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Review of 20 Don Street Commercial Development

Invercargill City Council
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The 20 Don Street development

1. Invercargill City Council (ICC) undertook the development of a commercial site in its CBD over the period 2014 through 2018. It cost substantially more than anticipated and, as of December 2018, is yet to be fully completed and fully tenanted. Many commented that the development is good as it has acted as a catalyst for change and improvement in the CBD and its amenities are valued by most. However, in its current form it will remain a cost to the ICC ratepayer and does not deliver the intended commercial return.
2. ICC's elected members have considered the aftermath of the development and most particularly at its Finance and Policy Committee meeting on 04 December 2018 and subsequently at full Council a week later.
3. It sought to undertake a review based on a Terms of Reference, which is attached as Appendix 1.

Approach

4. The review was commissioned by ICC's Risk and Assurance Committee. The approach sought through the Terms of Reference were for a 'lessons learnt' review, rather than a more in-depth review seeking to identify and apportion any responsibility or blame. ICC engaged Bruce Robertson of RBruce Robertson Ltd (RBRL) to undertake the review on its behalf and is responsible for reporting the results of that review to the ICC.
5. The review was undertaken with the support of James Lovelock, a management consultant with specialist legal skills and experience in commercial development. The team was further supported by Robert Buchanan, an independent public law specialist, in a peer review/quality assurance and project probity role. Despite the team composition, the findings and recommendations of this report are solely those of RBRL.
6. This review has been guided by the standards and requirements of the External Reporting Board's (XRB's)¹ standard "Assurance Engagements on Compliance" (SAE 3100 (Revised)). The conclusions reached in this report are necessarily limited. The matters dealt with are increasingly historical over a period of a number of years and required assembling substantial documentation and undertaking a series of interviews. While all steps have been planned and taken to identify and ensure all relevant information is obtained in respect of the matters outlined in the Terms of Reference, the conclusions reached are necessarily provided on a limited assurance basis.

¹ Refer www.xrb.govt.nz. SAE 3100 is applied by RBRL to conform to NZC's ability to undertake an audit pursuant to s26P(1)(j) of the Conservation Act 1987.

7. While the completeness of all information associated with the review and the lessons drawn is limited in nature, the work has been designed to ensure the conclusions drawn are “meaningful”; which SAE 3100 (Revised) defines as “the level of assurance obtained ... is likely to enhance the intended users’ confidence about the compliance outcome to a degree that is clearly more than inconsequential”². In short, the review was designed to provide ‘lessons’ that will advance ICC’s governance and management practice.
8. The applicable criteria³ for the review were primarily developed from the good practice that has developed in the public sector. Key references are drawn from the work of the Office of the Auditor-General. Attention is drawn to the body of work and practice developed from its publications. These include:
 - Inquiry into property investments by Delta Utility Services Limited at Luggate and Jacks Point (March 2014) (the DELTA report)
 - Reflections from our audits: Governance and Accountability (April 2016) (the Reflections report).

Further, useful references to the body of practice that has developed around this guidance and recognised in this review include the Office’s work investigating various matters associated with procurement.

9. Fieldwork was based around reviewing ICC files and interviews with Council staff and some of the current tenants at 20 Don St. Other external parties associated with the development (generally on contract at some stage to ICC) were interviewed. Contact extended to some former elected members and former staff. The nature of the intended outcome of this report – lessons learned – plus the limited recall of detailed events by some of those interviewed restrict the definitive conclusions and lessons identified in this report.
10. Not all parties or individuals involved in the development were interviewed. As the review developed, we established a list of those we needed to see due to their role or to help confirm otherwise unsubstantiated events.

Reporting approach

11. The following analysis is based on describing:
 - What we expected to see (based on the good practice guidance)
 - What we found

² Refer AE 3100 (Revised), paragraph 17 (o).

³ Meaning the benchmark, framework or legislation used to evaluate whether the compliance requirements have been met (SAE 3100, para 17(g)).

- What action we recommend ICC take.

12. The analysis is based on the timeline in Appendix 2. This is kept at a high-level that is considered sufficiently detailed, yet summarised enough, to enable a quick understanding of the development.

