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Dear Duncan

## **INQUIRY INTO THE QUEENSTOWN LAKES DISTRICT COUNCIL'S DECISION-MAKING PROCESS FOR PROVIDING REGULATORY AND RESOURCE MANAGEMENT SERVICES**

This letter is to advise you of the outcome of our inquiry into decisions made by the Queenstown Lakes District Council (the Council) and the council-controlled organisation that it established as a wholly owned subsidiary (the CCO)<sup>1</sup> to provide regulatory and resource management services for the district. These services were being provided until recently through a contract with a private company Civic Corporation Limited (CivicCorp).

This letter summarises our findings and our inquiry process, outlines the background and the matters that we considered, and notes some lessons to be learned.

### **1 Summary**

**1.1** The main decision-making processes that we considered resulted in the Council's decisions to accept the outcome of the service delivery review, to establish a council-controlled organisation, and to facilitate the purchase of CivicCorp by the CCO. Overall, we found that the Council followed good and appropriate processes.

**1.2** We found that:

- The Council used an appropriately robust and transparent process to determine the future delivery structure for regulatory and resource management services that complied with the requirements of the Local Government Act 2002 (the Act). The Council should be commended for allowing enough time to complete this process.
- The Council complied with the requirements of the Act when establishing the CCO.
- The Council followed a good process regarding the purchase of CivicCorp.

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<sup>1</sup> We note that the CCO was originally called QLDC Regulatory Services Limited, then became Civic Corporation Limited after a merger, and has recently been renamed Lakes Environmental. To avoid confusion, we refer to this entity as the CCO throughout this letter.

1.3 There were some points within the process leading to the purchase of CivicCorp that we wish to comment on:

- We acknowledge that the negotiations to purchase CivicCorp were conducted by expert advisers on behalf of the Council under conditions of strict confidentiality. The confidentiality requirements and uncertainty about the outcome of the negotiations affected the Council's ability to consult with the public on the option of purchasing the assets or shares of CivicCorp. Under these circumstances, more community engagement was not practical, but the Council was able to rely on its awareness of community views gathered through the earlier service delivery review process and the consultation process to establish the CCO. However, had the Council been able to be more explicit about the option of purchasing CivicCorp in the statement of proposal on whether to form the CCO, it might have received more views from the community.
- Some of the Council's assessments that decisions were not significant were made on the basis that the CCO, not the Council, was to ultimately purchase CivicCorp. We question whether this analysis adequately acknowledged the substance of the Council's actions and involvement in this process. Had those decisions been assessed as significant to the Council, it does not necessarily follow that further consultation would have been required, as the Council had an existing understanding of the community's views.
- The extent to which consideration was given by the Council to the community's views when making decisions that led to the purchase of CivicCorp might have been clearer if there had been more coverage of the community's views in reports to the Council by the Council's staff.

1.4 We found that the CCO appropriately considered the purchase of CivicCorp, based on negotiations and due diligence undertaken by the Council, and the directors of the CCO acted independently of the Council in making that decision.

#### Overall lessons

1.5 The purchase of CivicCorp raises some interesting questions about the application of the consultation requirements in the Act. For a local authority, there is a tension between being open and transparent in its actions and obtaining community feedback when engaging in commercial and sensitive transactions. This is not unique to the Queenstown Lakes District Council.

1.6 We acknowledge that a more formal consultation process may often be problematic during commercial negotiations, and note that a good understanding of community views can be ascertained by other means and before the negotiation stage. This is a sensible and practical balancing of the conflicting imperatives in such situations.

- 1.7 In this instance, the Council obtained community views from a service delivery review and from the processes used to establish the CCO. These views could be used to inform the Council's subsequent decision-making about the purchase of CivicCorp.
- 1.8 A local authority must structure its decision-making processes for significant and complex decisions – including commercial decisions – to ensure that at each stage of the decision-making process it has an understanding of community views. This alone does not require a local authority to use any specific consultation process or procedure. However, obtaining community views in the early stages of a decision-making process can inform subsequent decisions.
- 1.9 The process regarding the purchase of CivicCorp also illustrates some of the complexities that can arise when a council and a council-controlled organisation make decisions about the same matter in a commercial environment. In our view it is important to focus on the substance of the decisions being made, not the form, by the respective entities.
- 1.10 Finally, one issue highlighted by our review of the CivicCorp contract is that local authorities will often enter into long-term contracts without giving detailed thought at the time of entering into the contract to what will happen when the contract ends. Contracting out of a specialised function, such as delivery of regulatory services, whereby internal expertise and knowledge is lost, is likely to lead to difficulties in the future when the contract comes to an end (whether it expires or there is a need for it to be terminated). In the CivicCorp example this was an issue because of the limited general market to supply regulatory services in the district, which reduced the options available to the Council. While we noted in our 1999 report (*Contracting Out Local Authority Regulatory Functions*) that the Council had not established procedures for a range of extreme events (such as a contingency plan if CivicCorp were to go bankrupt), the extent of the risk was not fully appreciated then.

## 2 Our inquiry

### Scope

- 2.1 Our inquiry was carried out under section 18(1) of the Public Audit Act 2001, which provides that the Auditor-General may inquire into any matter concerning a public entity's use of its resources.
- 2.2 The inquiry focused on:
- the Council's decision-making process for the delivery of regulatory and resource management services, including:
    - the Council's service delivery review for regulatory and resource management services undertaken in 2005 and 2006; and

- the Council's consultation and decision-making processes when establishing a council-controlled organisation to perform regulatory functions; and
- the decisions by the Council and the CCO about the purchase of CivicCorp, including the process for determining the price.

2.3 We were also interested to find out about the Council's experience in managing the end stages of a long-term contract. We envisaged that this would provide a case study on this phase of the contracting process, and complement the work we carried out in 1999 when we considered the Council's decision to contract with a private company for the delivery of these services.

