Executive summary of the public audit report

# ENACTMENT AND EXECUTION OF THE PRELIMINARY AGREEMENT BETWEEN NT VALDOS UAB AND KARALIENĖS MORTOS MOKYKLA UAB ON 11 SEPTEMBER 2015

01 June 2016, No. VA-P-60-1-9

Full audit report in Lithuanian available on website of the National Audit Office : www.vkontrole.lt

# DEFINITIONS AND ABBREVIATIONS

**OECD (EBPO):** Organisation for Economic Co-operation and Development**.**

**GCC (VKC)**: Governance Coordination Centre.

**NLS (NŽT)**: National Land Service under the Ministry of Agriculture of the Republic of Lithuania.

State-owned enterprise, SOE (VVĮ): public enterprise or state-owned enterprise[1].

**Public enterprise, PI (VĮ)**: an enterprise founded on state capital or an enterprise that has been handed over to the state in compliance with the law, the property rights of which belong to the state, and the assets of which are entrusted to be managed, used and disposed of by the state[2].

**State-owned enterprise**: public limited liability companies (AB) or limited liability companies (UAB), shares of which equal to more than ½ of the votes in the general shareholders' meeting of the said company are the property of the state[3].

**Preliminary agreement**: an agreement between parties based on which the parties commit to entering an agreement in the future on the terms and conditions discussed in the preliminary agreement. If the parties do not enter into an agreement by the deadline established in the preliminary agreement, then the obligation to enter into this agreement expires[4]. In this report, 'preliminary agreement' refers to preliminary agreement No. Ps_N-15-23100-1327 of 11 September 2015, signed by NT Valdos UAB and Karalienės Mortos Mokykla UAB.

**Investment project**: the long-term use of capital for the purpose of developing a certain project and generating profit. An investment (investment project) is also considered to be the development of new services.

**IRR**: internal rate of return – the discount rate at which the present value of future cash flows from a particular investment equals the capital (own or borrowed) invested.

**NVP**: net present value – the difference between the value of future inflows and outflows on a given day (including the cost of acquiring the investment object), calculated by applying the appropriate WACC indicator.

**ROE**: return on equity.

**ROI**: return on investment.

**WACC**: weighted average cost of capital (pre-tax).

**EBITDA**: Earnings Before Interest, Taxes, Depreciation and Amortization.

**CAPEX:** capital expenditure (funds required for developing a project).

---

[1] Description of the Procedure for Implementing the Property and Non-property Rights of the State in State-owned Enterprises, approved by resolution No. 665 of the Government of the Republic of Lithuania of 06/06/2012, p. 3.7.

[2] Law of the Republic of Lithuania on Public and Municipal Enterprises, 21/12/1994, No. I-722, Art. 2, p 1.

[3] Description of the Procedure for Implementing the Property and Non-property Rights of the State in State-owned Enterprises, approved by resolution No. 665 of the Government of the Republic of Lithuania of 06/06/2012, p. 3.6.

[4] Civil Code of the Republic of Lithuania, Art. 6.165.

# SUMMARY

## SCOPE OF AUDIT

With the aim of implementing resolution No. XII-2268 of the Seimas of the Republic of Lithuania of 22 March 2016 on mandating the National Audit Office to conduct a public audit, the National Audit Office completed an audit of the formation and implementation of the preliminary agreement signed by NT Valdos UAB and Karalienės Mortos Mokykla UAB (hereinafter referred to as the preliminary agreement) on 11 September 2015. In consideration of the fact that one of the parties to the agreement – NT Valdos UAB – is a subsidiary of the state-owned group of companies Lietuvos Energija UAB, our audit addressed both the preliminary agreement and the circumstance that led to the formation and implementation of such an agreement:

- How the Ministry of Agriculture shapes its policy with regard to state-owned enterprises (SOEs), including the range of activities conducted by SOEs;
- The supervisory activity of the Governance Coordination Centre of Turto Bankas VĮ with regard to the activity of SOEs;
- The suitability of how the Ministry of Finance, which is responsible for fulfilling the rights and duties of the shareholder (i.e., the state), represents the interests of the state with regard to Lietuvos Energija UAB;
- The internal control system set up within Lietuvos Energija UAB and actions related to the activity of NT Valdos UAB;
- The activity of NT Valdos UAB and its compliance with company statutes and strategic documents;
- The development of the real estate at 4 Gervėčių St. in Vilnius, which belongs to NT Valdos UAB, including aspects related to the lease of state-owned land and the respective actions of the National Land Service as the service to which public land is entrusted;
- the regularity, economic rationale and implementation of the preliminary agreement and other related circumstances.