Council reporting

13. The Council report of 04 December 2018 remains authoritative. Our review agrees with its findings including its identification of 4 high-level lessons:

- Better reporting for major projects is needed
- A focus is needed on post capital development operational requirements and benefits realisation
- Council should consider the method of 'delivery' (and operational management) of such an investment
- Scope changes need to be justified and ensure they are consistent with (and in this case, not counter to) Council's strategic objective of inner city revitalisation.

14. The Council report also outlines the costs and associated with funding the Don St development – including indicative financial outturns over the next 5 years to 2022/23. These are not outlined again in this report.

Review analysis

The following table summarises the review analysis of the events outlined in Appendix 2 that occurred (and in many cases didn't occur from a control perspective) in the development of 20 Don St.

What did we expected to see?	What did we see?	What action we recommend ICC take
<p>Council would consider the nature of the development and set the strategic objectives for it prior to approving the development..</p>	<p>Council did approve the development, including granting delegated authority to a Council officer to expedite the development. It did have the opportunity to ask “powerful questions”⁴ and establish answers to the core questions – what are our objectives (profit or public good or potentially a combination) and what is our appetite for risk/return?</p> <p>It is also noted there was a sense of speed asked of Council for the Don St development. At its 04 November 2014 meeting it was stated “that McCulloch and Partners have a Partners’ meeting on 19 November 2014 to commit to a site for their office....[and] require an indication from Council that we are prepared to undertake this development”. While it took to the following January (27 January 2015) for Council approval to be given, there was a sense of need for speed and</p>	<p>Project initiation is important. It constitutes the opportunity for governance to get assurance the project is being established with the right objectives.</p> <p>Council would benefit from workshopping how it should initiate significant projects, especially identifying the “powerful questions” it needs assurance on and establish what approval processes, including the indicative time, needed to make a decision.</p>

⁴ Refer the Reflections report, para 2,40 which outlines the type of *powerful questions* that could have been asked; including “Have we carried out a project of this nature and size before? Is so, what did we learn?; Do we have the right team in place to carry out the project and realise the benefits?; Why should the Council carry out this project and how does it link to our strategic objectives?; How could it be delivered differently?; How clear are the accountabilities and ownership for this initiative?; What are the most important performance indicators?”. There are several more key questions that the experienced governor noted were their key questions for any project.

	<p>consequent pressure to make a decision. It was uncertain this was the reason given for limited project initiation, but it appears so.</p>	
<p>Council would define what constituted success for the project.</p>	<p>We did not see any definitive description of what constituted success. For example, much of the reporting was based on return on investment and equity (a straight commercial assessment often compared to “money in the bank”) but:</p> <ul style="list-style-type: none"> • an acceptable return was not defined, and Council just seemed to ‘accept’ a diminishing return as costs of the development to Council climbed and this metric reduced. • the base for the investment was never established – both the quantum of the investment and what it covered – for example should it include the carpark development costs and land acquisition costs. <p>As the commercial return reduced, success seemed to have been (re)defined into non-commercial terms; such as, it is making enough to cover its cash costs at 66% occupancy and therefore is a success or even “it’s is a good development which everyone is proud of and it regenerates the central city”.</p>	<p>At the commencement of any development project, Council needs to identify what constitutes success – often called ‘benefits’ – and how it plans to derive them from the development.</p> <p>This includes defining how the benefits are measured.</p> <p>Reporting should be consistent and based on these benefits in future reporting.</p> <p>Defining the benefits is also closely related to identifying and managing risk (refer below).</p>
<p>Council would consider what threshold needed to be met before initiating the project – this would be in the form of a business case – with a clear</p>	<p>It was unclear whether Council had set any requirements for a business case prior to approval of the Don St development. Critical to</p>	<p>The key decisions which currently affect the outcomes of this development were made prior to the commencement of construction.</p>



