners. Delta also wanted to understand Jacks Point Limited's strategy for the rest of the project – specifically, the planned hotels, other accommodation, and the retail village. Mr Coburn got more information on these matters from Mr Darby and gave this to the joint venture subcommittee.

5.67 Although Delta did not expect to start selling sections until June 2010, it planned to sell at least 10-15 lots each year from then.

5.68 Mr Hudson said that the proposal needed to be considered by the liaison committee of the Council and the holding company, which would decide whether the approval of the full Council was required. Mr Liddell was asked to arrange a meeting with the Mayor and the chief executive to brief them on the proposal.

5.69 On 1 April 2009, the Delta board approved the proposal in principle and delegated authority to the joint venture subcommittee to enter into the required agreements. The board also resolved to get approval from the holding company. The minutes record that Mr Hudson abstained from voting but do not record why he did so.

The holding company approved the Jacks Point investment

5.70 In seeking approval from the holding company, Delta summarised its expectations of the arrangement and alignment with its overall strategic objectives. It summarised these in a document called *Growth Strategy in the Wakatipu Basin*, dated 3 April 2009.

5.71 Delta's main strategic objective was to increase its turnover from $86 million to $120 million in five years. Important aspects of its strategy included that:

- the Wakatipu Basin was the highest growth area in the South Island and a major component in the planned revenue increase;
- Delta's revenue from the region in 2009 was expected to exceed $10 million; and
- to succeed, the growth strategy required a permanent base in the Wakatipu Basin, and a stable workforce with a good baseload of work in the area.

5.72 The strategy noted that the economic and other benefits of the Jacks Point opportunity were:

- expected annual income of more than $1 million from providing services and maintenance to the Jacks Point township as it developed, and the chance to show how well Delta could manage the infrastructure of small towns (and so provide access to similar opportunities in other locations);
- being the preferred contractor on site would provide substantial benefits when further developments took place (the income from the planned 1300 lots would be substantial and a steady workload was expected to result);
- the lease of the depot would enable Delta to consolidate all of its activities in the area to one site, with annual lease savings of more than $125,000 expected, and related efficiency and employee benefits of having all staff on one site;
- the development work would be done by Delta, with an expectation that about $700,000 of profit would be achieved;

- access to ongoing work in developing Jacks Point would provide a sustainable base workload and an ability to smooth workloads, resulting in Delta being able to attract and retain staff with core skill sets;
- Delta could manage the timing of the development of the 98 lots to ensure continuity of productive work;
- the land was projected to have a sales value of $22 million in the next six years, generating a cash surplus of about $7 million during that time; and
- all surpluses from the additional work and the property development would return to Dunedin.

5.73 The growth strategy summarised the four parts of the Jacks Point opportunity:

- having a five-year agreement to provide all services to Jacks Point residents (including managing and maintaining water, sewerage, vegetation, and meter reading) with a five-year right of renewal at the end of the initial period;
- being the preferred contractor for all future development and infrastructure work for Jacks Point, including building up to 1300 residential lots in Henley Downs during the next 10 years;
- leasing a depot and work site at Jacks Point, with an option to buy a permanent depot in 18 months' time with the price locked in below the market value; and
- buying consented land that could be developed into 98 residential sections in a three-year timeframe, which would provide about 88 weeks' work for Delta employees and deliver good returns on the sale of the lots.

5.74 The holding company noted that the opportunity was consistent with Delta's growth strategy. Mr Hudson, Mr Liddell, Mr McLauchlan, Mr Coburn and Dr Evans, all of whom were also Delta directors, signed the holding company resolution approving the Jacks Point investment.

Payment and funding arrangements and other agreements

5.75 In May 2009, Newtons entered into a conditional agreement to buy the 98 undeveloped but consented residential lots of land at Jacks Point from Jacks Point Limited. The agreement became unconditional on 13 July 2009.

5.76 The cost to Newtons of the Jacks Point land was $8.82 million plus GST, comprising payments of:

- $500,000 on agreement;
- the balance of $5 million and the GST paid a year later on 1 April 2010;[63] and
- a final balance of $3.32 million six months after that, with interest.[64]

63 Delta borrowed $5 million from Dunedin City Treasury Limited to enable Newtons to meet this payment.

64 The final payment was made on 30 September 2010, being the balance of principal plus $41,841 in interest. Jacks Point Limited provided a vendor mortgage for the final payment.

5.77 At a board meeting in July 2009, the Newtons directors resolved to approve the development budget for Jacks Point, to apply to Dunedin City Treasury Limited for a $5 million-loan facility, and to borrow $500,000 from Delta for the deposit for Jacks Point. As with Newtons' decisions about Luggate Park, the directors made these resolutions without a statement of intent in place.

5.78 Delta agreed in August 2009 to provide the funding to Newtons for the Jacks Point investment by way of interest-bearing shareholder advances, on the same terms that Delta incurred when borrowing from Dunedin City Treasury Limited. Delta did not buy shares in Newtons, as it had for the Luggate Park investment. It was agreed that Delta would borrow the $5 million from Dunedin City Treasury Limited rather than have Newtons set up a loan facility with Dunedin City Treasury Limited.

5.79 In July 2009, Delta entered into a series of agreements with entities involved at Jacks Point and Henley Downs as part of its broader objectives for Jacks Point.

5.80 Figure 12 summarises the agreements Delta entered into about Jacks Point.

Figure 12
Agreements that Delta Utility Services Limited entered into about work at Jacks Point and Henley Downs

Parties	Delta's entitlements under the agreement
Delta and Jacks Point Limited	Preferred contractor status for future infrastructure development work at Jacks Point
Delta and Jacks Point Residents and Owners Association (JPROA)	Exclusive provider of operational, maintenance, and asset management services for communal facilities and utilities to be constructed at Jacks Point (with a term of five years and a right to renew for another five years)
Delta, Arith Holdings Limited, Jacks Point Limited, and JPROA	A license to occupy land at the Jacks Point site to establish and operate an Infrastructure works depot (and a related agreement with Henley Downs Farms Limited to identity the most suitable site)
Delta and Arith Holdings Limited (developer and owner of Henley Downs)	Preferred contractor status for future infrastructure development work at Henley Downs and provider of operational, maintenance, and asset management services for communal facilities and utilities to be constructed as part of the development at Henley Downs (with a term of five years and a right to renew for another five years)

Mr Coburn's advisory role

5.81 On 1 April 2009, in seeking approval in principle from the Delta board for the Jacks Point investment, the joint venture subcommittee noted that it intended to enter into an agreement with Mr Coburn for Mr Coburn to provide project director services to Newtons for the Jacks Point contract work.

5.82 As noted above, Mr Coburn had worked closely with Delta's staff when they prepared advice to Delta directors on the Jacks Point opportunity in early 2009. His knowledge of the Jacks Point development, from his recent role as Executive Director of Jacks Point Limited, was clearly useful to Delta managers when they prepared that advice.

5.83 We were told that Delta board policy was that directors could be paid for additional work on Delta projects for work over and above their directors' duties. The rate for additional work was $200 for each hour.

5.84 Mr Coburn proposed a fee of $75,000 for the first year of his project role at Jacks Point (and also mentioned Luggate Park), based on an average of 10 hours a week at the director rate of $200 discounted by 25%. The contract was to be with Mr Coburn's company, Ruboc Holdings Limited.

5.85 In August 2009, the Newtons board approved the project management agreement with Ruboc Holdings Limited for Mr Coburn's services for an annual fee of $60,000. This amount was based on the project management arrangements at Luggate Park with Mr Boult.

5.86 Mr Coburn told the meeting that the Jacks Point development would be a good training exercise for Delta and that this could result in a good outcome for Delta and Newtons.

5.87 At its September 2009 meeting, the Newtons board noted that the project management agreement with Mr Coburn had been agreed but not signed, and Delta managers were asked to arrange this when Mr Coburn returned from holiday.

5.88 Newtons directors were given a copy of the unsigned agreement for their 27 October 2009 board meeting, and were told that Mr Coburn was prepared to sign it in that form. The board approved the agreement for signing.

5.89 Delta's practice was to update directors at each board meeting about any agreements signed since the last meeting. We did not see this for the agreement with Ruboc Holdings Limited for Mr Coburn's services. Because neither party has been able to find a signed copy, it is not clear if the agreement was formally signed. We consider that Delta needs to better manage such matters to ensure that all agreed actions are completed.

5.90 The unsigned agreement set out the main terms:

- Ruboc Holdings Limited would provide Mr Coburn's services.
- Payment was to be $5,000 plus GST for each month, starting from 1 October 2009.

- The fee was to be reviewed 12 months after the date of the agreement.
- The agreement was to end on 30 November 2011.

5.91 Mr Coburn's main responsibilities were:

- managing the development of residential sites for Newtons at Jacks Point (and any other agreed sites);
- overseeing all site activities, including health and safety requirements and compliance with resource consents;
- delivering the residential lots in the agreed timeframe and within budget;
- providing monthly reports on progress with construction and expenditure against budget;
- pre-approving all purchases and payments before Delta's chief executive authorised them; and
- marketing the completed lots and providing monthly reports on sales and market conditions.

5.92 Delta gave us information about payments to Ruboc Holdings Limited from Delta and Newtons (with its more recent name, Delta Investments Limited) since 2008 (see Figure 13).

5.93 Figure 13 shows:

- payments from Delta Utility Services Limited to Ruboc Holdings Limited from 2008 to 2012;
- payments from Delta Investments Limited to Ruboc Holdings Limited from 2010 to 2012; and
- a reconciliation between the above information and relevant annual reports, with an explanation of differences.

5.94 Mr Coburn, through Ruboc Holdings Limited, had begun charging Delta for his time spent on the Jacks Point project from January 2009 before entering into the formal consultancy arrangement. There was also a small payment of $320 to Ruboc Holdings Limited in February 2008 to reimburse Mr Coburn for mileage expenses between Dunedin and Queenstown.

Figure 13

Payments to Ruboc Holdings Limited from Delta Utility Services Limited and Delta Investments Limited since 2008

Ruboc related-party transactions

Expenditure breakdown

Financial year	Delta Utility Services Limited[1] $	Delta Investments Limited[2] $	Group Total $
2008	320	-	320
2009	15,727	-	15,727
2010	22,345	63,139	85,484
2011	11,524	49,388	60,912
2012	4,121	736	4,857
Totals	**54,037**	**113,263**	**167,300**

1 Payments are largely for consultancy services provided and for accompanying Delta management to meetings in Christchurch for a Delta project there. The 2010 amount includes a payment from Delta to Ruboc of $8,444 for an item of plant (toro lawnmower).

2 Payments are largely for Jacks Point management fees and associated expenditure such as mileage under the consultancy agreement between Newtons/Delta Investments Limited and Ruboc. There were a smaller number of payments for meetings about Luggate and other projects.

Annual report reconciliation

Financial year	As per Delta Group Annual Report $	Delta Utility Services Limited $	Delta Investments Limited $	Difference $
2008	-	320	-	320[1]
2009	-	15,727	-	15,727[1]
2010	85,484	22,345	63,139	0
2011	60,912	11,524	49,388	0
2012	24,971	4,121	736	(20,114)[2]
Totals		**54,037**	**113,263**	

1 Transactions with Ruboc were overlooked in the annual financial statements.

2 Directors fees ($20,850) were included in the Delta Group related-party figure. Also, a minor Delta Investments Limited amount ($736) was missed on consolidation.