The auditors of the NAO examined the results of an internal audit of NT Valdos UAB conducted by the Internal Audit Service of Lietuvos Energija UAB, the conclusions issued as part of this internal investigation and the conclusions issued by the Seimas Anti-Corruption Committee.

Accordingly, the audit covered the period from 2010 to the first half of 2016.

We would like to note that the preliminary agreement is not a material transaction, but rather an agreement between the parties regarding a future commitment to enter into a contract.

We would also like to point out that, in consideration of the auditee, we only assessed the following:

- the conclusion, content, regularity of the contract and the economic grounds for it; in other words, we did not assess the rental agreement of 08 April 2013 for administrative premises, signed by NT Valdos UAB and Karalienės Mortos Mokykla UAB. During the audit, we examined this agreement and how it was concluded as one of the circumstances linked to the conclusion of the preliminary agreement;

- the terms and conditions established by the parties in the preliminary agreement; in other words, we could not assess the planned contract, the amendment thereof, additional agreements or the consequences of enforcing such a contract. We also could not assess potential future transactions between the parties in connection with the property on 4 Gervėčių St. in Vilnius.

It should also be pointed out that in view of the indicated audit completion deadline, we did not investigate the project for the development and reconstruction of the administrative complex at 4 Gervėčių St., the terms and conditions of the project or the possible differences between the development and execution of a project for constructing a building for the purposes of education or administrative purposes.

Worth noting is the fact that on 23 March 2016, the parties terminated the preliminary agreement and did not enter into a contract regarding the lease of administrative premises as planned in the preliminary agreement.

## CONCLUSIONS AND INSIGHTS

1. Assessing the preliminary agreement (the agreement of the parties regarding a future contract) and the circumstances under which the agreement was drawn up, signed and executed, but unable to assess agreements that could have been made by the parties in the future, we established the following:
   - the preliminary agreement complies with the provisions of the law as well as the purpose of NT Valdos UAB and the competencies established by the statutes of the company (because a preliminary agreement is not a material transaction but simply an agreement between the parties regarding their commitment to sign a main contract in the future, the vote of the managing board was not required for entering the agreement). In terms of economic groundedness, the agreement was signed once an evaluation of investment alternatives and the appropriate calculations were carried out and indicated that the optimum scenario would, based on the calculations of NT Valdos UAB, produce a greater (than expected in the NT Valdos strategy for 2015–2020) return on equity (Section 6);
   - no terms violating the equality of the parties and their balance of interest were identified, however, taking into account the stage of the investment project and the fact that the main contract was never signed, we cannot evaluate the scope and balance of the parties' financial obligations. No risks were identified during the assessment of whether the terms of the agreement point to state support (Subsection 6.2);
   - the rental fee indicated in the preliminary agreement for the planned administrative premises corresponded to the price established in market overviews for commercial space. However, we did notice that the project was never made public – such a requirement was never established in the internal procedures of NT Valdos UAB. Thus, the principles of transparency, openness and competitiveness were not applied (currently applicable regulations only recommend this for the subsidiary companies of SOEs) and other potential stakeholders did not have the chance to compete for the planned administrative premises. With this in mind, we cannot assess whether publicly announcing the intention to build

administrative buildings and offer them as rental premises would have attracted other potential clients who would have offered more favourable terms than those established in the preliminary agreement and potentially generated greater economic gain for NT Valdos UAB (Subsection 6.1);