2.4 We are interested in the interrelationship between commercial and contractual obligations on the one hand, and the obligations imposed by the Act on the other. We are also interested in the issues that can arise for local authorities in managing longer-term contractual relationships, particularly in respect of large contracts for key services and the issues that can arise in changing or reviewing these contracts.

#### The inquiry process

2.5 During our inquiry we reviewed a substantial amount of documentation and spoke with elected members and staff from the Council and the CCO.

2.6 We focused on the processes used by the Council and the CCO leading up to their decisions on these matters. We did not examine, and nor do we express an opinion on, the merits of the decisions that were made. Those are properly matters for the elected representatives of the Council and the board members of the CCO, and not within the mandate of the Auditor-General.

### 3 Background

3.1 Discussions about the performance of the CivicCorp contract were held around the same time as the Council's service delivery review took place. However, these were different processes.

#### The CivicCorp contract

3.2 In May 1998, the Council entered into a contract with CivicCorp for the provision of regulatory and resource management services for a renewable five-year term from 1 July 1998. Under the contract, CivicCorp was responsible for the Council's regulatory functions including parking; planning; liquor licensing; land information memorandums; building, animal, bylaw, and general enforcement; and resource management services. CivicCorp was established by a former senior planner with the Council.

3.3 The management fee payable under the contract was about \$1.1 million a year. In addition, CivicCorp was entitled to some additional fees, and to keep all revenue earned through resource and building consent charges.

- 3.4 In our 1999 report *Contracting Out Local Authority Regulatory Functions*, we considered, as an example, how the Council went about contracting out its regulatory functions to CivicCorp. We reviewed the procurement process followed by the Council and discussed some of the inherent risks involved and lessons for others. The 1999 report contained a good practice guide for local authorities that may have been considering contracting out some or all of their regulatory functions.

#### **Renewal of the contract and performance**

- 3.5 The CivicCorp contract was initially for a five-year term, but was renewable for a subsequent term if requested by CivicCorp, unless CivicCorp had not complied with the contract to the Council's satisfaction or there was no agreement as to the contract price. The contract was renewed in 2003 for a further five-year term. Although the Council had some concerns at that point about levels of performance under the contract, the Council did not believe that the contract terms sufficiently enabled it to cancel the contract. It decided to renew the contract and pursue the performance issues through agreed work plans with CivicCorp.
- 3.6 It was outside the scope of our inquiry to consider the performance of the contract by CivicCorp, which was a private entity. However, to provide context for the events which followed, we acknowledge that the Council had various concerns about CivicCorp's performance of the contract. The Council told us that these issues were compounded by a substantial increase in the number of resource and building consent applications being received during the period of the contract.
- 3.7 The Council told us too of a perception in the district of an unacceptably high profit being made under the contract by a private sector organisation, and a related lack of comfort about being regulated by a profit-making company.

#### **Material breach notice and subsequent discussions**

- 3.8 In April 2004, after a report to the Council on the status of the work plans agreed at the time of the contract renewal, the Council authorised its Chief Executive to consider contractual remedies.
- 3.9 During 2004 and 2005, there were various discussions and negotiations between the parties about alleged breaches of the contract on both sides. Various meetings were held and some progress was made to improve performance.
- 3.10 However, in February 2006, the Council gave notice to CivicCorp of a material breach under the contract. The breach related to failures by CivicCorp to meet timeliness requirements for issuing consents and concerns about a lack of qualified senior planners within the company. The contract provided that, in the event of a material breach by one party, the other could require the breach to be remedied within 60 days. If there was no agreement as to whether there was a

material breach, an independent legal counsel would be asked to determine if there was a breach, and there was a subsequent ability to terminate the contract.

- 3.11 CivicCorp disputed the notice and initiated the dispute resolution process. After correspondence between the parties and their lawyers, representatives of the Council and CivicCorp met to discuss performance of the contract. To facilitate discussions, the Council suspended the notice of material breach.
- 3.12 At the same time as discussions were taking place about performance, the Council and CivicCorp began to discuss “life after the contract”. It became clear to both parties that the contract would not be renewed in 2008, and that CivicCorp might be willing to entertain an early end to the contract.
- 3.13 In addition, the service delivery review undertaken by the Council (see paragraphs 3.15-3.23) resulted in a decision to consider a council-controlled organisation structure for the future delivery of regulatory and resource management services. The Council consulted with CivicCorp from June to August 2006 about the future of the relationship. This resulted in an agreement in principle to engage in a process whereby the Council might purchase CivicCorp.
- 3.14 A staff report to the Council on 22 June 2006 noted that of the three options available to the Council – to pursue the material breach, to continue working with CivicCorp, or to purchase CivicCorp – the option to purchase was the only one that allowed the Council to take control of service delivery and to manage the transition to a new delivery structure.

#### **Service delivery review**

- 3.15 As a matter separate to performance of the CivicCorp contract, the Council began a process in late 2004 to review how it wanted to deliver services that were then being provided by service delivery contracts. A number of these contracts were due to expire in 2008. As well as the CivicCorp contract, there were Lakes Contract Services (infrastructure, parks, and reserves), Lakes Property Services (property management), and Harbourmaster services. The Council's intention to review service delivery was noted in its 2004-14 Long-Term Council Community Plan.
- 3.16 In December 2004, the Council's Finance, Audit, Property and Corporate Committee agreed to the Chief Executive's recommendation to form a sub-committee to address the issues through a review of service delivery. A report by the Chief Executive noted that there were a number of deficiencies in the contracts that the Council was operating, including specifications, monitoring, enforceability, and conflicts of interest.
- 3.17 The Council agreed to a principles-based methodology for the service delivery review in the first half of 2005, beginning with the areas of resource management and building services.
- 3.18 The goals of the service delivery review were to:

- raise the performance of service delivery;
- ensure that service delivery was economical, effective, efficient, and open;
- create opportunities for the private sector; and
- ensure that the best interests of the community were served through an appropriate allocation of risks and returns.

