Independent assessment of NSW Treasury's processes in relation to the preparation of the 2021 State Financial Statements

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Executive Summary

This Independent Assessment addresses lessons NSW Treasury (Treasury) should learn from its interactions with the NSW Audit Office in calendar years 2020 and 2021 regarding the recording of the Transport Asset Holding Entity (TAHE) in the Total State Sector Accounts (TSSA) for the financial year 2020-21 (2021 TSSA). It considers the actions of Treasury, not any other party. Nor does it question the judgments of the Auditor-General for NSW or the government. It does not seek to assign blame. The focus is on finding options to improve Treasury's systems, processes and culture.

Treasury and the Audit Office often work together to ensure that the NSW public sector follows best practice and Australian Accounting Standards. In this instance, however, they were on opposing sides in a complex and, as it turned out, personally challenging argument.

The establishment of TAHE had been foreshadowed in the 2015-16 NSW budget. TAHE was intended to operate commercially and secure better value from the management of the state's rail assets, especially its property portfolio. However, it took some years to bring TAHE to fruition. The 2021 TSSA was the first to include the new entity, which was established on 1 July 2020.

The audit of the 2021 TSSA and TAHE's accounts surfaced major issues, leading to reservations of the NSW Auditor-General about the proposed treatment of capital contributions to TAHE as equity injections rather than expenses to the state budget. In essence these turned on whether there were reasonable expectations that TAHE would earn a sufficient return over time for the government on its investment. In the end, the government, TAHE, TfNSW and rail operators agreed (at least in principle) to adopt revised arrangements for the funding of TAHE, which increased projected revenue streams of TAHE and removed the need for the Auditor-General to qualify the 2021 TSSA. In her subsequent report to Parliament on the 2021 TSSA, *State Report 2021*[1,] the Auditor-General was highly critical of some of Treasury's interactions with the Audit Office during the audit process.

In many respects, the genesis of the issues that came to a head in 2020 and 2021 lies years before. The Assessment makes findings and recommendations which, if adopted, could reduce the risk of a recurrence in future similarly complex environments. Key findings include:

- Arguably, the transition to fully establish TAHE took too long.
- Treasury had committed to a particular treatment of TAHE in the 2015-16 budget, and subsequent TSSA accounting, before developing a sufficiently detailed business model.
- Treasury's substantive engagement with the Audit Office on the accounting issues came too late for so significant and so complex a case.
- At the time, Treasury's believed they were required to provide documents to the Audit Office that it judged to be 'relevant' and 'material' for the Auditor-General to assess management's proposed accounting treatment.
- Treasury, like all other NSW government entities, should operate on the basis that the Audit Office is entitled to access the full range of documents necessary to undertake the audit, to enable the Auditor-General to form a view about the matters before her.

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[1] *State Finances 2021*, New South Wales Auditor-General's Report to Parliament on the audit of the Consolidated Financial Statements of the NSW General Government Sector and Total State Sector, 9 February 2022, p 10. After auditing the TSSA, the Auditor-General is required to present a report to Parliament particularising any departures from the provisions of relevant legislation that are sufficiently material to the financial position disclosed and may make suggestions for the better collection and payment of government money, for more effectual and economical auditing of the TSSA, and any matter arising from or relating to the exercise of the audit or the Auditor-General's other functions. (s. 52 and 53 *Government Sector Audit Act* 1983)

- Treasury has a strong culture focused on delivering government policy, which in this case had been in place since 2015. This may have reduced Treasury's capacity to be open to alternative views, leading to insufficient consideration being given to the benefits of making policy adjustments in order to more securely achieve the intended outcomes. This apparently affected the approach taken in their interactions with the Audit Office.
- By 2021, the matters were controversial and in the public domain, and substantial budgetary benefits were at risk, which intensified the pressures faced by Treasury officers.
- While accepting the prerogative of the Auditor-General to decide otherwise, Treasury accounting experts still consider that their positions on the major accounting issues in dispute were at least arguable – in other words these were professional disagreements and not an 'error'. The Auditor-General remains of the view that significant errors were made.
- While not being definitive, there is evidence to tentatively suggest that senior management could profitably investigate the effectiveness of cross team collaboration throughout the TAHE transition period.
- Treasury's accounting expertise is strong. However, it appears that Treasury has a relatively small team of dedicated professionals and a clear key person risk regarding highly specialist areas. Treasury should actively monitor progress in addressing such risks**.**
- Consultants have been substantially involved with the policy development and implementation of TAHE from the beginning. It is unclear whether all in Treasury were sufficiently aware of the risks or of how blurred the lines became at times between the roles played by consultants as an 'external advisor' and as 'part of team Treasury with an outcome to achieve'.

All parties have cooperated fully and openly with the Assessment and are keen to learn from their experience in the hope that it is not repeated.

The circumstances of TAHE were somewhat unique – including the long lag between the decision to establish TAHE and its full execution, the complexity of the issues, the almost 'perfect storm' of other events that occupied senior Treasury officials at key times, and the high stakes consequences of any departure from by then long-established budget practices.

All involved believed they were discharging their responsibilities professionally and acting in the best interests of NSW. I was somewhat saddened to learn that trust has been eroded between Treasury and the Audit Office, with key personnel reporting they have been deeply hurt in the process. Although it will take time to fully restore relationships, the key players also say they are professionals, with a common desire to achieve the best outcomes for the government and people of NSW, who are committed to working together to discharge their responsibilities. I have no reason to doubt that commitment. Indeed, I have been generally impressed by the high standards and commitment exhibited by those with whom we spoke.