5.95 Delta told us that payments to Ruboc Holdings Limited of $320 (in 2008) and $15,727 (in 2009) were overlooked when it prepared its annual reports for those years. The 2008 expense claim was not significant, but the payments in 2009 should have been disclosed in related-party information. Mr Coburn had not made an interests register notification for Ruboc Holdings Limited at that time, which would have put Delta staff preparing the 2009 annual report and our auditors on notice of the need for related-party disclosures. The need to make this disclosure was realised in time for it to be included in Newtons' half-yearly statements for the six months ended 31 December 2009, which disclose payments to Ruboc Holdings Limited in the related-party information.

5.96 The payments under the contract with Ruboc Holdings Limited for consultancy services for Jacks Point are included in the Delta Investments Limited figures for 2010 and 2011. The payments were disclosed in related-party information in Delta Investments Limited's financial statements. Delta Utility Services Limited was also paying Ruboc Holdings Limited for services in those financial years. Most of those payments were for representing Delta at meetings in Christchurch for a Delta project there.

5.97 Delta's annual report for 2013 states that consultancy services and materials of $12,484 were bought from Ruboc Holdings Limited in 2012/13.[65] The annual report for Delta Investments Limited states that no consultancy services were bought from Ruboc Holdings Limited in 2013.

Communication with Dunedin City Council

5.98 Delta communicated more with the Council about Jacks Point than about Luggate Park. The communication took place while Delta was considering the investment but had not yet bought the land.

5.99 Communication about the Jacks Point investment included:

- Delta preparing a short paper on Delta's investment strategy to use in briefings;
- Delta director Ross Liddell briefing the Mayor (Peter Chin) and chief executive (Jim Harland);
- senior council officers being present at a meeting of the holding company board on 8 April 2009, when the investment and the need to brief the Council on it were discussed;[66]
- the holding company board meeting with the committee for liaison with the Council on 22 April 2009 to discuss the investment; and
- the holding company and Delta representatives meeting the Council about the Jacks Point investment and other holding company matters on 29 April 2009.

65 This amount includes director's fees of $7,116. As noted in Figure 13, Delta included directors fees paid to Ruboc (for Mr Coburn) in the Delta group related-party figure in its 2012 annual report. It continued this practice in the 2013 annual report.

66 Minutes of the board meeting for 8 April 2009. The minutes record that Athol Stephens, Doug Jackson (Acting Governance Support Officer), and Jim Harland were in attendance for the item about Council and holding company matters.

5.100 No formal records were kept of the briefings to the liaison committee or the Council, but we have seen a copy of the presentation used at the April 2009 Council meeting. The presentation contained information on the Jacks Point investment opportunity.

5.101 Delta issued a press statement on 6 June 2009 about entering into an agreement with Jacks Point Limited to provide estate management services at Jacks Point and noted the possibility of entering into other agreements. The press statement did not mention that Delta had acquired land for property development at Jacks Point. The *Otago Daily Times* reported in early July 2009 that Delta had bought 100 sections at Jacks Point for between $2 million and $3 million. Delta's chief executive declined to comment on the incorrect reporting of the purchase price for reasons of commercial sensitivity.

Our comments

Timing of the purchase

5.102 Delta, through Newtons, purchased the land at Jacks Point as part of its growth strategy but at a time when a similar investment at Luggate was not delivering the expected benefits.

5.103 We wanted to understand why Delta invested in Jacks Point considering the then state of the Luggate Park investment. The initial report to the joint venture subcommittee in March 2009 on the Jacks Point opportunity did not refer to Luggate Park. However, the strategic goal of Delta continued to be the pursuit of growth and a firmer foothold in Central Otago.

5.104 The Jacks Point deal was seen as fitting with these goals in a more attractive area for development than Luggate Park. Jacks Point was already more established and the proposal had some broader benefits. One of the Delta directors told us that Luggate Park and Jacks Point were regarded as quite different projects. The chief executive said that, given the broader benefits to Delta (such as the contracting work), Jacks Point was also seen as a longer-term proposition than Luggate Park.

Determining the price

5.105 Delta decided it did not need a valuation for Jacks Point. This decision was based on the expected outcome of Delta's financial modelling, and the fact that one of its directors, Mr Coburn, had property development experience in Queenstown and an understanding of the local market. Also, Delta directors considered that the valuation report for the Luggate land had been optimistic.

5.106 One of the complainants noted that the Jacks Point land that Delta purchased had a rating valuation at 1 July 2008 of $2.3 million. They questioned why Delta would pay $8.82 million in 2009 for land valued at $2.3 million in 2008. In July 2008, the land was undeveloped and its rating valuation would have reflected that. Delta's financial modelling showed that the price sought was reasonable and would enable it to make a profit on selling the developed sections. Delta did not consider the rating valuation for undeveloped land to be relevant.

5.107 In our view, given that this was a new activity for Delta and because sales at Luggate Park had yet to eventuate, it would have been prudent to get an independent review of the financial projections to ensure that $8.82 million was a reasonable price to pay for the land. The directors have explained why they did not seek a valuation, but we consider an external independent review would have been useful, given the amount of the investment.

Local Government Act requirements and Newtons

5.108 The directors of Newtons made decisions about the Luggate Park and Jacks Point investments, and entered into legal agreements and funding arrangements for those investments, in April 2008 and in 2009. The company did not have a statement of intent in place when those decisions were made.

5.109 The records we reviewed do not show any consideration of Newtons' status as a council-controlled organisation when the directors started making decisions.[67] The Local Government Act states that decisions by directors of council-controlled organisations must be made in accordance with the statement of intent (and, if applicable, the constitution).

5.110 Newtons did not meet all of the accountability requirements for council-controlled organisations when it was first owned by Delta, but began to do so from mid-2009 after it became more active. Newtons prepared a report for the six months ended 31 December 2009, an annual report for the year ended 30 June 2010, and its first statement of intent for the year starting 1 July 2010.

5.111 In its 2010 annual report, Newtons disclosed the fact that it had not prepared a statement of intent for the year starting 1 July 2009. Audit New Zealand issued a qualified audit report referring to that omission. Newtons (now Delta Investments Limited) has met Local Government Act accountability requirements since then.

5.112 It is unfortunate that Delta did not consider accountability requirements for Newtons sooner. In our view, this was an oversight rather than an example of Delta intentionally avoiding accountability requirements.

67 Newtons had not met any of the accountability requirements when it was owned by Dunedin City Council, either. The company was inactive, so the Council could have exempted it from those requirements but had not done so.

Managing Mr Coburn's interests

5.113 We have reviewed the interests registers of Delta, Newtons, and the holding company, and minutes of relevant meetings, to see how Mr Coburn's interests at Jacks Point were managed.

5.114 The practice of the directors in the holding company group was to make general declarations of their directorships and shareholdings in other companies. Most of the directors had many other such interests, and the Companies Act would deem them to be interested in any transactions with those other companies. It is standard practice to make general disclosures, even if it is unlikely that the company will transact with those other entities.

5.115 Directors can also make specific disclosures about their interests from time to time, for entry into the company's interests register, and can also disclose other interests not covered by Companies Act requirements that they wish their fellow directors to know about.

5.116 Figure 14 summarises Mr Coburn's interests and disclosures.

Figure 14
Michael Coburn's interests and disclosures

Mr Coburn's interests	Delta's dealings with those companies/interests during period of the interest	Disclosures/references in Delta records and annual reports
Jacks Point Limited – director from May 2004 to December 2008 and Executive Director from April 2005.	Delta carried out contracting work at Jacks Point from late 2005. Proposed joint venture discussions between Delta and Jacks Point Limited from August 2006 to January 2007.	Disclosed in Dunedin City Holdings Limited and Delta interests registers – May 2004 and April 2005 respectively. Related-party disclosures of payments by Jacks Point Limited to Delta for construction work in Delta annual reports from 2006 to 2009.
Ownership interest in Jacks Point land through Ruboc Holdings Limited/Jacks Point Equities from May 2005 to October 2006, and director of Jacks Point Equities from July 2004 to August 2008.	As above.	Not disclosed in interests registers. Minutes of meetings of Delta directors in late 2006 and early 2007 record that "Mr Coburn advised that he had a general notice of interest noted in the interests register on all matters associated with Jacks Point."

Mr Coburn's interests	Delta's dealings with those companies/interests during period of the interest	Disclosures/references in Delta records and annual reports
Owner of nine lots at Jacks Point, member of Jacks Point Residents and Owners Association, and director of JPROA subsidiary (Coneburn Water Limited).	Mr Coburn proposed in early 2009 that Delta buy land at Jacks Point for development.	Disclosed to Delta in March/April 2009 and board advised.
Director of Arith Holdings Limited from January 2007 to August 2008.	Delta carried out contracting work for Arith Holdings Limited in the 2007 and 2008 financial years.	Disclosed at Delta Utility Services Limited board meeting in June 2007. Related-party disclosures of payments by Arith Holdings Limited to Delta for construction work in Delta's 2007 and 2008 annual reports.
Director and shareholder of Ruboc Holdings Limited from December 2002.	Consultancy arrangement for Jacks Point proposed in April 2009 and approved in August 2009.	Not disclosed in interests registers (neither Mr Coburn's interest in Ruboc nor the particulars of the consultancy arrangement). Directorship disclosed in related-party information in Newtons' 31 December 2009 half-yearly financial statements and Newtons' and Delta's annual reports from 2009/10. (Payments in 2008 and 2009 were not disclosed in annual reports.)
Director of Jack Tewa Appointer Foundation Limited.	Not significant.	Disclosed in August 2011.
Trustee of trust that holds shares in Locations Realty Limited/Locations Realty Queenstown Limited (no beneficial interest).	Possible role in marketing Jacks Point development (not just Delta land) in March 2010. Possible role in marketing Delta's Jacks Point land in July 2011.	Disclosed to Delta Investments Limited board meeting in July 2011. Interests register disclosure in August 2011. Newtons' annual report 2011/12.
Committee member of JPROA.	JPROA introduced a possible buyer for some of Delta's Jacks Point sections in August 2012.	Disclosed to Delta Investments Limited board meeting in August 2012.

5.117 As well as Mr Coburn's interests register notifications and disclosures at meetings, we noted several references in Delta documents that confirmed that Mr Coburn's interests were known to Delta:

- Delta managers told the joint venture subcommittee and Delta directors in March and April 2009 that Mr Coburn had advised that he had no financial interest in Jacks Point Limited or Henley Downs other than as a beneficial owner of nine lots and as a board member of the JPROA and of Coneburn Water Limited;
- Delta's searches in April 2009 of land ownership information at Jacks Point confirmed Mr Coburn's interest in nine lots through a trust; and
- As part of their due diligence review of the proposed Jacks Point investment, Delta staff did a company search of Mr Coburn's interests on 3 April 2009. A report to directors on 1 July 2009 noted that Mr Coburn confirmed his earlier resignations from the boards of Arith Holdings Limited and Jacks Point Limited.[68]

Companies Act disclosures

5.118 The Companies Act defines the circumstances in which a company director will be considered to be "interested" in a transaction with the company. Mr Coburn adequately disclosed his interests, being:

- a director of companies and other entities relevant to Delta's dealings at Jacks Point; and
- a trustee of a trust that holds shares in the Locations real estate companies that his son is involved with.