<p>line of sight in this case on how the “rent roll/book” was being built.</p>	<p>such a commercial development is the “rent roll/book”.</p> <p>Council does not appear to have asked or received any information on the strength of interest outside that brought to Council by the anchor tenants. The review could not establish the strength of Council’s own actions to seek tenants other than a general letting the real estate sector know about the development and available space – in part because it didn’t want to be seen favouring one real estate agent. (This contrasts with the position taken in late 2018 by Council to engage one agent to actively pursue tenants with some success).</p> <p>The absence of a plan to tenant exacerbates Council meeting its objectives and benefits and demonstrates the risks of a lack of business case. By the time the Council agreed to the contract to build Don St, the full scope of the existing building had been established – a full 3 floors across both the east and west wings but with effectively no extra tenancies than the originals.</p> <p>Had a more analytical and business case approach been taken it may have been able to modify its approach to minimise risk which currently has crystallised.</p> <p>There is strength to the argument that the approved size was not backed by a strong</p>	<p>Council needs to do its “homework” – it needs to ensure there has been appropriate analysis of the case for the development and enable itself to identify a clear line of sight to the development’s success. (This in part relates to the point above – defining what constitutes success).</p>
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	business case, but rather it was a “punt”. Some of those involved acknowledged it was such.	
Council would consider the nature of the development and the nature of general controls and skills that are in place to ensure its success.	<p>There is no indication Council turned its mind in 2014 or 2015 to the controls or skill mix needed to pursue the development. Arguably there was evidence of an ‘optimism bias’ and a tenor of we need to be ‘entrepreneurial’ in commissioning this development. The review could not definitively establish this other than Council did not turn its mind to how the project should be carried out.</p> <p>Council left the project “in the hands” of one senior manager (SM). Even if qualified to undertake commercial development, this left the SM with minimal support, an overreliance on one person (for whom there was no evidence his other duties were lightened) and personal exposure if the development did not proceed as planned.</p> <p>There was no indication that the Council considered supporting the SM with such conventional controls as a Project Control Group, nor did it establish any formal lines of governance and accountability over the project.</p> <p>The project being in the hands of one key person – the SM, with broad delegated authority – and adopting a design and build approach, concentrated roles in a few key individuals. There was no turning of minds to whether external</p>	Governance needs to work with management to develop and understand the high-level controls that will be put in place commensurate with the nature and risk of the project.



	<p>support through independent advice could be required. For example, it was only at progress payment 9 that a quantity surveyor was engaged to control payments to the building contractor and then it was a restricted role. Legal advice was taken over the leases but only after the SM had committed ICC to the form and nature of the lease with the tenants.</p> <p>No independent probity assurance was implemented.</p> <p>One candid comment received was the approach (concentration in the hands of one employee, the SM) was adopted to ensure there were minimal costs (“overheads”) associated with the development. The review considers this as a false economy.</p>	
<p>A commercial development of this nature requires tight financial management. The returns are sensitive as to who carries the costs – landlord or tenant.</p>	<p>There appeared to be a level of dissonance between benefits defined in commercial terms (a return on investment) and actual financial management control and decision-making. While the size of the project and ability to tenant is fundamental to the financial returns, so is cost control. T</p> <p>he original size and scale was determined relatively early in the development. However, it also appears substantial cost was imposed on the ICC by decisions reached in the Agreements to Lease. Without commenting on the merits of</p>	<p>Strong financial management disciplines and controls need to be implemented for a major development – especially one which is fundamentally commercial in nature.</p> <p>While delegated authority to make decisions aids agility and progress, a key negotiating position should have been overseen by a control group. This would have been possible if key decisions had been identified early and, if appropriate, expert external advice had been obtained.</p>



	<p>negotiations, this phase added substantial cost of development onto Council in the order of \$2.2m.</p> <p>These were costs that were outside the base build.</p> <p>While legal advice was ultimately taken by the Council, the substantive decision committing Council to these costs had already been made.</p> <p>The downstream impact is that these financial decisions have added to the operational costs of the development which must be borne by the Council.</p>	
<p>Aiding project control and governance, the development would have strong accountability through effective reporting.</p>	<p>The review considers the level of reporting to Council – primarily the Finance and Policy Committee – to have been substandard. Effective governance oversight was not possible, based on the lack of quality of the reports. It also raises questions on the quality of Council decision-making in relation to the development.</p> <p>An analysis of the reporting could not define a suitable financial or physical base on which to base reporting nor on which to base approval for scope or financial variations.</p> <p>There still remain some gaps in understanding either the movement in financial amounts or the consistency of reported numbers between reports (for example, whether cost of land or carparks was included or excluded).</p>	<p>Council development of control must include adequate financial management controls and disciplines. In the case of a commercial development, those controls need to recognise that variation to scope and particularly the incidence of who pays is significant to the success of the project.</p> <p>Council needs to consider how reporting can actually be improved to support effective decision-making.</p>