**3.19** Two working groups were established in June 2005 – one to consider resource management and the other to consider building services. The members of these working groups were mostly from outside the district because of the contested nature of the issues within the district. The substantive work feeding into the service delivery review was performed by the two working groups, with regular dialogue between the groups and councillors, and co-ordinated by the sub-committee.

**3.20** A comprehensive assessment framework was developed by the Council to guide the working groups through a structured evaluation process, using three evaluation tools. The working groups consulted with various stakeholders within the community and evaluated the service delivery models against the principles and assessment criteria agreed to by the Council.

**3.21** Five delivery structures were considered:

- create a new council organisation with a separate legal structure;
- bring the contract back in-house;
- service sharing with other public bodies;
- a joint venture between the council and a private contractor; and
- contracting out.

**3.22** The two working groups reported formally to the Council in May 2006. The reports were endorsed by the sub-committee and then provided to the Council for consideration. The reports were very detailed – explaining the process, detailing the evaluations, and providing recommendations – and included stakeholder consultation feedback. Both reports recommended that the respective resource management and building services be provided through a council-controlled organisation.

**3.23** The Council considered the reports on 26 May 2006 and resolved to receive the reports and adopt the recommendations. Plans to implement the recommendations were also discussed. The staff report accompanying the reports noted that:

- the decision was not significant under the Council's significance policy, and section 88 of the Act (use of the special consultative procedure in relation to change of mode of delivery of significant activity) did not apply; and
- both working groups had undertaken significant consultation with stakeholders.

### **Forming a council-controlled organisation to deliver regulatory and resource management services**

- 3.24** On 3 November 2006, the Council resolved to proceed with the formation of a council-controlled organisation and to establish a proposal for the special consultative procedure required by the Act. The Council publicly consulted during December 2006 and January 2007 on the proposal to establish a council-controlled organisation to deliver regulatory and resource management services from 1 July 2008.
- 3.25** The proposal summary noted that, although not part of the public consultation process, it should be noted that the Council was negotiating to "takeover the CivicCorp contract" and that the proposed CCO would begin operating earlier than 1 July 2008 if that occurred. The statement of proposal referred to the possibility of "a purchase of the balance of the CivicCorp contract". The consultation papers included a draft statement of intent for the CCO and the details of the proposed directors.
- 3.26** The Council had called for expressions of interest for directors of the CCO in November 2006, on condition that any appointments would follow the outcome of the CCO public consultation process.
- 3.27** Eleven submissions were received from the public consultation process. The majority of submissions were in favour of the CCO; some raised concerns about performance issues relating to CivicCorp, and two submissions opposed the CCO. One submission commented on the potential buy-out of CivicCorp before the contract expired, indicating that some people in the community were aware that this was a possibility, even though it was not expressly discussed in the consultation papers.
- 3.28** On 2 March 2007, after considering the submissions, the Council resolved to form the CCO to provide regulatory and resource management services, taking effect from 1 July 2008. QLDC Regulatory Services Limited was incorporated as the CCO on 12 March 2007, with the Council as the sole shareholder. Start-up capital of \$50,000 was provided by the Council. The Council decided on the appointment of directors at its meeting of 2 March 2007.
- 3.29** The CCO's draft statement of intent for the year beginning 1 July 2007 notes that it is to provide regulatory and resource management services within the district on behalf of and under a contract with the Council, and that it will operate on a not-for-profit basis.

### **Acquisition of CivicCorp**

- 3.30** The Council started negotiations for the purchase of CivicCorp around June 2006. These discussions began as a proposal to resolve the Council's concerns about current and future performance under the CivicCorp contract. The Council was concerned that CivicCorp might be unable to continue to deliver its contract to the end date of June 2008 because staff were leaving and the company was finding it difficult to replace them.
- 3.31** At the Council meeting in October 2006 the Chief Executive was authorised to appoint a team to negotiate for the purchase of CivicCorp and to conduct due diligence. A valuation team, led by a barrister and comprising representatives from an accounting firm and a law firm, was formed to determine the value of CivicCorp and to handle negotiations with the owner of CivicCorp.
- 3.32** The Council also considered a "counter-factual" analysis, which weighed up the option of purchasing CivicCorp against the following scenarios in dollar terms:
- an efficient handover at 30 June 2008 (low probability);
  - an opposed handover at 30 June 2008 (high probability);
  - the contract falling over (moderately low probability);
  - a favourable termination of the contract (moderately low probability); and
  - an unfavourable termination of the contract (moderately low probability).
- 3.33** The purchase option came out favourably in this evaluation. The most likely of the scenarios if the purchase did not go ahead was thought to be an opposed handover. This scenario was described as the contract running to 30 June 2008 but with continued antagonism between the Council and CivicCorp, no improvement in performance levels, no agreement on transitional arrangements, and the Council having to make arrangements to develop new staff. An opposed handover was expected to cost about \$1 million more than a purchase, and the purchase option was expected at this time to cost about \$2.2 million. It was thought that the significant advantage of purchasing CivicCorp was that it presented the best opportunity to secure the staff from CivicCorp, providing the only real opportunity for the Council to ensure a continual provision of services and a seamless transition.
- 3.34** The valuation of CivicCorp was performed by the valuation team under very strict confidentiality rules, with the Council not being privy to many of the details until the agreement for sale and purchase was signed. The Council was kept continually updated on progress and obtained legal advice about the negotiation process being followed.
- 3.35** In December 2006, the Council endorsed the components of the purchase price and authorised the Chief Executive to enter into an agreement for the sale and purchase with CivicCorp, as agent for a company to be formed, and conditional upon the outcome of the CCO process and

due diligence. This decision was further endorsed on 2 March 2007 after these conditions were satisfied.