5.119 However, the Companies Act requires the disclosure of circumstances in which a person will or may receive a material benefit from a transaction. In our view, Mr Coburn should also have disclosed:

- his indirect ownership interest in the Jacks Point land from May 2005 to October 2006 through his 15% shareholding in Jacks Point Equities Limited, held by his company Ruboc Holdings Limited; and
- in Delta's and Newtons' interests registers, that he is the shareholder as well as the director of Ruboc Holdings Limited.

5.120 Because of his indirect shareholding in the company that had proposed the joint venture, we consider that Mr Coburn might have received a material benefit if the proposed joint venture with Delta for construction work had proceeded. In our view, Mr Coburn should have disclosed his indirect ownership interest in Jacks

68 The resignations took place in August and December 2008 respectively.

Point Limited to Delta directors at the start of discussions on the proposed joint venture company between Delta and Jacks Point Limited even though:

- there was only a brief period when the ownership interest applied (Mr Coburn ended his shareholding in October 2006); and
- the proposed joint venture did not proceed.

5.121 Also, as Mr Coburn is the sole shareholder and director of Ruboc Holdings Limited, there is a material benefit to that company from Delta's payments for Mr Coburn's services. Mr Coburn should have disclosed that he is a shareholder as well as a director of that company and should have disclosed his interest in Ruboc Holdings Limited in the interests registers of Newtons and Delta. Mr Coburn notes that Delta paid his director's fees to Ruboc Holdings Limited since he was appointed as a director and believes that his interests in that company were always known.

Management of Mr Coburn's interests during the 2006 joint venture negotiations

5.122 We have covered in detail the 2006 discussions between Delta and Jacks Point Limited about the proposed joint venture construction company because those discussions raised concerns about Mr Coburn using knowledge gained as a director of Delta for his own gain. We wanted to see how Mr Coburn's conflict of interest (because he was involved on both sides of the proposal) was managed.

5.123 We note that the minutes of significant meetings refer to his "general notice of interest noted in the interests register on all matters associated with Jacks Point". We also note that Mr Coburn did not take part in the significant decision about whether to proceed with the proposed joint venture.

5.124 Delta managed the conflict adequately by not sending Mr Coburn some of the information sent to other directors. Mr Coburn did not take part in the joint venture subcommittee's decision-making. Had the proposed joint venture company proceeded, Delta would have faced ongoing challenges in sharing information while managing Mr Coburn's conflict of interest. It may not have been possible for Mr Coburn to continue to be a director of both Delta and Jacks Point Limited.

What Mr Coburn knew about Delta's strategy and business operations

5.125 The Companies Act provides that a director who has information in their capacity as a director, being information that would not otherwise be available to them as a director, must not disclose that information to any person or use or act on the information, except for the purposes of the company or if permitted to do so by the board.[69]

69 Section 145 of the Companies Act 1993.

5.126 A Delta manager raised a concern about Mr Coburn's possible use of Delta information at one point during the joint venture discussions, as a hypothetical instance. Again, we consider that this would have presented ongoing challenges had the joint venture proceeded and had Mr Coburn remained involved with both Jacks Point Limited and Delta. That said, we note that the arrangement was intended to benefit both companies and that the board could have authorised Mr Coburn's use of information that would not prejudice Delta.[70]

Mr Coburn proposed the 2009 Jacks Point investment

5.127 Soon after resigning from his role as Executive Director of Jacks Point Limited, Mr Coburn proposed to Delta that it buy land at Jacks Point and develop it. At that time, Mr Coburn's main interest at Jacks Point was as a beneficial owner of nine sections at Jacks Point.

5.128 In our view, this interest as a land owner gave Mr Coburn an interest in the overall success of the Jacks Point property development concept and therefore in the sale and development of some of the lots by Delta. The viability of the overall Jacks Point development and planned retail village and accommodation depends on developing the land and selling lots. Delta's buying and developing its lots should contribute to the development's long-term success and appeal.

5.129 Having disclosed his interest to his fellow directors and managers, Mr Coburn took an active role in board discussions about the proposal. Because he had met the requirements of the Companies Act, there was no problem with Mr Coburn being involved in Delta's decision to invest.

Consultancy payments

5.130 Delta managers and directors saw Mr Coburn as having useful skills to contribute to the Luggate Park project as well as Jacks Point, and engaged him to help with those projects in return for payment. This was in keeping with Delta's policy at that time.

5.131 We asked Delta directors if this was an unusual arrangement, and none said it was or had a problem with it. We accept that the directors were in the best position to judge what skills they needed to help with the projects at the time, and Mr Coburn's previous role as Executive Director of Jacks Point Limited and background in property development meant he was well placed to help Delta to manage costs. Mr Coburn's involvement also reduced the work time required of Delta's staff. Delta believes it could not have got a better person to manage the project if it had gone to the market.

70 Section 145(3) of the Companies Act 1993.

5.132 The board of a company may approve paying a director for work done in another capacity, but the Companies Act imposes some requirements on the board to ensure that such arrangements are transparent and appropriate.[71] The Companies Act requires:

- particulars of the payment to be entered in the company's interests' register; and
- directors who vote in favour of the payment to sign a certificate saying that the arrangement is fair to the company and state the grounds for that opinion.

5.133 The Newtons board approved the agreement with Mr Coburn's company for signing. Even though the parties have not been able to produce a signed copy, there was an approved arrangement in place to support the payments that were made.

5.134 Newtons prepared six-monthly financial statements for the period 1 July 2009 to 31 December 2009. Those financial statements disclosed that the company had paid Ruboc Holdings Limited $29,790 for consultancy services in the six-month period from 1 July 2009 and that Mr Coburn was a director of that company. Newtons' annual reports from 2010 include Ruboc Holdings Limited in the list of directors' interests, and make further related-party disclosures of subsequent payments to Ruboc Holdings Limited under the consultancy arrangement.

5.135 However, Newtons did not meet the core requirements of the Companies Act for such arrangements in that:

- the board did not enter the particulars of the arrangement in Newtons' interests register; and
- the directors who voted in favour of the arrangement did not sign a certificate stating that it was fair to the company with their reasons.

5.136 These requirements are in place to ensure that payment arrangements between a company and a director for extra work are fair to the company and disclosed to shareholders. The Larsen review noted the high number of related-party transactions in the holding company group and the need to be vigilant about these because of the inter-dependence of the companies in the group.

5.137 The directors did not show this sort of vigilance. They:

- did not take the extra steps required to certify that the arrangement was fair to the company;
- did not disclose details of the arrangement in the interests register; and
- have been unable to provide us with a signed copy of the contract for the work.

71 Section 161 of the Companies Act 1993.

5.138 Because Delta gave this work to Mr Coburn without going to the market, it was important to meet the Companies Act requirements to ensure that the arrangement was appropriate and in the company's best interests and was disclosed in the interests register.

5.139 We did not see any advice from Delta staff about the need to meet these Companies Act requirements, but are surprised that experienced company directors omitted to meet them.

Consequences of breach

5.140 Where a company has not properly authorised a payment arrangement between the company and a director, the director to whom the payment was made is personally liable to the company for the amount of the payment except to the extent that they can prove that the payment was fair to the company at the time it was made.

5.141 The directors of Newtons who approved the arrangement are best placed to judge whether they are satisfied with Mr Coburn's services under it. There is nothing in the minutes or other records to suggest that they were not.

Part 6
How the investments fared

6.1 In this Part, we discuss:

- who was governing the investments from 2009;
- how the Luggate Park joint venture fared;
- how the Jacks Point investment fared; and
- the wider context of Delta's financial performance.

6.2 We then comment on the financial outcome of the investments and their governance and oversight.

Summary of our findings

6.3 The Luggate investment did not fare well in the period covered in this Part. Despite the further efforts of the joint venture partners, only a few sales took place between mid-2009 and November 2012, when the joint venture land was offered for sale.

6.4 The interactions between the Luggate joint venture parties on significant matters in this period are further evidence of a robust commercial arrangement, with each party being concerned to protect its own interests – especially when it had become clear that the joint venture was uneconomic.

6.5 The final outcome of Delta's Luggate Park investment is reasonably clear after the sale of the land in August 2013 – a loss to Delta of about $5.9 million, which might yet be offset by a deferred tax credit of about $1.5 million.

6.6 We can see why the directors viewed the Jacks Point investment as a better proposition than Luggate Park, largely because of the broader benefits to Delta in terms of the rights secured under the related agreements for ongoing work for the company at Jacks Point. The first stage of the development was completed within budget and, in contrast to Luggate Park, the estimated development costs for each section proved to be accurate.

6.7 However, as with Luggate Park, the market has affected Delta's profit expectations. Delta hoped to make a profit of about $70,000 for each developed section at Jacks Point but the sections have sold at a loss.

6.8 The expected gain on sale was only one aspect of this arrangement. However, now that Delta is ending its involvement in civil construction in Central Otago, it will no longer be able to take advantage of all the broader benefits it expected when entering the investment.

6.9 The final outcome of the investment at Jacks Point will be known only after Delta completes the sale of its land, but Delta has projected an after-tax loss of about $2 million.

6.10 The performance of both investments needs to be seen in the context of Delta's wider financial performance. For the nine-year period from 2004 to 2012, Delta returned dividends of $32 million to the holding company. The turnover of Delta and Newtons increased from $63.4 million to $108.6 million in that period, so Delta's growth strategy had some success. However, more recently, Delta has had to restructure its operations and stop work in civil construction.

Governance of the investments from 2009

6.11 From July 2009, Newtons had to manage both the Luggate Park and Jacks Points investments. Newtons' board began meeting more regularly from about July 2009, meeting the day before Delta's board meetings. From mid-2009, Delta's staff reported every month to the Delta board on behalf of Newtons. Staff then prepared a one-page report to the Delta board on the Jacks Point and Luggate Park projects.

The owner board for the Luggate Park investment

6.12 In July 2009, Mr Coburn replaced Mr Liddell as one of Newtons' representatives on the Luggate Park owner board. It appears that Mr Coburn's earlier Luggate Park conflict was no longer considered a problem, and that his expertise in property development was considered useful for the Luggate Park project now that it was in an operational phase.

6.13 Figure 15 shows the membership of the owner board from 2007 to 2013.

Figure 15
Members of the owner board for the Luggate Park joint venture, 2007 to 2013

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Ray Polson (chairman)	✓	✓	✓	✓	✓	✓
Ross Liddell	✓	✓	×			
Michael Coburn			✓	✓	✓	×
Neil Macdonald	✓	✓	✓	✓	✓	✓
Jim Boult	✓	✓	✓	✓	✓	✓

× Left during the financial year.

6.14 Changes were also made to the Newtons board in July 2009. Mr Liddell and Dr Evans resigned and were replaced by Mr Cameron, Mr Coburn, and Mr McLauchlan (see Figure 16).

Figure 16
Members of the board of Newtons Coachways (1993) Limited/Delta Investments Limited, 2007 to 2013

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Ray Polson (chairman)	✓	✓	✓	✓	✓	✓	✓
Ross Liddell	✓	✓	✓	×			
Michael Coburn				✓	✓	✓	×
Stuart McLauchlan				✓	✓	✓	✓
Grady Cameron				✓	✓	✓	×
Norman Evans	✓	✓	✓	×			

× Left during the financial year. David Frow and Ian Parton joined the board in April 2013 after being appointed as directors of Delta Utility Services Limited.