	<p>The worst example was the 19 July 2016 report to the Finance and Policy Committee which was clearly wrong – representing a return on all costs when they were not all included.</p> <p>The SM did eventually engage a quantity surveyor to assist in clearance of progress claims to the building contractor. However, the full range of control and reporting options possible under this arrangement was not taken by Council. Had the Council done so it would have enabled a more complete reporting on the total project costs, including against the base case.</p>	
<p>Major projects need a specific risk management framework associated with the development, and oversight of those risks needs to be integrated into Council’s overall risk management framework and approach.</p>	<p>The files on the project did not reveal any form of risk management framework or analysis of the risks. The original approach by the anchor tenants provided an opportunity to Council, which was not unreasonable to pursue. However, there is no real evidence Council turned its mind to what could prevent the full value of the opportunity being grasped.</p> <p>One key decision was in part risk-based. This was the decision to accept the design and build approach of the building contractor. There is no evidence this was primarily seen as a risk-based decision, but it possibly ensured that the project was delivered on time, given the conditions in the agreements to lease reached with the tenants. (Further confusing the understanding of this decision is the absence of a procurement plan</p>	<p>Projects undertaken by Council represent an opportunity. Effective governance will also consider and identify the risks that prevent achieving the project potential and set in place a framework to minimise risks crystallising.</p> <p>Development of effective risk frameworks around developments needs to be aligned with Council’s broader development of its risk capability and maturity.</p>

	<p>setting out the context and objectives in selecting a contractor).</p> <p>It is unknown whether in fact there was a counter risk that this decision to accept a design and build bid may have meant Council felt its risks were covered. There was no sense that other decisions such as leases and fit out costs were considered risky.</p>	
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Concluding comments

15. The lessons identified in Council's 04 December 2018 report (and summarised above) along with those determined by this review suggest Council needs to fundamentally rethink its approach to major projects – especially those involving commercial objectives - and which it proposes to pursue outside normal ICC capital development processes.
16. There is a risk of 'hindsight bias' in analysing the development of Don St – in part because of the patently over ambitious assumption the building would be fully tenanted from 'day 1' through to the people and personalities involved. There are many good aspects of the actual development 'on the ground'. However, this has been a development which has not been well-executed and is yet to prove its commercial worth or that it has achieved such non-commercial worth as stimulating a recovery in the CBD.
17. ICC ratepayers are paying for the development and will still for some time to come. Consequently, ICC does need to cast a critical and sceptical 'eye' over the development to date.
18. The review has isolated the key issues that were created upfront – how the development was planned for and carried out within Council. Further, once the project was commenced, there appears to have been very poor formal communication to Council.
19. However, collectively, elected members have to ask themselves did they ask the right questions – what the then Auditor-General noted in her 'Reflections Report' as the "powerful questions". This review has also formed the conclusion that Council did not ask the right questions and in doing so helped lay the foundation for the events that unfolded.
20. The review's key lessons are:
 - Council needs to recognise the importance of project initiation – both as a means to ask the significant questions such as what are our objectives and benefits and what are the risks of undertaking the project and how will they be managed? Council also needs to understand, at a relevant governance level, how the project will be controlled and how appropriate internal accountabilities (based on 'project ownership' and reporting) will be maintained.
 - Enthusiasm for a project must be tempered by clear-eyed thinking and analysis of the 'business case' for the project. The objectives and benefits of a project must be clearly defined and the pathway to gaining them obvious (subject to appropriate acceptance of managed risk).

- Council must consider the appropriate approach to ownership and control of a project. While there are a number of ways and processes in which a project can be controlled or delivered, it should be concerned if there is not a reasonably 'traditional' approach, involving such mechanisms as a project control group and expert advisors, or if a single person (staff or otherwise) has virtually sole control.
- Council and management need to assess, prior to authorising the project, the skills required to deliver the project. These may not exist inside Council and the means to acquire or engage them must be established.
- At the initiation stage (and throughout a project), a framework for identifying and managing the risk associated with the project must be implemented. It should also be integrated as part of the Council-wide approach to risk management.
- Identifying project ownership (who is responsible for delivery) must also encompass the process for internal accountability. This process must include effective reporting and financial management.

21. While these lessons may appear high-level, many were absent in 20 Don St. The absence of attention to these lessons gave rise to the detailed problems that became evident as the development proceeded. They also reflect the absence of recorded consideration of the detailed questions raised in the Terms of Reference either around project scope or its implementation. The detailed questions of the terms of reference are redundant in light of not implementing core project controls.