- 3.36 Acting in its capacity as sole shareholder, the Council asked the CCO to acquire CivicCorp, substantially on the terms of the draft agreement for sale and purchase that it had negotiated. The CCO board resolved to do so at its meeting on 19 March 2007. The Council approved a resolution agreeing to the transaction, as required by the Companies Act 1993 for “major transactions”.
- 3.37 On 4 April 2007, the CCO purchased the outstanding share capital in CivicCorp for \$3.05 million. This figure represented \$204,000 for assets (primarily CivicCorp’s Wanaka and Queenstown offices) and \$2.85 million for potential earnings (that is, profit) that CivicCorp’s shareholders would have earned had they continued with the remaining 15-month balance of the contract, reduced to reflect the time value of money and risk elements such as bad debts.
- 3.38 The purchase was funded by a three-year bank loan to the CCO, guaranteed by the Council. The Council agreed to act as guarantor at its meeting of 2 March 2007.
- 3.39 On 4 April 2007, the CCO and CivicCorp merged into one entity. The CCO was the surviving entity and its name was subsequently changed to Civic Corporation Limited. It continued to trade as CivicCorp for some time, before re-branding as Lakes Environmental from 30 June 2007.

#### **4 Our comments**

- 4.1 The CivicCorp contract, the service delivery review, and the establishment of the CCO and subsequent purchase of CivicCorp were all quite complex events and we have not commented on every aspect of these matters in this letter. We comment on the points that were of most interest to us in this section.

##### **The Council’s decision-making processes**

###### **Service delivery review**

- 4.2 Overall, our general impression is that the service delivery review undertaken by the Council was a robust and well-structured process. The Council’s management established a thoughtful and thorough principles-based process and evaluation methodology so that service delivery issues could be analysed in a structured manner. The Council identified relevant stakeholders and engaged with them in the process.
- 4.3 We are pleased that the Council allowed enough time for this process to take place before a number of its long-term contracts expire in 2008. This is in marked contrast to the rushed and unstructured process originally used to contract out the regulatory services in 1998.

###### **The role of the two working groups**

- 4.4 The Council recognised the complex and contentious nature of the issues and appointed external, experienced individuals to the two working groups that were responsible for conducting a detailed analysis of the options. The working groups were appropriately guided by the Council, which approved the evaluations to be performed.
- 4.5 The two working groups carried out their duties separately, performed the evaluations, and consulted with relevant stakeholders before making their own judgements as to the most appropriate method of service delivery. The working parties consulted with stakeholders early in the process to get an idea of the issues and to inform their debate and analysis.
- 4.6 While we did not review the detailed activities of the working groups as part of this inquiry, we are satisfied that they undertook their roles properly and reported back to the Council with enough information to enable the Council to adequately consider their recommendations. There was no evidence that the working groups had been “captured” by the Council or were subject to undue influence by staff when making their decisions.

#### Compliance with Part 6 of the Act

- 4.7 Part 6 of the Act sets out the decision-making procedures required of local authorities. A local authority must identify and assess all reasonably practicable options before making a decision, give consideration to the views and preferences of persons likely to be affected by, or to have an interest in, the matter at various stages during the decision-making process, and to consider the consistency of the decision with relevant policies and plans. It is for the local authority to decide how best to achieve compliance with these requirements, and to be guided in this by the significance of the matters affected by the decision, relevant principles in the Act, and the extent of the local authority’s resources. The extent of compliance with the Act should be in proportion to the significance of the matters affected by the decision.
- 4.8 More generally, section 14 of the Act sets out the various principles that a local authority should take account of in performing its role, including:
- operating in an open, transparent, and democratically accountable manner;
  - taking account of the likely impact of any decision on the social, economic, environmental and cultural well-being of the community, the need to maintain and enhance the quality of the environment, and the needs of future generations (a sustainable development approach);
  - being aware of and having regard to the views of all its communities; and
  - ensuring the effective and efficient use of its resources in the interests of the district.

#### Key decisions by the Council

- 4.9 The key decision arising out of the service delivery review came at the Council's meeting in May 2006, when the reports from the two working groups were considered by the Council. We understand that the councillors received the reports to read before the meeting, and that there was extensive discussion about the contents of the reports at the meeting before the vote to accept the recommendations.
- 4.10 The Council did not carry out specific consultation with the district on the options available or this decision at this time, but it did later in the year when it decided to implement the decision by way of establishing the CCO. The working groups discussed the issues with stakeholders as part of their process to evaluate the options, and the public had access to detailed information about the review on the Council's website.
- 4.11 The Act requires that consideration is given to the views and preferences of the community at various stages within the decision-making process, including the stage at which proposals are developed. However, this does not require formal consultation at every stage of the decision-making process. Instead, the Council must decide how best to give effect to the various requirements, by reference to the significance of the decision.
- 4.12 The Council assessed the decision to adopt the recommendations of the working groups as "not significant" under its policy of significance. The Council noted that section 88 of the Act did not apply to the decision. That section provides that a local authority must use the special consultative procedure in relation to a proposal for certain alterations in the mode in which a significant activity is undertaken. This is essentially for the contracting out situation. It was not relevant in this instance where the proposal was to bring the delivery method back closer to the Council.
- 4.13 In our view, the Council sufficiently complied with the requirements of Part 6 of the Act in its decision-making process for the service delivery review. In addition, the use of external working groups, a principles-based approach, and comprehensive evaluation methodology appear to have been particularly appropriate in this case.
- 4.14 Our review of this process was greatly assisted by the well-documented approach that was taken by the Council. Retaining comprehensive records to document and illustrate the process was especially important for such a substantial process.

#### **Establishing a council-controlled organisation**

- 4.15 The Act requires that a proposal to establish a council-controlled organisation must be adopted in accordance with the special consultative procedure outlined in the Act. We do not have any concerns about the process followed by the Council in this regard.
- 4.16 In November 2006, the Council resolved to proceed with the special consultative procedure and formally consulted with the district during the next couple of months. The Council prepared a statement of proposal and a summary of the information contained in the proposal, as required

by the special consultative procedure, and the consultation papers included a draft statement of intent for the CCO.