How the Luggate Park joint venture fared

6.15 The Luggate joint venture project remained largely on hold throughout 2010. There were no sales of lots in the early part of 2010, but the house-and-land package was sold in April 2010. The sale proceeds were used to reduce the joint venture's debt.

6.16 The sewage treatment upgrade and electricity undergrounding projects were completed in the first few months of 2010, with Aurora Energy Limited doing the undergrounding work.

6.17 The bank agreed to extend the loan to up to $1.935 million to cover those costs, but negotiated stricter terms than for previous loan extensions. At first, the bank wanted a valuation, but did not pursue this at the time after discussions with the joint venture partners.

6.18 The bank agreed to a new maturity date for the loan of 31 March 2011, with a new condition requiring four lots to be developed and sold by the end of October 2010. If this did not happen, or if the loan was unpaid at the maturity date or another increase sought, the joint venture would need to get a valuation of the joint venture land.

6.19 The joint venture partners did not seek further extensions to the loan after the increase for the sewage treatment upgrade and undergrounding costs. Instead, they agreed to share any joint venture costs.

6.20 The owner board began to focus on options to clear the debt, with a view to keeping the project on hold until the market improved. The owner board considered, but did not pursue, the following options:

- developing 20 of the stage 2A1 lots;
- marketing the "high end" stage 2B lots, or developing one of those lots to generate interest and demand; or
- selling a block of the developed lots for a discount.

6.21 The higher-than-expected development costs affected the viability of some of the proposals, and the owner board was not keen on increasing the bank debt further. Therefore, the owner board decided in April 2010 not to proceed with stage 2B at that time and that stage 2A would take place in the longer term. Mr Boult's assessment at that time was that the market was "effectively dead", and, in June 2010, the owner board noted that the market was unlikely to change in 2011.

6.22 In July 2010, Delta became concerned about the declining value of its security over the land. It was concerned that the funds borrowed from the bank had not necessarily increased the value of the land by the same amount, given the longer-term nature of the investment. Because the bank's debt ranked ahead of Delta's, the value of Delta's security had gone down. Under the mortgage priority arrangements, the bank would need to be repaid about $2 million before Newtons or Luggate Properties Limited would be repaid any of their contributions.

6.23 In September 2010, the owner board discussed the bank's impending deadline to sell four lots by the end of October 2010. The owner board noted that the sale of the house-and-land package in April would count towards the target of four sales, and an offer had been received for one other lot.[72] The owner board discussed what its options might be if it did not meet the bank's target, including each joint venture partner taking responsibility for its share of the bank debt. Delta continued to view Luggate Park as a long-term investment that would require keeping the necessary funding in place, either through an external bank loan or from within each partner's own facilities.

6.24 The joint venture did not meet the bank's sales target. By the end of October 2010, the joint venture had achieved two sales between April and September 2010 and one sale in 2008, before the joint venture was formally settled.

6.25 In December 2010, the bank told the joint venture that it had arranged for a new valuation of the land.

72 This lot sold in September 2010 and the proceeds were used to reduce the bank debt.

Events in 2011

6.26 The owner board continued to meet in 2011 but less often, because the project remained on hold. Delta's staff provided regular updates to Newtons' board meetings. The updates were then passed on to Delta's board.

6.27 During 2011:

- the bank agreed to extend the term of the loan for another year, to the end of March 2012, but wanted the joint venture to focus on selling the developed lots (see paragraphs 6.28-6.30);
- the bank-ordered valuation was finalised in the middle of the year (see paragraphs 6.31-6.34);
- Mr Boult offered to sell the Luggate companies' share of the joint venture to Delta, but Delta declined the offer (see paragraphs 6.35-6.40);
- the joint venture continued to market the land, including looking for a housing company partner for house-and-land packages and listing the developed lots for sale with different real estate agents;
- Audit New Zealand raised the matter of whether the value of the Luggate Park joint venture should be reduced (impaired) in Newtons/Delta's financial statements; and
- the joint venture worked with the Luggate Homeowners Association and Luggate Village Services Limited (a company formed to own the sewerage treatment plant) on transferring ownership of an irrigation scheme and the sewage treatment plant to Luggate homeowners.

Extending the bank loan

6.28 In late March 2011, the owner board agreed to:

- focus on selling the 11 developed lots rather than do any further work on the undeveloped land; and
- request a one-year rollover of the bank loan, with continuing interest capitalisation and facility to fund the estimated operating deficit of $100,000 for 2011/12.

6.29 The bank agreed to extend the loan until the end of 2011. This was conditional on proactive marketing and selling of the developed lots. The owner board agreed on sale prices for those lots in September 2011, and they were listed for sale with several real estate agents. One more lot sold in October 2011.[73]

6.30 The updated valuation required by the bank was dated July 2011.

73 This was the fourth lot to be sold since the joint venture began.

The 2011 valuation for the land at Luggate

6.31 The 2011 valuation that the bank required was done by a different company than had done the previous valuations and on a different basis. That company estimated the individual values of the 10 unsold developed lots from stage 1 on both a current market value and forced sale basis. It estimated the value of the undeveloped blocks of land (stages 2A and 2B) as single blocks (rather than for their subdivision potential). This was because the planned subdivision was uneconomic in the prevailing market.

6.32 The valuer considered that the best use of the undeveloped land would be as a single house block, but keeping the excess rural land for its future subdivision potential. This meant the land was valued at far less than the earlier valuations, which had partly been done on a "hypothetical subdivision" basis.

6.33 The 2011 valuation put the combined value of the developed lots and the undeveloped blocks of land at $1.83 million (current market value) or $1.54 million on a forced-sale basis.

6.34 The valuer commented on the state of the market:

> *The general Wanaka property market entered a period of consolidation with subsequent falls in value levels from circa 2007. The subject development is located within a secondary location that caters for the lower end of the market and demand and sales numbers for 2011 appear weak. With the current property climate we believe the two development blocks to be uneconomic to currently develop with the likely purchaser being an entity who would hold the land for future potential, with the possibility of developing the land in the short term with a residence and grazing the balance.*

Delta declines the opportunity to buy out the other joint venture partner

6.35 In early March 2011, Delta began to consider its options in the event that the Luggate companies might wish to exit the joint venture and sell their share of it. Under the joint venture agreement, a party wanting to sell their joint venture interest had to give formal notice to the other joint venture partner and offer the other partner the first opportunity to buy it. The other party could accept the offer, have the "fair value" of the interest worked out under a process set out in the joint venture agreement, or decline the offer. If the party declined and the seller decided to offer it for a lesser amount to another party, the seller then had to offer it to the joint venture partner for that lesser amount.

6.36 Delta summarised its financial position and significant information about the joint venture at that time:

- Delta owed the bank about $770,500 (half of the current bank debt);
- Delta had an outstanding advance to the joint venture of about $5.3 million, which was repayable only if the land was developed and lots were sold;
- the estimated development costs for each lot had risen from $55,000 to $105,000; and
- Delta had carried out about $650,000 worth of contracting work for the joint venture.

6.37 Delta needed to consider whether the joint venture development would be viable if it took over the whole project. It decided that it did not wish to invest more money in the joint venture land at that time, but would consider its options if Mr Boult decided to sell.[74]

6.38 In July 2011, Mr Boult formally offered Delta the opportunity to buy the Luggate companies' share of the Luggate Park joint venture, including the joint venture land and their share of the bank debt.[75]

6.39 Delta declined the offer in late July 2011, but noted that, if Mr Boult was not able to sell the Luggate companies' share to another person for that price, then it would consider any alternative proposal.

6.40 In September 2011, Mr Boult told Delta that the Luggate companies intended to sell their share of the joint venture by tender. However, at the end of November 2011, he noted that he thought Delta remained the best option as a purchaser and Delta agreed to reconsider the offer early in 2012.

Events in 2012

6.41 At first, Delta's focus in 2012 was on how it should position itself in the event that the bank called in the loan, and then how to exit the Luggate Park investment.

6.42 Between September 2011 and November 2012, the owner board did not meet, but Delta's staff continued to report on Luggate Park to board meetings of Newtons (re-named Delta Investments Limited from 1 July 2011) and kept in contact with Mr Boult, as required.

6.43 In January 2012, Delta reconsidered its position on buying the Luggate companies' share of the joint venture and again declined the offer. Delta declined again in March 2012, when the companies offered their share for a lesser price.

74 Minutes of Newtons' board meeting, 2 March 2011.

75 The interests of Luggate Holdings Limited and Luggate Properties Limited in the joint venture were referred to in the offer as "the Boult assets". For convenience, in this section of the report, we refer to those interests as those of "the Luggate companies".

6.44 The bank did not extend the term of the loan after expiry at the end of 2011. The bank said that the parties would have to pay the interest owing in order to get another renewal. The arrangement with the bank moved to a month-by-month one.

6.45 Delta considered paying its share of the bank debt, but thought this might be to its disadvantage if the joint venture ended and the land had not been developed. Delta got legal advice on its position. One option was to negotiate with the bank for Delta to buy out the bank debt. If Delta did this, it would need to be confident that it could sell the land for more than the amount of the bank debt or that it could afford to hold the land until the market improved.

Providing for impairment in the value of the Luggate Park and Jacks Point investments

6.46 In April 2012, Delta directors agreed that the value of the Luggate Park and Jacks Point investments should be written down by $5 million and $2.5 million (before tax) respectively in Delta Investments Limited's 2012 financial statements. This was partly because the new directors of the holding company had said that Delta should exit from its property investments and consider providing for impairment in the value of the investments to reflect their net realisable value in the event of a relatively quick sale.[76] Denham Shale, the chairman of the holding company at that time, confirmed to us that he and another holding company director had given Delta this message.

Delta decides to sell the Luggate Park land

6.47 In May 2012, Mr Polson reported to the Delta board that Delta Investments Limited had decided that Delta should sell its interest in the Luggate Park joint venture for as much as it could and that Delta staff would work with Mr Boult to achieve that.

6.48 The joint venture partners considered whether to sell the remaining developed lots separately from the undeveloped blocks of land (stage 2A and 2B), including whether to first sell the developed lots by auction. They later decided to market the developed and undeveloped land as a package, after receiving proposals from local real estate firms.

6.49 In mid-2012, the bank was pressing for a loan repayment proposal and considering issuing a notice demanding repayment.

6.50 Delta got advice on its options. It was not a simple matter of Delta repaying its share of the bank debt because this might be to its disadvantage later. Delta also

76 Audit New Zealand had raised this issue during the audit of the 30 June 2011 financial statements. The directors took advice from Delta management and decided not to provide for impairment of either investment at that time.

received advice that it was important to keep the joint venture structure in place to get the benefit of any tax loss. This further complicated the situation.

6.51 In July 2012, Delta updated the holding company about the decision to sell the Luggate Park investment. Delta noted that the holding company was comfortable with the direction being taken.

Selling the Luggate Park land

6.52 By the end of September 2012, two more of the developed lots had been sold. This brought the total number of lots sold since the joint venture began to six.

6.53 The joint venture offered the rest of the developed lots and the undeveloped blocks (stage 2A and 2B) for sale by tender, with a closing date of 14 November 2012.

6.54 Three offers were received and the joint venture partners began to negotiate with one of the prospective buyers.

6.55 On 30 November 2012, the joint venture partners entered into a conditional sale and purchase agreement with a company to sell seven developed lots and the undeveloped land (stages 2A and 2B) for $1 million. The sale was conditional on the joint venture subdividing one of the lots to create a separate title for an existing cottage, and settlement was to be 42 working days after the subdivision had been completed and a title issued.