- The technical project for the new administrative buildings to be built at 4 Gervėčių St. in Vilnius established the requirement that the buildings should be suitable for educational activity but also be easy to adapt for administrative purposes if necessary (Subsection 6.1);
- Based on data provided by NT Valdos UAB, the factual expenses incurred by NT Valdos as of 27 April 2016 for implementing the terms of the preliminary agreement amounted to 0.18 million euros. These expenses (paid by NT Valdos) were incurred in connection with project management, the development of project proposals and a technical project, supervision of construction, geological surveys, topographical imaging, technical expertise, contracting offers based on expert assessments and establishing easements. The expenses were planned for in the NT Valdos budget plan for 2015, which is why the managing board of NT Valdos UAB was not required to pass any separate decisions based on company statutes. The work completed on the project and the expenses incurred as a result thereof had a positive impact on the value of the development object at 4 Gervėčių St., Vilnius: the value of the project increased preliminarily from 0.95 million euros (the value of the object at the start of development, based on a real estate evaluation of 21 October 2014) to 1.6 million euros (based on data of an independent property evaluator from January 2016) (Subsection 6.1);
- the expenses related to the agreement signed between NT Valdos UAB and Karalienės Mortos School UAB, would not have been included in the price of electricity, heating or gas because the final price of electricity, heating or gas for users is only influenced when products, services or work is sold to companies in the energy sector, whose activity is licensed or to whom state-regulated prices are applied, and whose expenses are included in the price of electricity, heating and gas. However, managing such a risk requires the amendment of articles 2, 6, 9, 21, 25, 30 and 37 of Law No. IX-884 of the Republic of Lithuania on Energy, so that the National Commission for Energy Control and Prices would have the right to receive information from all energy enterprises. Worth noting is the fact that this amendment bill has already been submitted by the Ministry of Energy to the Seimas (Subsection 6.1).

2. The activity of NT Valdos UAB assessed during the audit complies with company statutes and strategic documents; however, there are doubts as to whether the subsidiary of the Lietuvos Energija group should be involved in real estate development – an activity that is not related to the strategic goals of the energy sector or the Lietuvos Energija group – as a participant in the real estate market. In view of the current situation (current legislation allows such diversification of activity and this might not conform to public expectation), relevant authorities should address issues such as the range of activities SOEs can be involved in, defining what is acceptable and appropriate for the sector a given SOE operates in and the objectives that have been set for it on a national scale (Section 3).
3. The principles applied by NT Valdos UAB, which has been operating since 2010, in the management of property should be considered acceptable practice, however, the property management process has taken too long: an analysis of managed property was initiated in 2012, but the property was only categorised as acceptable, improvable (in terms of lease conditions) and to be sold at the end of 2015, and the decision to sell unnecessary property was only made in 2016 (Section 7).

4. In consideration of the audit findings, a nationwide assessment of real estate that is not used by or necessary for SOEs should be conducted. Such an analysis would help establish guidelines and directions for the management of SOE real estate, contributing to the return on the investment of the state in the expansion of SOEs (Section 7).
5. The plot of state-owned land managed by NT Valdos UAB at 4 Gervėčių St., Vilnius was rented out in order to make use of the existing buildings. The National Land Service, which is entrusted with managing state-owned land, did not take any action over a period of 5 years to ensure that the leased plot and buildings were used according to their purpose and that the plot of land leased by NT Valdos UAB is of an appropriate size for making use of the buildings on it. The service did not oversee the use of state-owned land at 4 Gervėčių St., Vilnius. It should be noted that overseeing the use of state-owned land designated for other purposes has not been established as a priority area for the past five years (Section 4).
6. In our analysis of the circumstances behind the preliminary agreement, we established that real estate would have been developed on leased public land. The possibility for construction is provided for in the public land lease agreement of 2003. Because new buildings would have been built, the owner would have had the right to extend the public land lease agreement in compliance with the law for the period of building use. Thus, conditions could be established for a leaseholder to lease public land for a maximum period of 99 years. This means that there are grounds for doubt as to whether it is right and beneficial for the state to allow for the construction of new buildings in a public land lease agreement when public land is leased out to entities without a public auction (Section 4).
7. In our analysis of the legal regulation of leasing land designated for other uses according to purpose, we identified several issues:
   - the law does not stipulate the period of time for which misuse can be justified or the period of time that is deemed to be behaviour that is not economically effective. This means that there is a risk that establishing failure to exploit a building can depend on the subjective opinion of the evaluator;
   - the law does not define the size of a plot of land that must be developed for the purpose of exploiting a specific building, so there is no possibility for assessing the ratio of plot size, built-up area and territory required for using the building according to purpose (Section 4).
8. The Ministry of Finance, which is responsible for fulfilling the rights and duties of the shareholder (i.e., the state), essentially represents the interests of the state in an appropriate manner with regard to Lietuvos Energija UAB: the *Guidelines for the Corporate Management of the State-Owned Energy Enterprise Group* approved by the minister of finance, the shareholders' expectations submitted to the company and the scope of participation of the governing bodies of the enterprise can be considered as best practices in managing SOEs. Because of the corporate management model implemented in Lietuvos Energija UAB, the Ministry of Finance receives necessary and essential information about its subsidiary enterprises, including NT Valdos UAB, along with other data from the Lietuvos Energija group, and information acquired through examining issues during supervisory council meetings. However, with the current situation in mind, it would be worth considering whether the Ministry of Finance should have identified the risk of the activity carried out by NT Valdos UAB that is not directly related to the energy sector and alternative decisions with regard to the company's property (Section 2).
9. The OECD notes that corporate management is one of the most advanced, transparent and effective forms of managing SOEs; however, we have identified risks related to the fact that the activity of SOE subsidiaries is not always sufficiently publicly available. The same