- 4.17 The consultation was specific to the formation of a council-controlled organisation for delivering regulatory and resource management services. However, the documentation also referred to the possibility of purchasing the balance of the CivicCorp contract.
- 4.18 We were contacted by a member of the public from Queenstown Lakes who suggested that the Council's consultation process for establishing the CCO was "a sham", and that the Council had already determined to follow this route regardless of the nature of public feedback. We did not find this to be the case, and we note that the majority of submissions received by the Council were in favour of bringing the regulatory functions back closer within the Council's control. The consultation papers indicate that a proper process was followed. It is the nature of the decision-making process in the Act that some "interim" decisions must be taken by the local authority in formulating the matters on which it is to consult on.
- 4.19 The Council's action to call for nominations for directors for the CCO before the consultation was completed does not, in our view, suggest that the Council had a closed mind on the matter. This timing was considered by the Council, and it was thought that it would help the community to better understand the proposal. Nominations were clearly called for on the basis that the establishment of the CCO was subject to the consultation process.
- 4.20 The proposal to establish the CCO considered that the matter was likely to be significant under the Council's policy on significance. This was because:
- the underlying matter had a history of generating wide public interest within the district;
  - the ability of the Council to deliver the statutory services affected a large number of ratepayers and residents to a moderate extent; and
  - the delivery of the services affected the capacity of the Council to perform its role and carry out its activities.
- 4.21 However, the proposal also stated that the decision that was recommended "*is not itself a significant issue. Notwithstanding this, the decision to establish a CCO, when/if it is made, is one that has to follow the special consultative procedure...*".
- 4.22 The Council established a council-controlled organisation, rather than a council-controlled trading organisation. The key difference is that the former cannot operate for the purpose of making a profit, and this was an important consideration for the Council, given that it wanted to move away from a profit-making entity to a "public good" model.
- 4.23 Choosing the company form has some risk as the presumption is that a company is a profit-making entity. We have not assessed the CCO in respect of this distinction, but note that the Council has obtained legal advice on this issue. The advice notes that the Council and the CCO

will need to be very clear in documents such as the statement of intent, annual plan, and the Long-Term Council Community Plan that the purpose of the CCO is not to make a profit but to provide services on behalf of the Council. We agree with that advice.

#### The decision to purchase CivicCorp

- 4.24 Although the CCO purchased CivicCorp, we also discuss this issue in relation to the Council because the Council made various decisions leading up to the decision to purchase. This included instructing the negotiation team, and making the decision to use the CCO to purchase CivicCorp. The CCO was established in March 2007, yet the negotiations with CivicCorp's shareholders about the possible purchase of the company had begun in mid-2006. The Council had agreed in principle to the recommendation of the two working groups that a council-controlled organisation should be the service delivery mechanism, and considered that it was negotiating on behalf of its yet-to-be-formed subsidiary. This was not unreasonable.
- 4.25 At the Council meeting in October 2006 that began the consultation process for forming the CCO, the Chief Executive was authorised to appoint a team to negotiate the purchase of CivicCorp and conduct due diligence. He appointed a team of external professional advisers to lead the negotiations. In our view, this was appropriate and in accordance with sound business practice (as required by section 14 of the Act) and the requirement to manage financial matters prudently. Being prudent essentially involves being careful and taking appropriate advice, so it is useful to bring in external expertise for complex transactions. Using an external team also provided distance between the Council and CivicCorp, which meant that the dispute between the Council and CivicCorp about contract performance did not dominate negotiations.
- 4.26 The Council effectively approved the purchase of CivicCorp at its meeting on 2 March 2007. Its resolutions at this meeting included:
- agreeing to act as guarantor for a loan to fund the purchase price, should the directors of the CCO resolve to go ahead with the purchase;
  - agreeing to the terms of the draft agreement for sale and purchase;
  - delegating to the Chief Executive the authority to authorise the transaction on behalf of the Council as shareholder of the CCO; and
  - delegating to the Chief Executive authority to enter into any transactions that may be required of the Council as shareholder to complete the purchase of the shares of CivicCorp and to amalgamate the CCO and CivicCorp.
- 4.27 The valuation for the purchase was previously agreed by the Council in December 2006.
- 4.28 We consider that, when the Council made the decision to acquire CivicCorp, it properly analysed the practicable options through its counter-factual analysis, and took into account the earlier analysis of appropriate structure from the service delivery review.

4.29 One of the main reasons for the purchase was to secure the staff from CivicCorp to ensure the continuous fulfilment of the statutory functions, and to improve services and service performance for the benefit of the community. The Council considered the purchase to be a pragmatic solution to the ending of the CivicCorp contract. A former CivicCorp employee told us that he thought it was a good outcome for CivicCorp staff.

#### Significance assessment

4.30 The Council did not consider that decisions it made about the purchase of CivicCorp were significant under its policy of significance. This was on the basis that the “*Council’s interest is as the proposed shareholder of a company to be formed that will undertake the transaction*”. Similarly, none of the earlier decisions taken by the Council to move ahead with negotiating a price and a contract, and conducting due diligence, were considered by the Council to be significant.

4.31 The Council’s policy on significance states that, in determining the question of significance, the Council will determine the effect to which:

- the consequences or impacts of the issue, assets, or other matters affect a large number of residents and ratepayers to a moderate extent;
- the consequences or impacts of the issue, assets, or other matters affect a small number of residents and ratepayers to a large extent; and
- the issue, assets, or other matters have a history of generating wider public interest within the district, the region, or New Zealand generally.

4.32 The policy contains other provisions, including a threshold for matters that incur more than \$1 million of budgeted or \$100,000 of unbudgeted expenditure.