6.56 The bank expected the joint venture debt to be reduced even with the sale and before settlement. This did not happen, but the bank agreed to the sale proceeding on the basis that the joint venture parties would repay the loan immediately after settlement.

6.57 After a delay with settlement (because it took longer than expected to complete the cottage subdivision), the Luggate Park joint venture land was sold on 5 August 2013 for the agreed price of $1 million. The net sale proceeds were paid to the bank to reduce the debt for development costs. Delta then cleared its 50% share of the remaining bank debt.[77]

How the Jacks Point investment fared

6.58 The land Newtons purchased at Jacks Point was in two blocks, known as neighbourhood 3 (N3) and neighbourhood 2B (N2B). Each block had room for 49 developed lots.

6.59 In August 2009, Delta staff told the Newtons board that members of the project delivery group for Jacks Point would be Mr Coburn (project director) and a representative from Peak Projects Limited (a company engaged as project

77 See paragraph 6.123.

manager). Representatives from an engineering company and a surveying company were engaged to help.

6.60 In October 2009, Delta began to develop 49 lots at N3, with a planned finishing date of April 2010. The Newtons board had approved the work starting, subject to the total estimated price of construction costs for N3 being no more than $2.55 million ($52,000 for each lot).

6.61 The Newtons board monitored progress with the development and the wider property market each month from September 2009. The board received written reports from Delta staff and the project manager. These reports covered progress on matters such as earthworks and storm water, titling, marketing updates, expenditure against budget, and actual against planned timing to complete.

6.62 The first few reports were positive in terms of marketing opportunities, expenditure against budget, and timing. Mr Coburn's responsibilities included preparing a marketing plan for the development, and his marketing efforts in late 2009 included discussing:

- possible house-and-land packages with house builders, which were also being considered at Luggate Park; and
- the option of selling the whole N3 development to one overseas buyer for the purpose of marketing house-and-land packages.

6.63 By February 2010, the sale of the N3 block to the overseas buyer was looking less likely because the market was softening. Instead, that buyer was considering 12 to 15 house-and-land packages.

6.64 In February 2010, Mr Coburn advised the Newtons board that a company that had acquired a block of Jacks Point sections from Hanover Finance might offer to sell those sections at a low value. Mr Coburn was working on a proposal to mitigate the risk to other land owners of low price sales. The mitigation proposal involved all major landowners at Jacks Point operating from a common sales office under a "master agent" but with involvement of all the main Queenstown agencies.

6.65 A March 2010 report to the Newtons board from Peak Projects Limited named Locations as the master agent for Jacks Point sales, and said that Mr Coburn was going to request a proposal from Locations to act as master agent for Delta's N3 lots. However, it appears that this did not happen. Marketing efforts were put on hold about this time and the minutes of Newtons' March 2010 board meeting do not refer this proposal.[78]

6.66 In March 2010, Mr Coburn told the Newtons board of a possible arrangement whereby Jacks Point Limited or a related company would buy back all of the N3

78 Mr Coburn disclosed an interest in Locations Realty Limited at a later board meeting in July 2011, when marketing options for Delta's land at Jacks Point were again being considered.

sections when they were developed in return for a payment of half cash and half land, being another 49 lots at Henley Downs.

6.67 In April 2010, Delta managers told the Newtons board that services at the N3 block had been largely installed, but staff might need to be reallocated to other work and this would delay finishing the construction work until after that winter.

6.68 Managers noted that marketing activity was on hold but that a strategy could be prepared for a summer sales campaign. It would be timed to coincide with the revised completion date for the N3 block of the end of September 2010 (this was later moved to mid-October 2010).

6.69 In June 2010, Mr Coburn said that the buyer of the Hanover Finance sections was selling them for low prices as had been anticipated. Mr Coburn also said that he was expecting to get the terms of the offer from Jacks Point Limited to buy the N3 sections back from Newtons by the end of June, and that he had received some low offers for the N3 sections from other buyers.

6.70 The Newtons directors discussed what minimum price they would accept for the developed Jacks Point sections. They noted that, at the prices other lots were selling for, Newtons would be making minimal profit but also that Delta had made a profit margin on the development work of about $3,000 for each lot[79] and the development was keeping its staff in work.

6.71 Newtons put its first statement of intent in place for the year beginning 1 July 2010. The statement of intent said that Newtons' mission was to become a leading infrastructure investor, and that its principal activities would be to procure and develop land for residential and commercial purposes and to make any other infrastructure investments for a commercial return. The statement of intent noted that these activities would generally be outside the scope of Delta's activities.

Position in September 2010

6.72 As the work progressed, it became apparent in late September 2010 that Delta's (through Newtons) overall investment in Jacks Point could breach the $10 million threshold. At first, Delta had told the holding company and the Council that the investment would not exceed $10 million at any time. That amount was a trigger point that would require specific formal approval from the Council. However, as work had taken longer than planned and as no sections had been sold, the $10 million threshold had been breached.

79 This amount appears to have been conservative. In August 2011, Delta managers told the directors of Delta Investments Limited that the average construction profit on the N3 sections was $6,000 for each lot.

6.73 On 29 September 2010, Mr Cameron wrote to Delta about the breach. In October 2010, Delta then wrote to the holding company, saying that:

- although no sales had taken place, increasing activity on the overall Jacks Point site was encouraging;
- Delta hoped to sell up to 16 lots by the end of 2010/11 (consistent with the original projections for the year);
- receivers of failed investment companies had been selling some of the poorer quality sites at low prices and this could affect pricing of other lots at Jacks Point;
- Delta remained confident that its sites were superior and able to be sold at a price that exceeded the total cost;
- total costs were expected to be inside the original estimate;
- the plan to complete sales by June 2015 was extended to June 2017; and
- it was likely that Delta would be in breach of the $10 million threshold for the next two financial years.

6.74 Delta directors assumed that the holding company would pass this information on to the Council.[80]

6.75 We asked the chief executive of the holding company how the holding company responded to this information. The chief executive told us that the holding company did not respond formally to the letter. He said that by that stage it was clear that investment was well under way and it was too late for anyone to say "No". Also, because the Delta directors and holding company directors were largely the same, they were effectively writing to themselves.

6.76 At the Newtons board meeting in September 2010, Mr Coburn updated directors about the possible deal that he had been discussing with Jacks Point Limited, whereby Jacks Point and Henley Downs interests would buy the developed sections from Newtons for a mixture of cash and land at Henley Downs. He advised that Newtons should not acquire more land in the prevailing market. Mr Coburn said he would recommend a marketing strategy for the N3 sections for launch in October 2010.

6.77 The Newtons board agreed to start construction work on the N2B block of land from October 2010, noting that part of the rationale for the purchase had been to provide work for Delta staff. However, in late September 2010, the board noted that the recent Canterbury earthquake might significantly affect Delta's future workload and the timing of work on the N2B development. The Newtons board later decided to review this in early 2011.

80 Minutes of Delta Utility Services Limited board meeting 27 October 2010.

6.78 Construction of the N3 block of 49 lots was completed in late October 2010, within the original budget. The Newtons board decided to begin marketing the sections in early 2011, with section prices starting at $195,000 (including GST).

6.79 In December 2010, Mr Coburn told the Newtons board that the marketing plan would be close to completion for the next board meeting and the direction of the market would become more apparent during the Christmas period.

Jacks Point events in 2011

6.80 In February 2011, Mike Coburn reported to the Newtons board on sales of other sections at Jacks Point and said that the marketing campaign was ready to start. However, he recommended that Newtons hold the release of the sections until the market improved. Mr Coburn also reported on discussions with other land owners at Jacks Point. He said it was hoped that there would be a common sales office for Jacks Point sections in the next six months.

6.81 In March 2011, Delta staff reported that the N2B development had been put on hold until further notice because the Delta resources were to be redirected to another joint venture development at Hanmer Springs[81] or Christchurch in the near future. Titling of the N3 lots was put on hold because rates would become payable when titles were issued and there was no point paying rates on unsold lots. Mr Coburn told directors that a marketing plan was being prepared and that he still expected some sales before July 2011.

6.82 Mr Coburn continued to discuss with interests at Jacks Point and Henley Downs their offer to purchase all of the developed N3 lots in return for cash and some undeveloped land at Henley Downs. The board considered the amount offered too low, but agreed to leave the offer on the table. Mr Coburn:

- reported on recent sales of 16 other sections at Jacks Point once owned by Hanover Finance; and
- said he was looking to market the N3 lots with a starting price of $195,000, and that a September marketing launch was now planned.

6.83 At the Newtons board meeting on 2 March 2011, Delta staff had advised that the agreement between Newtons and Ruboc Holdings Limited for Mr Coburn's project management services was overdue for mid-term review, including of the fees payable, and this should have happened in October 2010.

6.84 Delta staff were asked to report to the next Newtons board meeting at the end of March 2011. At that meeting, Mr Coburn said that, as from April 2011, he would charge for project management services at Jacks Point at the directors' rate of

81 Delta put some effort into negotiations about this venture, which had a similar structure to the Luggate Park one but was smaller. The venture did not proceed.

$200 an hour, rather than for the fixed fee that had previously been agreed. His work would be mainly in marketing.

6.85 There were no sales during 2010/11.

6.86 Newtons changed its name to Delta Investments Limited in 1 July 2011. At a Delta Investments Limited board meeting in July 2011, Mr Coburn reported that the intended spring 2011 launch target date was on track and that Locations was working on the marketing plan. The minutes of the meeting record that:

- Mr Coburn told the meeting of his relationship with Locations and asked that it be noted in the company's interests register; and
- the interests register would "record that Mr Coburn has an association to Locations Realty Limited, through his son being a shareholder".

6.87 Soon after the meeting, in an interests register disclosure to Delta on 4 August 2011, Mr Coburn confirmed that he was a shareholder, through a trust, in Locations Realty Queenstown Limited.[82]

6.88 At a Newtons board meeting on 30 August 2011, Mr Coburn noted that Locations and another agency had submitted marketing proposals. The directors agreed that Delta staff would evaluate the proposals and make a recommendation to the next board meeting.

6.89 A report to the Delta Investments Limited board at 27 September 2011 summarised the position and the options:

- Delta had paid $8.82 million in total for the land and spent $2.2 million developing the first 49 lots. Holding costs were estimated to be about $6,000 a year for each developed lot.
- Based on sale prices during the last 12 months in the area, including a block of plots sold under a "mega sale process", the current market price for Delta's developed lots was estimated to be between $185,000 and $225,000.
- Options for the future were to:
  - sell the developed lots as soon as possible;
  - hold the lots until the market improved;
  - sell all the lots as a package to one buyer; or
  - work with construction companies on house-and-land packages.

6.90 Delta staff recommended that they continue to work with Locations and others on house-and-land concepts and present a preferred strategy to the board.

6.91 Mr Coburn reported that he was working with other parties on a potential bulk sale agreement, as well as individual section sales.

82 Mr Coburn is a trustee of a trust that holds shares in two related companies – Locations Realty Limited and Locations Realty Queenstown Limited – and has no beneficial interest.

6.92 During the next couple of months, Delta met with Locations and another company about house-and-land packages and with companies interested in building show homes on Delta's land at Jacks Point. In November 2011, Delta managers reported on options that the show-home companies proposed. The Delta Investments Limited board agreed to fund one of the companies to build two show homes.