principles of transparency and publicity that apply to SOEs should apply to their subsidiary companies. It is probable that implementing certain recommendations issued as part of the OECD overview of SOE management in Lithuania will make the activity of SOEs and their subsidiary companies more effective and transparent (Section 1).

# RECOMMENDATIONS

## To the Government of the Republic of Lithuania:

1. With a view to maximising the effectiveness of SOEs, assign a responsible institution or institutions representing public interest in SOEs to the task of analysing and assessing the activities carried out by SOEs (including their subsidiaries) and their compliance to the strategic goals of the state and the goals of the enterprises themselves, and decide on the direction and scope of a company's activity based on the results.
2. With a view to maximising return to the state, assess the property at the disposal of SOEs (including their subsidiaries) and how this property is used, as well as assign a responsible institution or institutions representing public interest in SOEs;
   - evaluate the property used by SOEs based on the goals established for the SOE;
   - set directions and formulate guidelines for what SOEs should do with the unused real estate at their disposal within the scope of their activity in order to maximise public gain.
3. With a view to ensuring the rational use of public land, consider the possibility of amending the legal regulation of construction in leased public land.
4. With a view to ensuring the more beneficial lease of state-owned land, amend legal regulation and set criteria based on which it would be possible to objectively evaluate the following:
   - the size of the state-owned plot in relation to what the building is used for;
   - the period of time for which misuse of a building on state-owned land can be justified and the period of time that constitutes behaviour that is not economically sound.

## To Lietuvos Energija UAB

With a view to avoiding situations that perhaps do not meet the public's expectations, take action to ensure the application of the principals of transparency, openness and competitiveness in the development of NT Valdos real estate projects.

Measures and time frames for the implementation of the recommendations for Lietuvos Energija UAB are presented in Annex 2, 'Plan for Implementing Recommendations'. The plan for implementing the recommendations issued to the Government of the Republic of Lithuania is currently being prepared.

## CHANGES MADE DURING THE AUDIT PERIOD

During a meeting of the collegium of the Ministry of Finance that took place on 29 April 2016, the 2015 performance reports, financial results and implementation of the 2016–2019 strategic action plan of Lietuvos Energija UAB and its subsidiaries were discussed. In response to a resolution issued by the collegium, the minister of finance issued order No. 1K-189 of 19 May 2016 to the managing board of Lietuvos Energija UAB to revise the strategy of NT Valdos UAB by 01 July 2016 with a view to optimising the management of its real estate. This decision was based on the aim of resolving property issues related to public institutions and establishments. Lietuvos Energija UAB is obliged to cooperate with Turto Bankas VĮ, which manages information about the need for real estate among public institutions and establishments, and assess the scale of the unoccupied administrative premises managed by NT Valdos and the enterprises of the Lietuvos Energija UAB group, and propose methods and alternatives to the Ministry of Finance for the use of this property for satisfying public sector needs.

## FURTHER ACTIONS OF THE SUPREME AUDIT INSTITUTION

The supreme audit institution will be investigating the systemic issues and risks identified during this audit as it carries out the systemic performance audits on the "Return on Equity of State-Owned Enterprises" as well as "Internal Auditing in the Public Sector", and by carrying out a strategic study of state-owned property management.  Based on the results of this study, it will then consider carrying out a systemic performance audit of this area.