4.33 The Council obtained external legal advice on its obligations in respect of the proposed purchase of CivicCorp in July 2006. The adviser commented that he had not considered the extent to which the Council would need to consult, but assumed that the decision would be “significant” for general decision-making purposes. A finding of “significant” would mean that the Council had to appropriately observe the decision-making requirements in the Act; a lesser degree of observance would not be appropriate. The legal advice was given before the Council decided to consult on forming the CCO, and on the basis that the Council would make the purchase.

4.34 Once the Council had decided to form the CCO, it considered that the proposed acquisition of CivicCorp would have no direct effect on the Council because the proposed transaction was to be made through a subsidiary. A Council paper noted that the Council retained the statutory responsibility for the services to be provided and therefore retained the residual risk. The paper

did not mention the potential financial effect on the Council of guaranteeing the loan – it stated that there would be no direct financial effect from the proposal on the Council.

- 4.35 At the time of considering the guarantee, the Council was aware of the purchase price and the methodology for determining it, and had obtained summary legal and financial due diligence reports. The information about the methodology for determining the purchase price enabled the Council to calculate the potential income stream to the CCO for the remainder of the term of the CivicCorp contract. The Council told us that this information gave the Council assurance that the CCO would be able to repay the loan from that income stream and that the guarantee was therefore low risk. The Council had legal advice that no specific consultation was required before agreeing to give the guarantee. We agree with that advice, and with the Council's assessment that the guarantee is low risk.
- 4.36 If the Council had purchased CivicCorp, we would consider this to be significant under the Council's policy of significance. The performance of regulatory functions affects a large number of residents, and the purchase price exceeds the financial thresholds. While the financial thresholds were not affected at the Council level by the CCO purchase of CivicCorp, we would question whether the Council's assessment adequately acknowledged the substance of the arrangement and the number of decisions required by the Council to bring about the purchase.
- 4.37 In particular, the fact that the CCO could not have purchased CivicCorp without the Council's approval as sole shareholder and the fact that the Council agreed to facilitate the purchase by providing a guarantee seem to support the need for a more thorough assessment of whether those decisions by the Council were significant.
- 4.38 It does not necessarily follow that the Council should have carried out specific consultation on the purchase having reached agreement in principle to the transaction. However, a decision that the transaction was significant could have led to more information about community views being included in reports about the purchase by the Council's staff, to inform that stage of the decision-making process.
- 4.39 The Council's view is that providing a guarantee for the CCO's debt and approving a major transaction as shareholder of the CCO did not constitute a significant transaction for it under its policy of significance.

#### Consultation and community interests

- 4.40 The Council did not consult specifically on the purchase of CivicCorp. The Chief Executive told us that he considered that it did not need to do so because the company was to be purchased by the CCO, not the Council. The Mayor told us that it was a commercial decision, not requiring consultation.
- 4.41 The external legal adviser considered that there was no separate obligation to apply the special consultative procedure to the CivicCorp acquisition (that is, separate to the obligation in respect

of forming the proposed CCO). However, the legal adviser told the Council to refer, in the statement of proposal to establish the CCO, to the possibility of the CCO taking over CivicCorp's activities before the end of the contract. This was done by the Council. The legal adviser suggested that doing this would enable the Council to meet its general obligations under the Act in respect of the CivicCorp acquisition.

4.42 The Council needed to consider community interests at each stage of the decision-making process (section 78(2) of the Act). At the Council's meeting on 2 March 2007, the relevant portion of the report stated:

**CONSULTATION – INTERESTED OR AFFECTED PERSONS**

*No statutory consultation required or undertaken. As a part of the consultation on the proposal to form a CCO to deliver resource management and regulatory services the nature of the proposal was discussed with community associations and stakeholder groups. Each group was advised that the price of the transaction would be revealed after the transaction was completed.*

4.43 There was no other reference to community views or interests in the staff report. At the earlier Council meeting on 20 December 2006, when the Council confirmed that its obligations under the Act had been satisfied, endorsed the components of the purchase price, and authorised the Chief Executive to enter into an agreement for sale and purchase, there was no specific reference to the community's views. In our view, the Council's consideration of community views could have been made more explicit in the documentation. It could be useful to incorporate "community views" as a heading in the Council's report templates.

4.44 The Council offered to talk to each community association in the district about the proposal to form the CCO during the period of consultation on that proposal. A report to the Council on the results of consultation records that presentations and discussions were held with six community or residents' associations in that period. The Mayor and/or Chief Executive attended those meetings. As well, the Chief Executive spoke directly to members of the professional community associated with the CivicCorp services (mainly planners, landscape architects, and lawyers) and to the development community (developers and project managers) in both Queenstown and Wanaka. The Council told us that:

- the prospect of purchasing CivicCorp was raised at all meetings;
- the methodology behind the price that might be paid was discussed, including the Council's intention that there was to be no margin for either party (that is, that the purchase price was to be based on the value of the outstanding portion of the CivicCorp contract);

- in all of these meetings there was clear and open dialogue, discussion, and consensus about the proposal to form the CCO and the prospect of purchasing CivicCorp; and
- the community at large was also made aware of the prospect of CivicCorp being purchased. (The possibility of the CCO taking over the CivicCorp contract before 1 July 2008 was noted in the statement of proposal for the formation of the CCO and in media releases from the Chief Executive on 7 and 28 November 2006.)

4.45 Although the Council and CivicCorp are discrete entities, the main decisions about the purchase of CivicCorp were made by the Council. It decided to begin negotiations with a view to purchasing CivicCorp – conducting due diligence and negotiating a purchase price and an agreement for sale and purchase – and followed this with a request for the transaction to be entered into by the CCO.

4.46 The Council approved the purchase of CivicCorp by the CCO as a major transaction under the Companies Act 1993 and agreed to guarantee the CCO's loan for the purchase price. The Council was highly involved in the decision and the CCO could not have made the decision without the Council's approval as shareholder.