6.93 The intended marketing launch in the spring of 2011 did not take place. It is not clear whether the marketing plan that Mr Coburn referred to during various meetings was ever formalised or presented to the Delta Investments Limited board.

6.94 Delta managers and Mr Coburn have said that Delta did not enter into an agency agreement with Locations for the sale of Delta properties at Jacks Point.

Jacks Point events in 2012

6.95 In early 2012, Delta worked on or considered the following options to achieve sales at Jacks Point:

- continuing to work with various parties on building show homes on Delta's land;
- considering a possible bulk sale of sections to a party based in Singapore;
- commissioning a master plan layout that would show building platforms and house positions to potential buyers;
- taking a "mega sale" approach to liquidate as many of the developed sections as possible, as well as the undeveloped lots in N2B; and
- the possibility of a "land bank" to be formed by other Jacks Point owners taking over 10 of the developed N3 lots or all of the undeveloped N2B lots, and the lots being sold in smaller blocks over time to maintain the land value.

6.96 In April 2012, resource consent was declined for Delta's proposed works depot at Jacks Point (Woolshed Road). As part of buying the Jacks Point land, Delta had an option to buy land for a works depot for $1.5 million subject to the necessary resource consent being obtained.

6.97 In April 2012, after considering the holding company's comments and discussing the matter themselves, Delta directors agreed to recognise impairment in the value of the investments in Jacks Point and Luggate Park and to sell those investments.

Going concern discussions for Delta Investments Limited

6.98 Mr Polson, as chairman of Delta Investments Limited, reported to the Delta board in May 2012 that the company was unlikely to be a viable in the long term. He expected that the company would eventually be wound up. He noted that provision had been made for a pre-tax $5 million loss in the company's 2012 financial statements (this was the effect of writing down the value of the Luggate Park joint venture by that amount) and that the Jacks Point investment was also to be written down by $2.5 million before tax.

6.99 As part of the 2012 audit of Delta Investments Limited, Audit New Zealand raised the matter of whether the company could reasonably expect to recover enough funds from property sales to repay the advance owing to Delta. It was agreed that Delta would provide a letter of support to Delta Investments Limited, and would make a doubtful debt provision for the money that the company owed it.

6.100 Delta Investments Limited's annual report for the year ended 30 June 2012 noted that the board intended to sell its property investments at Luggate Park and Jacks Point because of the continuing weakness in the residential property market in the Queenstown Lakes district.

Delta's exit strategy

6.101 In July 2012, a party with an interest in Jacks Point sought Delta's support for a proposal to buy out various other ownership interests at Jacks Point and sell the sections in bulk to other new investors. This would re-launch the Jacks Point brand under new ownership but with a single co-ordinated marketing effort, and provide ongoing development work for Delta.

6.102 In July 2012, Delta agreed to pursue a parallel strategy of direct sales, as it could take some time for the "re-launch" strategy to eventuate.

6.103 In August 2012, Delta Investments Limited received an unsolicited conditional offer to buy one lot at Jacks Point and agreed to sell the section to the purchaser in September 2012.[83] Delta also had two other offers under consideration:

- from a building company, to buy five lots with a three-month settlement period and an option to buy a further five lots in the next six months; and
- from Singapore investors, for a bulk purchase of the developed N3 sections in two tranches.

6.104 Delta had asked the Singapore investors to improve their offer price.

83 This sale did not proceed as the offer was withdrawn.

6.105 In August 2012, Delta managers updated the Delta Investments Limited board on negotiations with potential purchasers, including that a verbal offer had been received from a party that was looking to sell house-and-land packages to Singaporean investors. The JPROA and another Jacks Point party had introduced the offering party to Delta. Mr Coburn declared that he was a committee member of the JPROA when the offer was discussed.

6.106 After discussion on the average cost to Delta for each of the developed sections in the N3 block and the effect of the $2.5 million impairment provision on the value of the developed and undeveloped sections, directors authorised staff to continue to investigate bulk offers that would meet or be above Delta's average cost of developing the N3 lots.

6.107 After further negotiations on price and timing of settlement, on 12 September 2012, Delta Investments Limited entered into a conditional agreement with a company acting for the Singapore investors (Jacks Point N3 Limited) for the sale of 25 of its N3 sections. The price was $135,000 plus GST for each section, with the option to buy a further 24 sections for the same price. The purchaser had a 60-day due diligence period before the agreement became unconditional and a 10% deposit was payable.

6.108 In advice to the Delta board on this offer, Delta's staff noted that:

- the offer price represented a loss of $6,000 for each section because Delta Investments Limited's average development cost for each section was $141,000, but it was an opportunity to realise a significant proportion of the Jacks Point investment;
- should the market price improve in the future, Delta would remain well placed to benefit through the sale of the undeveloped block N2B; and
- the holding company board might need to be consulted, in terms of Delta's statement of intent, because the value of the assets exceeded $5 million.

6.109 Delta's directors agreed with managers' recommendation to accept the offer. Some were reluctant, given that the price was lower than they wanted. Mr Coburn said that he supported the sale "under the circumstances we now find ourselves in (pressure from shareholder to reduce debt)".

6.110 In November 2012, Delta Investments Limited agreed to a variation sought by the purchaser to allow the purchaser to confirm 13 of the first batch of 25 lots, rather than all 25 at once, but settle between three and five of those sections earlier than previously agreed when titles were issued (then expected to be February 2013).

Governance changes at the end of 2012 and early 2013

6.111 As noted earlier in this report, the Larsen review had criticised the common director arrangements in the holding company group. The review recommended that directors who were on the holding company board should not also be on the boards of subsidiaries.

6.112 In October 2012, Mr Coburn, Mr Liddell, and Dr Evans ended their terms as directors of Delta, Mr Coburn resigned as a director of Delta Investments Limited, and Mr Frow and Dr Parton were appointed as directors of Delta. Mr Polson and Mr McLauchlan remained on the boards of both Delta and Delta Investments Limited.

6.113 In April 2013, Mr Frow and Dr Parton became directors of Delta Investments Limited and Mr Cameron ended his term as a director of Delta Investments Limited.

Events in 2013

6.114 Delta's focus in early 2013 was on getting titles issued for the N3 sections so that the sale to Jacks Point N3 Limited could proceed. Titling took longer than planned but was completed in May 2013. The timing of settlement was delayed until the titles were issued. Delta agreed to extend the date for the unconditional offer for the remaining N3 lots to become conditional while titling was delayed.

6.115 In January 2013, Delta received an offer for the undeveloped N2B block that was below its expectations. Delta agreed to negotiate but to go to the market if agreement on a satisfactory price could not be reached. In March 2013, Delta agreed to get the N2B block valued, and agreed on a counter-offer price to put to the potential purchaser.

6.116 In April 2013, the Delta Investments Limited board noted that:

- agreement had been reached with the JPROA to terminate Delta's licence to occupy the depot land at Jacks Point and that Delta would not be required to buy the depot site for $1.5 million as previously agreed; and
- Delta's preferred contractor status for future developments at Jacks Point had been retained.

6.117 At the end of May 2013, Delta managers told the Delta Investments Limited board that:

- Delta had been paid for eight of the 13 sections and was about to be paid for the remaining five;
- the purchaser had confirmed that it would buy the next 12 sections, but had let the option to buy the remaining 24 sections lapse for the time being; and

- the valuation of the undeveloped N2B block was under way, which managers considered would validate the carrying value of Delta's Jacks Point land at 30 June 2013 (along with the recent sales).

Financial information needed to assess the investments

6.118 Here, we set out some financial information to put the investments in the wider context of Delta's overall operations. We also explain the income, expenditure, and financial outcome of the two investments.

Significant financial information about Delta in the period of the investments

6.119 Delta gave us a summary of financial information for the Delta group (Delta and Newtons/Delta Investments Limited) from 2004 to 2012. The summary notes that, during this period:

- Delta group's annual turnover increased from $63.4 million to $108.6 million.
- Delta's fixed assets increased from $24.0 million to $34.0 million and its total assets increased from $39.7 million to $75.7 million.
- The Jacks Point and Luggate Park investment decisions accounted for about $9.4 million of the $36 million increase in total assets (after the write-down of $7.5 million at 30 June 2012).
- The group recorded total net profits of $24.5 million (incorporating a loss of $5.9 million in 2012), and returned dividends of $32.0 million to the holding company.

6.120 Delta paid the holding company a dividend of $2 million for the year ended 30 June 2013.

Financial outcome of the Luggate joint venture

6.121 Figure 17 shows the financial projections for the Luggate joint venture when Delta agreed to it in 2007.

Figure 17
Financial projections for the Luggate joint venture in 2007

	$million[1]
Sales value of developed lots	30.39
Marketing and selling costs	(1.69)
Development costs	(9.68)
Overheads and funding costs	(0.60)
Land value	(10.75)
Surplus before tax	**7.67**

1 Figures are rounded.

6.122 The construction work at Luggate had an estimated value of about $5.3 million, and Delta expected to earn a profit of about $1 million from that work.

6.123 The joint venture sold the Luggate land in August 2013 for $1 million. The net sale proceeds of about $943,000[84] were immediately paid to the bank to reduce the debt for development costs. The total debt at that time was $1.731 million, and this was reduced to about $788,000 when the net proceeds from the property sale were paid. Interest of $17,500 was then charged on 6 August 2013, and Delta cleared its 50% share of the residual $806,000 balance by paying $403,000 in cash.[85]

6.124 It is not possible to do a direct comparison with the financial expectations when Delta went into the joint venture because the development did not proceed as planned. However, in simple terms, as shown in Figure 18, the estimated profit of about $7.7 million for the joint venture turned out to be a loss of nearly $11.4 million.

6.125 Figure 18 sets out, in broad terms, the overall income and expenditure for the Luggate Park joint venture.

84 After marketing costs of about $57,000.

85 Figures in this paragraph are rounded.

Figure 18
Overall income and expenditure for the Luggate Park joint venture

	$million[1]
Proceeds from sale of Luggate Park land[2]	1.124
Marketing and selling costs[3]	(0.057)
Development costs/bank debt including interest	(1.749)
Land cost	(10.700)
Surplus/loss before tax	**(11.382)**

1 Figures are rounded.
2 Made up of $124,000, the net proceeds from the sale of a lot at the start of the joint venture where the parties agreed to split the proceeds, and $1.0 million from the sale of the residual Luggate Park land in August 2013. There were a few other sales during the period of the joint venture, but proceeds were used to reduce the bank loan.
3 For the August 2013 sale only.

Delta's share of the loss

6.126 Delta's main expenses for the Luggate joint venture were its $5.3 million advance to Luggate Properties Limited[86] and its 50% share of the bank debt of about $874,000.

Other costs incurred by Newtons and Delta

6.127 After entering into the joint venture, Newtons paid Armada about $72,000 for some of the costs that company had incurred before Delta invested in the joint venture using a deemed start date for the joint venture of May 2007.

6.128 Under the management agreement, the fee payable to Armada for Mr Boult's time was initially set at $5,000 a month, but was reduced to $3,000 a month when Luggate Park was put on hold, and was not charged in full in 2010.

6.129 From the joint venture's financial records, the joint venture paid Armada management fees of:

- $68,000 in 2009;
- $28,000 in 2010;
- $42,000 in 2011;
- $36,000 in 2012; and
- $36,000 in 2013.