22. Two other observations are warranted in conclusion:

- The need for local government to be business-like, commercial and, where relevant, entrepreneurial, is recognised in the Local Government Act. These attributes are important if the Council is to partner with the private sector. However, the need to be 'commercial' does not mean that it can cut corners in how it goes about such a project. No matter the nature of the development and the 'need for speed' or agility – and Council did put itself under time pressure over 20 Don St – it cannot, like any other public or private entity, neglect to pay attention to the detail of how the project and its benefits will be delivered and how it stewards the ratepayers' money.
- The objective of this report is identifying lessons learnt and not apportioning blame. However, we note that the main high-level lessons coming out of 20 Don St relate to Council, as the elected governors of the City. There was a theme suggested to the review that we, as governors, had no option but to rely on our expert advisors. The good practice guidance and expectations on public sector governors, however, does not mean that elected members should just accept advice – it should be tested with the 'powerful questions' and if necessary, other expert advice obtained to provide

Council with assurance. Further, elected members need to become familiar with the principles of sound project delivery.

Appendix 1 – Terms of Reference

Review of project 20 Don Street

Background

In 2014, Council became involved in developing a commercial property at 20 Don Street. Initially a local business proposed the development to Council, and Council became involved on the basis that the development would aid with revitalisation of the inner city.

The development was a ‘business house’ development incorporating modern office, hospitality and retail space.

Council was advised three options were being considered – 2,000m², 2,450m² and 3,000m² – with cost estimates ranging from \$6.35M to \$10.37M. The preferred option presented was 2,450m² at a cost of \$9.2M. The revenue projections were arrived at through an optimistic assumption of 100% occupancy from day one.

Council approved a budget of \$12.4M as part of its 2015/25 LTP and the 2016/17 Annual Plan. This provided \$11.9M for site preparation and construction and \$460K for additional land purchase. (The original land purchase of \$1.5M was approved on 27 January 2015 and was funded from reserves).

As plans for the development progressed, both the scope and the cost of the project increased. The escalations were noted, although not explained, in reports in September 2015, July 2016 and April 2017. There were also inconsistencies in reporting – some reports included land purchase costs; others didn’t.

When the building was officially opened in October 2017 – still incomplete – the occupancy rate was 66%.

A report to Council in December 2018 detailed the final size of the building (4,104m² with 3,529m² tenatable); the total project cost to completion to be \$18M; and advised that whilst the ground floor was close to being fully tenanted, there is considerable vacant space on the second floor.

Purpose

In relation to the 20 Don St development, Council seeks to understand:

- 1 what processes were employed to scope the project initially, and what evidence was available to justify changes to it;
- 2 how appointments to key roles were evaluated and the contractual arrangements for these;

- 3 what gaps existed in its operating model that allowed project scope creep to occur;
- 4 how the balance between initial capital investment and ongoing operational costs was considered and determined;
- 5 what steps might have been taken to have delivered the project within budget;

And in light of the review of the 20 Don St development, Council wishes to identify any findings that should impact on:

- 6 Council's operating policies and procedures currently in place to deliver capital projects on time, and to approved scope and budget;
- 7 steps to demonstrate that a 'whole of life' approach is taken to major capital projects; and
- 8 how Council's governance practice might be improved to provide assurance on its oversight on major capital projects.

Council also seeks assurance, on the material available, that no unlawful activity has taken place.

Out of scope

The scope of this review does not require a Council-wide review of its contract or project management procedures. However, this does not prevent this review reaching a position where it may recommend such action, in light of its findings of 20 Don St development.

Role of consultant

The consultant should be experienced in local government finance, public sector governance practices and project management.

The consultant will review reports to Council, the project files, and interview Council officers to determine the facts of the project to the best of their ability.

Role of ICC

The Council shall provide all material at the outset and shall make Council officers available for interview as required.

The Council will request the cooperation of key third parties who contributed to the project – e.g. architect, quantity surveyor/project manager – and attended project meetings.

Outputs / Reporting

Council seeks a succinct report that focuses on learnings from this project – both at the governance level, and for the organisation. Clear recommendations on what improvements should be made – broken down into steps if necessary – will be valued.