4.47 The Council's guarantee of the CCO's repayment of the purchase price also facilitated the purchase, even though the CCO may have been able to borrow without that guarantee. We also understand that, as part of the process to appoint directors of the CCO, the Council briefed the preferred directors about the proposed transaction they would have to consider. The Council's view that consultation was not required for the actual purchase by the CCO is consistent with its assessment as to significance – on the basis that the transaction was to be carried out by the CCO and not the Council. However, there is still a requirement to consider the community's views in every decision.

4.48 In our view, the Council could have kept better records of the community engagement that occurred. Reports to the Council on the formation of the CCO and the purchase of CivicCorp could have included more information about the steps the Council had taken to obtain the community's views about the purchase, and about the views expressed. The Council told us that, despite the lack of coverage of community views in the staff reports, councillors were aware of the scope and scale of the community engagement that had taken place. We accept that the issue was canvassed during consultation, and that councillors had a good understanding of the views expressed.

4.49 An associated issue is how the requirements in Part 6 of the Act apply to a commercial decision such as an acquisition. For the same reason that such matters are often discussed by local authorities in meetings where the public is excluded, it can sometimes be inappropriate for details of arrangements to be made public while still being developed and negotiated. We have also seen this tension arise in other situations involving local authorities.

- 4.50 In this instance, the fact that negotiations for the purchase of CivicCorp occurred under conditions of extreme confidentiality and were done by advisers rather than by the Council's staff made the situation more complex for the Council and reduced its ability to carry out further engagement with the community during that process. The Council told us that it would not have been possible for it to provide the community with enough information at the time to enable the community to make informed comment or to make a reasonable contribution to a complex transaction. We accept the Council's advice on this aspect and consider it would not have been useful or necessary to seek community views once the negotiation stage had started and given the confidentiality requirement.
- 4.51 In this instance, it was also important that the future of CivicCorp was decided quickly to avoid unsettling CivicCorp staff and to minimise the risk of staff leaving the company. This would have been difficult to balance against a formal consultation process.
- 4.52 Where possible, a local authority should structure its decision-making processes to ensure that, at each stage of the decision-making process, it has an understanding of community views. This does not require a council to obtain community views by consulting at each stage, but to consider its available information about community views. In this instance, the Council obtained community views from the service delivery review and the process to establish the CCO, and decided that formal consultation was not required on the option of purchasing CivicCorp because the CCO would make that purchase. When we asked about this, the Council told us that confidentiality requirements and uncertainty about the outcome of the negotiations reduced the Council's ability to consult with the public on the option of purchasing the assets or shares of CivicCorp when the Council issued the statement of proposal to establish the CCO. We acknowledge that a more formal consultation process on the purchase option was not required, and note that a good understanding of community views can be ascertained by other means and before the negotiation stage.
- 4.53 The Council did not avoid the substantive requirements of the Act that applied to its decisions in this instance; indeed, we have concluded that its approach to consultation struck a sensible and practical balance. The process illustrates some of the complexities that can arise when a council and a council-controlled organisation are making decisions related to the same matter in a commercial environment. In our view, it is important to focus on the substance of the decisions being made not the form. The fact that a council-controlled organisation is not subject to the decision-making and consultation requirements in Part 6 of the Act does not mean that a local authority making related decisions can avoid those requirements.

#### The CCO decision-making process

- 4.54 The only decision-making process of the CCO that we considered was in relation to the purchase of CivicCorp.

- 4.55 After accepting the role of directors of the CCO, the directors had to decide how the CCO would provide regulatory and resource management services in the long term. The Council told us that it gave the directors the counter-factual analysis that it had conducted of the options available for providing services and the financial costs of the options. The directors had access to financial projections for CivicCorp prepared by an external adviser, and the legal and accounting due diligence reports from the advisers in advance of their decision on 19 March 2007 to purchase CivicCorp. This was before the Council had access to that information.
- 4.56 The CCO board had the opportunity to obtain its own professional advice but preferred to retain the Council's legal and accounting advisers and considered them sufficiently independent of the Council to be able to advise the board. The Chairperson told us that the board was satisfied with the financial information provided about the business and the purchase price that had been ascertained by the Council. The board considered that the price was a reasonable assessment of potential earnings for CivicCorp had the contract continued, based on forecast financial information made available to the directors. It was also consistent with the draft statement of intent prepared for the CCO. On this basis, the board agreed to enter into the agreement to purchase CivicCorp that had been negotiated by the Council.
- 4.57 The Act provides that the role of a director of a council-controlled organisation is to assist the organisation to meet its objectives and any other requirements in its statement of intent (section 58 of the Act). All decisions relating to the operation of a council-controlled organisation must be made by the board in accordance with its statement of intent and constitution (section 60 of the Act). The CCO's draft statement of intent specified that the CCO was to provide regulatory and resource management services within the district for the Council. The decision to purchase CivicCorp was clearly consistent with the CCO's objectives.
- 4.58 The decision-making process within Part 6 of the Act does not apply to council-controlled organisations so there was no obligation on the CCO to consult with the public about the purchase of CivicCorp.
- 4.59 The CCO was established with capital of \$50,000 and it acquired a three-year bank loan (guaranteed by the Council) to fund the purchase price. The CCO is considering how it intends to repay the loan and the appropriate repayment term. We understand the intention is that pricing levels for services will take into account the servicing of the loan, and that all of the CCO's operating costs are to come from charges levied under the Resource Management Act 1991 and Building Act 2004. Setting fees under those Acts is the Council's responsibility, with the CCO implementing such charges under delegated authority.
- 4.60 In determining charges under these Acts, the Council will need to have due regard to the limits on charges that it may impose, particularly in relation to the repayment of the capital amount of the loan. For example, section 36 of the Resource Management Act provides that the sole purpose of a charge is to recover the reasonable costs incurred by the local authority in respect of the activity to which this charge relates. The fact that the company is a council-controlled

organisation not a council-controlled trading organisation is also likely to be relevant to the setting of fees.