6.130 These costs were treated as operating expenditure for Newtons/Delta Investments Limited, so the company paid its half-share of $105,000 from its funds rather than out of the bank loan account. Other joint venture costs were met from the bank loan.

86 Initially $5.35 million, but reduced to $5.288 million in 2008 when Delta shared in the proceeds of the first section to sell at Luggate Park.

6.131 When these payments to Armada of $72,000 and $105,000 are added to Delta's $5.3 million advance and its share of the bank debt of $874,000, Delta's direct expenses increase to $6.35 million. However, this amount is offset by:

- about $470,000 (Delta's 50% share of the net income from the sale of the land in August 2013); and
- nearly $1.5 million – an anticipated tax credit, representing Delta's loss on the Luggate Park investment for tax purposes.

6.132 The result of these calculations is a loss of about $4.38 million if the anticipated tax credit is realised, or $5.88 million if it is not.

Tax credit

6.133 The joint venture agreement required the two parent entities, Delta and Luggate Holdings Limited, to ensure that their subsidiaries had enough funds to pay Luggate Properties Limited the purchase price of $10.7 million in the event that Luggate Properties Limited had not recovered that amount from land sales.

6.134 Luggate Properties Limited was then required to use those funds to repay the advances from both joint venture partners. Delta's tax advisors had suggested this during negotiations on the joint venture agreement, so that any loss suffered directly related to the joint venture property development activities rather than the financing activities of each joint venture partner.

6.135 When the land was sold in August 2013, each of the joint venture partners had to contribute nearly $5.3 million to make good the shortfall between the sale proceeds and the balance of the amounts owing to both joint venture partners. In August 2013, after Delta Investments Limited's balance date, both partners contributed their half-share of the loss, with those funds going to Luggate Properties Limited. Luggate Properties Limited, in return, has repaid the $5.3 million to Delta Investments Limited to clear its advance.

6.136 The anticipated tax credit available to Delta Investments Limited for its loss from the Luggate Park joint venture is 28% of that $5.3 million (nearly $1.5 million). The company has accounted for the tax credit from this anticipated tax deduction as a non-current asset in its balance sheet as at 30 June 2013. It has done so because it expects the deduction to be used by another member of the Council's consolidated tax group. Delta Investments Limited also expects that it will be compensated for its tax losses by another member of that group. Our appointed auditor accepted as reasonable this treatment in Delta Investments Limited's 2012/13 financial statements.

Income and expenses not included in our calculation of the overall loss at Luggate Park

6.137 Our calculation of the loss does not include all of Delta's costs during the Luggate Park joint venture. Other costs incurred were:

- interest paid by Delta on its loan from Dunedin City Treasury Limited to fund its acquisition of $5.35 million of shares in Newtons;
- management time – Delta did not charge the joint venture for time its staff spent on the joint venture;
- directors' fees; and
- meeting fees for attending owner board meetings.

Financial outcome of the Jacks Point investment

Jacks Point position at 30 June 2013

6.138 The status of Delta's involvement at Jacks Point at 30 June 2013 was:

- Delta continued to hold the services agreements for both Jacks Point and Henley Downs. These were the contracts for the water, sewerage, vegetation and meter-reading operations, and maintenance services. The value of the services provided under these contracts was about $300,000 for the year ended 30 June 2013.
- Delta had retained its preferred contractor status for all future development and infrastructure work at Jacks Point and Henley Downs.
- Delta had recently terminated its license to occupy the existing depot site at Jacks Point, on the basis that the Jacks Point maintenance services could be adequately delivered from another site that was to be made available to Delta (by Aurora Energy Limited) in Frankton, Queenstown. The agreement under which Delta took an option to buy land for a new permanent depot at Jacks Point for $1.5 million had been cancelled.

6.139 However, Delta announced on 5 July 2013 that it planned to close its civil construction operation in Otago and Southland. This will affect Delta's ability to benefit from all the arrangements noted above.

Jacks Point position at January 2014

6.140 The position for Delta's Jacks Point investment at January 2014 was as follows.

The N3 developed lots

6.141 Delta has sold all of the 49 developed N3 sections to Jacks Point N3 Limited.

6.142 Delta sold 13 of the N3 sections in May 2013, and a further 12 sections in November 2013. The sale price for the 25 sections was $3.375 million, which was based on $135,000 per section.

6.143 Delta has entered into an unconditional agreement with Jacks Point N3 Limited for the sale of the remaining 24 developed N3 sections. The sale price for these sections is $2.76 million plus GST (if any), which is based on $115,000 per section. The purchaser is due to pay for 12 of the sections in June 2014 and for the remaining 12 in December 2014.

The N2B undeveloped lots

6.144 Delta has entered into an unconditional agreement with another company for the sale of its undeveloped neighbourhood 2B.

6.145 The sale price is $2.425 million plus GST (if any). Delta received a deposit of $242,500 in December 2013 with the rest of the sale price due for payment in March 2014.

Delta's projected loss

6.146 Figure 19 summarises the financial position for the Jacks Point investment as at January 2014 and Delta's projected loss from the investment.

6.147 The summary includes:

- the actual sale proceeds from the 25 N3 sections received prior to 30 November 2013;
- the unconditional contract prices for the remaining N3 sections and the undeveloped N2B sections, less sales commission;
- the costs to Delta of developing the N3 sections, including development costs and interest costs;
- the impairment of the Jacks Point land recognised at 30 June 2012;[87]
- the Delta group's construction profit for the N3 lots of $294,000;[88] and
- Delta's overall projected after-tax loss from the investment of $2.009 million.

87 The impairment provision of $2.5 million in 2012 had the effect of anticipating the expected loss. Now that Delta can better calculate the loss, the impairment provision has been added back in Figure 19, to allow the full actual loss to be estimated.

88 This is the profit to Delta Utility Services Limited for construction work on the developed lots.

Figure 19
Summary of the projected financial position for Jacks Point, as at January 2014

	$000
2010/11	
Purchase price	8,820
Development costs capitalised	2,196
Interest capitalised during construction	239
Other costs capitalised	203
Book value at 30 June 2011	**11,458**
2011/12	
Development costs capitalised	43
Impairment provision at 30 June 2012	(2,500)
Book value at 30 June 2012	**9,001**
2012/13	
Development costs capitalised	40
Sale proceeds (13 x N3 sections)	(1,755)
Book value at 31 May 2013 after sale of 13 sections	**7,286**
2013/14	
Sale proceeds (12 x N3 sections)	(1,620)
Book value at 30 November 2013 after sale of further 12 sections	**5,666**
Projected loss after sale of remaining lots	
Unconditional contract prices for the remaining lots, after sales commission	5,082
Delta Group construction profit on development of N3 lots	294
	5,376
Less book value at 30 November 2013	(5,666)
	(290)
Impairment already recognised at 30 June 2012	(2,500)
Projected loss estimate (before tax) for Delta Group	**(2,790)**
Expected tax credit	781
Projected loss estimate (after tax) for Delta Group	**(2,009)**

Our comments

6.148 We have described in detail how the investments fared and events that happened during our inquiry. The final outcome of the Luggate Park investment is reasonably clear after the sale of the land in August 2013. The final outcome of the investment at Jacks Point will be known when Delta has received all of the sale proceeds from its sections.

The Luggate Park investment did not fare well

6.149 The Luggate investment did not fare well in the period covered in this Part. Despite the efforts of the joint venture partners, only a few sales were made from mid-2009 to September 2012. No further development activities were carried out in this period and the owner board met less often than previously.

A robust commercial relationship

6.150 In 2011, Delta had the opportunity to take over the whole Luggate Park project, but decided not to take on that further risk. Delta also considered partially or fully repaying the bank debt and becoming banker to the joint venture. Delta got legal advice on various scenarios, including if the bank demanded repayment. Delta carefully considered its options at these points, supported by legal advice where necessary.

6.151 The interactions between the parties about these significant matters are further evidence of a robust commercial arrangement, with each party acting in its own best interests – especially when it had become clear that the joint venture was uneconomic.

6.152 However, the complexity of the negotiations between the parties and with the bank does show a significant risk of a joint venture – that each joint venture partner's position can be affected by the other partner's approach. The parties had agreed with the bank at the start of the joint venture that interest costs would be capitalised up to a certain amount. However, because interest was not paid at any point during the joint venture, those costs continued to be capitalised and the overall debt increased. Delta could have started paying interest on its share of the increasing bank debt but it might have been to its disadvantage to do so if its partner did not also pay interest.

Deciding to sell the Luggate land

6.153 By mid-2012, the joint venture partners had no choice but to sell the Luggate land. The new holding company directors had directed Delta to do so. Delta had written down the value of the land in its 2012 financial statements by $5 million, paving the way to sell the land at a loss. The bank was also applying pressure on the joint venture to repay its loan and the Luggate companies had wanted to sell their interest in the joint venture since the end of March 2011. The partners resumed their marketing efforts and sold the land in November 2012. After a delayed settlement, Delta paid its share of the bank loan in August 2013, and intends to formally end the joint venture arrangement before the end of the financial year ending 30 June 2014.

Jacks Point was a better investment

6.154 We can see why the directors viewed the Jacks Point investment as a better proposition than Luggate Park, largely because of the broader benefits to Delta in terms of the rights secured under the related agreements for ongoing work for the company at Jacks Point. The investment was consistent with Delta's growth strategy for Central Otago at the time. The directors made a careful decision, informed by a comprehensive and robust business case.

6.155 The first stage of the development was completed within budget and, in contrast to Luggate Park, the estimated development costs for each section proved to be accurate. The directors were satisfied that the price they paid was reasonable, based on their financial modelling and their own knowledge of property prices in the area. As with Luggate Park, they made active efforts to market the land and considered various options, initially through Mr Coburn's efforts under his consultancy arrangement, and eventually succeeded in selling all of the sections.

6.156 Because of the state of the property market, it took longer to sell the sections than had been planned. This meant that the investment breached the $10 million limit that is the holding company's spending authority from the Council. Delta told the holding company of that at the time but, because of the overlapping directorships, this was telling the directors what they already knew. The holding company did not consider it necessary to pass that information on to the Council.

6.157 In our view, the Council should have been told. When Delta proposed to invest in Jacks Point, it told the Council as a courtesy but did not seek approval. Delta assumed that the $10 million threshold would not be breached. It would have been better for the holding company to tell the Council when that changed, although it was too late to get approval because the costs had already been incurred.

6.158 As with Luggate Park, the market has affected Delta's profit expectations for its Jacks Point investment. The first 25 developed sections were sold at a loss of $1,000 a section, when the estimated profit had been about $70,000 a section.

The next 24 developed sections were sold at a loss of about $21,000 a section,[89] and the undeveloped land was sold for about $2 million less than Delta paid for it.

6.159 The expected gain on sale was only one aspect of this arrangement. However, now that Delta is ending its involvement in civil construction in Central Otago, it will no longer be able to take advantage of all the broader benefits it expected when entering the investment.

6.160 The directors we spoke with were consistent in their view that the decision to invest in Jacks Point was a long-term investment. Some would have preferred to hold the land until the market improved, but the fact that Delta can no longer access all the broader benefits might change that view.

Governance and oversight

6.161 Delta used Newtons as the vehicle for the Luggate Park and Jacks Point investments, and the company became actively involved in overseeing the investments from mid-2009. New directors were appointed at that time. Delta managers reported regularly on Luggate Park and Jacks Point matters to the board meetings of Newtons held the day before Delta board meetings. Any additional reports or comments arising from those meetings were considered at the Delta meetings.

6.162 In our view, the reports that Delta provided were of good quality and comprehensive, and were supported by information that Mr Coburn and the project management company provided. Delta kept good records of discussion at meetings.

6.163 We consider that Delta could improve its “bring up” system to ensure that matters agreed for follow-up at one meeting remain on the agenda until completed. The unsigned consultancy agreement with Ruboc Holdings Limited is an example of why such an improvement is needed.

6.164 The governance and oversight arrangements for both investments were comprehensive and worked well. The fact that Newtons did not have a statement of intent in place when making some of the early decisions did not affect its governance and oversight.

89 The loss amounts in this paragraph take into account Delta Utility Services Limited’s construction profit of about $6,000 per developed N3 section.

Part 7
Our concluding comments

7.1 We have commented on Delta's decision-making process at each stage of the Luggate Park and Jacks Point investments and how the investments fared. In this Part, we give our overall findings on the investments, and then focus on lessons learned for Delta, for the holding company, for the Council, and for other local authorities and council-controlled organisations.

Delta's decision-making process for investing in Luggate Park and Jacks Point

7.2 We have set out Delta's decision-making process for the Luggate Park and Jacks Point investments in detail, to give an independent description of what happened and to provide assurance about the process followed. The investments have been of interest to the Council and residents of Dunedin since they were made, but some of the facts were not widely known or well understood. Our report should help to correct some misinformation and fill some gaps in people's knowledge.

7.3 We have identified some positive aspects and some deficiencies on the part of Delta, the holding company, and the Council. We consider that there are lessons to be learned for all involved, and for other local authorities and their council-controlled organisations. Some of our findings 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.

Our overall findings

7.4 The directors 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.

7.5 We 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.

7.6 Despite these positive findings, we did identify some aspects in which Delta met neither good business practice nor the expectations we have of public entities.

7.7 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, Mr Coburn, was perceived to have a conflict of interest. Delta's main manager advising the board had an acknowledged lack of expertise in the area.

7.8 Because of the money involved, it would also have been useful to seek an independent view of the price sought for the Jacks Point land and the financial projections for the project.

7.9 Other problems we noted are:

- In general, Delta focused too much on the potential benefits and not enough on what might go wrong.
- The directors of Newtons breached the Local Government Act by making decisions without a statement of intent.
- Delta paid for unconsented as well as consented land at Luggate at the start of the joint venture.
- Delta used artificial business structures to avoid public accountability.
- Delta's directors did not meet all the requirements of the Companies Act for the consultancy arrangement with Mr Coburn 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.
- There was a lack of questioning or oversight of the investments by the holding company because of the common directors.
- 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 wanted more cash from the holding company subsidiaries but did not have adequate governance and oversight arrangements in place to support that demand, and had not made clear how much risk the Council was willing to take on.

Lessons to be learned

7.10 Delta directors and staff regarded both investments as learning experiences for the company. Because of the losses involved, they proved to be expensive lessons. When we asked about lessons learned or what they would do differently for the Luggate Park joint venture, several directors and staff said that they would focus more on termination arrangements or an "exit strategy" to protect their position if the project did not deliver the expected benefits.

7.11 Delta identified this as a risk early on, but we did not see any detailed consideration of it apart from some advice on the tax position of the joint venture parties if the venture lost money.

7.12 One director said that, with hindsight, he would have held out for more "downside safeguards", but noted that when the board considered the Luggate Park proposal the benefits to each side looked "fairly even". He was clear that the main reason for both investments was to get work for Delta's workforce in Central Otago.

7.13 When the expected tax credit is taken into account, Delta's loss from the Luggate Park joint venture was about $4.4 million. Several of those we talked to thought the decision was reasonable at the time, but was affected by the global financial crisis and its unforeseen effect on the property market. However, Mr Polson, the former chairman of the joint venture subcommittee and Delta, told us that, in hindsight, he thinks the Luggate Park investment was a mistake.

7.14 We saw no consideration by Delta's staff or directors about whether Delta had enough property development expertise to enter the Luggate Park joint venture. Because of Mr Coburn's declared conflict of interest, and managers' acknowledged lack of experience, it would have been prudent to consider getting advice on the business case for the proposal and the property market from someone with property development expertise.

7.15 Having a strategy to grow a business means taking some risks, but when entering a new area it would have been better to get independent scrutiny of the risks.

7.16 The Luggate Park joint venture had complex legal and funding arrangements that were challenging for Delta's first venture of this nature. The complexity, and managing the joint venture relationship, added to Delta's costs in terms of management time and legal and tax advice. However, despite the parties' best efforts, the investment turned out to be a bad one.

7.17 Delta had more control at Jacks Point. It was a more straightforward arrangement than Luggate Park, and the loss will be less. Although Delta has not made the profits it expected, there is less scope for lessons learned there.

Communication

7.18 Good communication between council-controlled organisations and their parent councils is fundamental to good governance and effective relationships of trust between councillors and the directors of council-controlled organisations.

7.19 We did not see any evidence of any direct communication with the Council about Luggate Park at the time of the investment in 2007, although Delta's efforts to expand into Central Otago as part of its growth strategy would have been known to the Council from 2006 or earlier. Delta was sensitive about its Luggate Park investment at the time and was keen to maintain a low profile about it. However, it would have been better for the holding company to have let the Council know that one of its subsidiaries was departing from core business and was getting into a riskier venture. Because of their demands for extra dividends from the holding company group, it would have been useful for councillors to understand this.

7.20 There was more communication for the Jacks Point investment in 2009. This was higher value and nearer the holding company's spending authority of $10 million, so there was more reason to tell the Council about it. However, the Council should also have been told when it became clear that the $10 million threshold would be breached.

7.21 The Council's approval was not required for the Luggate Park or Jacks Point investments when they were made. However, the holding company's policy of telling the Council about certain investments below the threshold for the Council's approval was sensible. A "no surprises" approach is a significant part of good relationships between parent and subsidiary organisations. It would clearly be preferable for a councillor to learn about the investments from Delta or the holding company than from the media.

7.22 The arrangements between the Council and the holding company were effective in keeping a group of senior staff, the Mayor, and another councillor informed, but the system relied on that small group deciding the appropriate information to share with the wider Council. We do not know to what extent they did this. The Larsen review drew attention to the need for better communication practices within the Council group.

7.23 In the report, Mr Larsen noted that:

- important information was often held by a few people and not shared appropriately;
- communication within the Council and with its investment companies needed to improve, with formal reporting structures between the holding company and the subsidiary companies, and between the holding company and the Council;

- part of the blame for communication problems lay with councillors because of their poor attendance at important meetings about holding company matters; and
- councillors needed to show more trust and capability in handling confidential information.

7.24 We consider that the communication weaknesses that Mr Larsen identified in his review were present to some extent during the Luggate Park and Jacks Point investments. However, the Council and the holding company have since taken steps to improve these matters.

Effect of the loss on the group of companies and ratepayers

7.25 Adding the Luggate Park loss and the projected Jacks Point loss together gives an overall loss of about $6.4 million. This does not include all costs incurred and will increase by up to $2.3 million if the expected tax credits are not realised.

7.26 Delta has continued to increase its turnover and assets in the period of the investments and has managed the loss within its overall operations. Delta has continued to pay dividends to the holding company over the period of the investments, but would have been able to pay more had the Luggate and Jacks Point investments been successful. In essence, the net worth of the Council has decreased by about $6.4 million because of the Luggate Park and Jacks Point investments. The loss has affected Delta's overall operations and reputation.

The Council has improved governance structures

7.27 The Larsen review identified problems with how the Council governed and managed the organisations it controls. We are satisfied that the Council is taking appropriate steps to address those problems. Therefore, we have not made any specific recommendations for the Council, the holding company, or Delta.

Lessons for councils and council-controlled organisations

7.28 When we agreed to carry out this inquiry, we expected that there would be lessons learned for local government as a whole. We finish this report by commenting on more general lessons for the Council and for local government about risks and confidentiality.

Being clear about risk

7.29 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.

7.30 We consider 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.

7.31 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.

7.32 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

7.33 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,[90] including when the council-controlled organisation considers that there is a risk of leaking confidential information that might affect those negotiations.

7.34 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.

7.35 We will be exploring governance and communication matters between council-controlled organisations and councils in more detail in the study mentioned earlier. In the meantime, we trust that this report will provide some useful guidance for all other local authorities – especially those with council-controlled trading organisations.

90 Under the Local Government Official Information and Meetings Act 1987.

Appendix
Terms of reference for our inquiry

Inquiry into decisions by Delta Utility Services Limited to invest in residential development at Luggate, near Wanaka, and at Jacks Point, Queenstown

14 November 2012

The Auditor-General has decided to carry out an inquiry into decisions in 2008 and 2009 by Delta Utility Services Limited to invest in residential development at Luggate, near Wanaka, and at Jacks Point, Queenstown.

This document sets out the terms of reference for the inquiry.

Background

In 2008, Delta Utility Services Limited (Delta), a council-controlled trading organisation of Dunedin City Council, acquired a 50% interest in a joint venture for residential property development at Luggate. In 2009, Delta acquired 9.4 hectares of land at Jacks Point, for the same purpose. The combined cost to Delta was $14.12 million (comprising Luggate joint venture at $5.3 million and Jacks Point land at $8.82 million). Delta had not previously been involved in property development, but the company expected to expand its core business activities in the Central Otago region by providing infrastructure services as the land was being developed.

There has been less demand for the residential sections than expected. In 2012, Delta reduced the value of the land in its financial statements by $7.5 million.

The Mayor of Dunedin City Council wrote to the Auditor-General on 19 October 2012 to ask for an investigation into Delta's decisions to invest in the residential developments.

The inquiry

The inquiry will examine:

- how and why Delta made decisions to acquire an interest in the joint venture at Luggate and to purchase the land at Jacks Point, including its consideration of risks;
- compliance with legislation, including the Local Government Act 2002 and Companies Act 1993;
- the identification and management of any conflicts of interests;

- any consultation with or involvement by Dunedin City Council in the transactions; and
- any other matters the Auditor-General considers it desirable to report on.

The inquiry is being carried out under sections 16 and 18(1) of the Public Audit Act 2001. We will not comment while the inquiry is under way, but will publish a report when the inquiry is completed.

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- The Auditor-General's Auditing Standards 2014
- Maintaining a future focus in governing Crown-owned companies
- Delivering scheduled services to patients
- Continuing to improve how you report on your TEI's service performance
- Department of Corrections: Managing offenders to reduce reoffending
- Public entities in the social sector: Our audit work
- Immigration New Zealand: Supporting new migrants to settle and work
- Summary: Inquiry into the Mangawhai community wastewater scheme
- Inquiry into the Mangawhai community wastewater scheme
- Regional services planning in the health sector
- Effectiveness and efficiency of arrangements to repair pipes and roads in Christchurch
- Earthquake Commission: Managing the Canterbury Home Repair Programme
- Using the United Nations' Madrid indicators to better understand our ageing population
- Annual Report 2012/13
- Using development contributions and financial contributions to fund local authorities' growth-related assets
- Commentary on *Affording Our Future: Statement on New Zealand's Long-term Fiscal Position*
- Annual Plan 2013/14
- Learning from public entities' use of social media
- Inquiry into Mayor Aldo Miccio's management of his role as mayor and his private business interests

Website

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Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
Website: www.oag.govt.nz