- 4.61 We understand that the Council does not wish the CCO to charge for certain services of a “public good” type – for example, providing advice and information about consent processes. The Council should note our guidance<sup>2</sup> on setting fees and charges, as well as those of the Treasury<sup>3</sup>.
- 4.62 The CCO is currently performing the services under the CivicCorp contract, which expires on 30 June 2008. The Council and the CCO will then be required to enter into a new contract for the supply of services, as described in section 61 of the Act. We would expect the Council to use the lessons it has learned from the CivicCorp contract to inform this new contract and to ensure that appropriate and adequate financial and performance information is reported to the Council.

## 5 Other comments – lessons learned from the arrangement

- 5.1 We were interested in the ending of a long-term contract and evaluating lessons that can be learned to inform other local authorities that may be considering similar arrangements.

### The CivicCorp contract

- 5.2 The Council told us that it had attempted to enter into a “relational contract” with CivicCorp. The contract was for services that had not previously been contracted in local government; the Council was looking for an improvement in the levels of service that were being provided to the community; and the contract was initiated at the time the Council materially changed its funding policy to wholly user-pays for consenting services. In this context, the wording of the contract reflected that, at the outset, the Council at least expected the development of a relationship within the contract framework that it entered into that would provide flexibility for the parties as the relationship developed.
- 5.3 The relationship did not develop in the way that the Council intended. This suggests that, when entering into relational contracts, there is benefit in making explicit the nature of the expected relationship and the required outcomes (for both parties); as well as considering the steps or remedies needed if the relationship breaks down.
- 5.4 Some of the people we spoke with expressed the view that the term of the contract was too long, and that there was no need to enter into a contract of such length when the establishment costs for the contractor were not significant. There was no large capital cost involved that the contractor needed to recoup over a long period.

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<sup>2</sup> *Guidelines on Costing and Charging for Public Sector Goods and Services*, Office of the Controller and Auditor-General, May 1989

<sup>3</sup> *Guidelines for Setting Charges in the Public Sector*, The Treasury, December 2002.

- 5.5 There was also not enough flexibility within the contract to reflect changing circumstances, such as the increased volume of consent applications being received within the district, changing community expectations, the Council's changing views, and the changing employment context. However, a balance is needed between the flexibility to take account of changing circumstances and the certainty required by a contractor.
- 5.6 Further, the termination provisions proved to be inadequate in the circumstances. Although the Council had previously had some concerns about performance under the contract, the contract did not adequately detail service specifications and the performance measures against which CivicCorp's performance could be measured. This affected the renewal of the contract in 2003, which might not have gone ahead if the Council had had enough monitoring information to evaluate the contract performance.
- 5.7 One of the difficulties faced by the Council was the lack of financial information that it received about the services being provided by CivicCorp. There was insufficient financial transparency for the Council to be able to perform all its monitoring duties, and to assess charge out rates. This is important, because the charges that the Council can set for resource consents must reflect the "reasonable costs incurred" in respect of the activity to which the charge relates.

#### The end of the arrangement, and the effect on the nature of services

- 5.8 One issue that becomes apparent at the end of a contract is the extent to which the parties had considered at the outset of the contract what would happen when the contract ended – whether it was terminated or expired. If the service delivery was to be brought back in-house, then the Council would need to build up a new team of people and expertise. The Council's former knowledge and expertise had effectively been transferred to a private organisation. The solution reached by the Council of acquiring CivicCorp is an attempt to effectively regain this knowledge (CivicCorp originally retained the Council's staff at the outset of the contract).
- 5.9 This difficulty was magnified by the nature of the services being contracted out, as there was no general market for the provision of regulatory services. This limited the choice available to the Council, both at the end of the arrangement and during its term. For example, the option of finding a competitor to provide the services instead of CivicCorp was not open to the Council.
- 5.10 The Council's negotiations with CivicCorp were driven by an understandable concern for continuity of services. The Council was concerned that CivicCorp would find it increasingly difficult to maintain service standards the closer the contract came to expiry in July 2008. The Council also anticipated that it would become more difficult to negotiate and complete an efficient handover of services from CivicCorp. This issue did not appear to be fully considered when the arrangement was originally entered into.
- 5.11 A local authority needs to allow enough time to consider how to resume services at the end of a contracting arrangement. In this case, the long lead time between the service delivery review

and the end of the contract with CivicCorp positioned the Council well for the new arrangement that it has been able to embark on in advance of the contract end date.

#### Delegations

- 5.12** In our 1999 report, we commented on some of the legal issues involved when contracting statutory functions and powers to a private company, including the area of delegating functions to a company and the company's staff. We said that the extent of a local authority's ability to delegate to persons outside the Council is dependent on the legislation that confers the delegation power and the Act. The Council's approach to delegations to CivicCorp and to its employees was subject to reconsideration by the Council after entering into the contract and some of the formal approvals were brought back in-house. The delegations were also subject to legal challenge in the High Court.
- 5.13** We are pleased to note that the Council took legal advice on delegation issues as part of the service delivery review, including under the Building Act. The Council and the CCO should be well positioned to have valid delegations in place under the contract.

Our review of these matters has complemented our earlier report on the CivicCorp contract, and we wish to thank officers, staff, and members of the Council and the CCO for their willing and helpful assistance with our inquiry.

Finally, as we have discussed with you, the Auditor-General may seek to review the performance of the current arrangement once this has had some time to become established. The use of a council-controlled organisation structure for service delivery is a novel approach in the local government sector for the performance of regulatory functions (as was the prior contracted out arrangement). We would also be interested in reviewing the final service level agreement agreed with the CCO.

Yours sincerely

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