Key findings and recommendations are summarised in Section 5, with their rationale provided principally in Section 4.

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1 About this Assessment

Scope

This Assessment addresses lessons NSW Treasury should learn from certain interactions between it and the NSW Audit Office in calendar years 2020 and 2021 regarding the recording of the Transport Assets Holding Entity (TAHE) in the Total State Sector Accounts (TSSA) for the financial year 2020-21 (hereafter 2021 TSSA).[2] It does not express views about the actions of the Audit Office, or about their judgements in respect of how the relevant accounting standards should be applied in that context, or about the merits of the government's policy in establishing TAHE to manage the State's rail assets. Nor does it assess the actions of any other agency. My Assessment does not seek to assign blame.[3] The focus is on finding options to improve Treasury's systems, processes and culture.

The Australian Bureau of Statistics (ABS) currently classifies TAHE as a commercial entity (a Public Non-Financial Corporation) outside the NSW budget (or General Government) sector.[4] Since the 2015-16 budget, capital contributions to TAHE (and its predecessor, RailCorp[5]) have been treated as injections of equity rather than expensed as grants. A major question for the audit of the 2021 TSSA was whether the operations of TAHE, and its financial arrangements, justify retaining this treatment under current accounting standards.[6]

During her preliminary audit of the 2021 TSSA, the independent auditor, the Auditor-General for NSW, took the view that TAHE's financial underpinnings did not sufficiently satisfy the relevant tests for recording capital contributions as equity, and that she would need to qualify her opinion regarding the 2021 TSSA. This prompted policy changes by the NSW government and an in-principle agreement between TAHE and the rail operators, Sydney Trains and NSW Trains, intended to generate increased revenue to TAHE, which removed the need for such a qualification. In her subsequent report to Parliament on her independent audit of the 2021 TSSA, *State Report 2021*[7], the Auditor-General was highly critical of some of Treasury's interactions with the Audit Office during the audit process. I have not directly addressed each of the Auditor-General's findings or recommendations from Chapter 3 of *State Report 2021* but have used them to inform my

[2] The Terms of Reference for my Assessment are appended to this report at Appendix 6.2. An extension was provided requiring me to report to the Secretary of NSW Treasury by 30 June 2022.

[3] The Terms of Reference specifically exclude my Assessment from undertaking an investigation in respect of potential breaches of the NSW Code of Conduct. They leave open the possibility that such an investigation(s) could be a recommendation. This Assessment has made no such recommendation.

[4] The ABS independently determines in which sector a government entity belongs, for their classification in official statistics, based on consideration of Government Finance Statistics and the International System of National Accounts which, through the relevant manuals, provide the standards for measuring the financial activities of government.

[5] Rail Corporation New South Wales was a NSW Government agency established in 2004 under the *Transport Administration Act* 1988, later becoming a controlled entity of Transport for NSW.

[6] The process is complex and discussed further below.

[7] *State Finances 2021*, New South Wales Auditor-General's Report to Parliament on the audit of the *Consolidated Financial Statements of the NSW General Government Sector* and *Total State Sector*, 9 February 2022, p 10. After auditing the TSSA, the Auditor-General is required to present a report to Parliament particularising any departures from the provisions of relevant legislation that are sufficiently material to the financial position disclosed and may make suggestions for the better collection and payment of government money, for more effectual and economical auditing of the TSSA, and any matter arising from or relating to the exercise of the audit or the Auditor-General's other functions. (s. 52 and 53 *Government Sector Audit Act* 1983).

assessment of Treasury's processes in relation to the preparation of the 2021 TSSA, which is the subject of my Assessment.[8]

The circumstances surrounding the finalisation of the 2021 TSSA were somewhat unusual, including the challenges posed in establishing TAHE, significant changes to some accounting standards, and competing government priorities including natural disasters and the COVID–19 pandemic.

All parties are keen to learn from their experiences in 2020 and 2021 in the hope that they are not repeated. I was somewhat saddened to learn that trust has been eroded between Treasury and the Audit Office, with key personnel reporting they have been deeply hurt in the process. While accepting that relationships will require time to repair fully, they also report a common determination to work together to professionally discharge their joint and several responsibilities to the government and people of NSW.

> **A finding is that all involved believed they were discharging their responsibilities professionally and acting in the best interests of NSW. Damaged relationships will take some time to repair. Both parties say they are professionals who are committed to working together to advance the interests of the people and government of NSW. I have no reason to doubt that commitment. However, adoption of my Assessment's recommendations could reduce the risk of a recurrence in future similarly complex environments.**

Conduct of the Assessment

The Assessment commenced at the end of March 2022. It has been conducted over a relatively short period (thirteen weeks), which is somewhat longer than originally intended but still a short time given the complexity of the issues and the volume of material involved. Indeed, progress has been slowed by COVID-19 within the Assessment team, delays in assembling the small secretariat, and the need to identify and review relevant documents from a substantial number of formal documents and a very substantial amount of email communications. Some 21 interviews were conducted involving 25 people (several more than once) across Treasury, the Audit Office, Transport for NSW (TfNSW), TAHE, and other individuals, including some who were no longer Treasury employees. The former Secretaries to Treasury and TfNSW were offered an opportunity to participate, which neither has taken up.

Structure of this Report

This Report contains 5 substantive sections:

1. About this Assessment
2. TAHE
3. Key accounting issues
4. Interactions between Treasury and the Audit Office
5. Findings and recommendations

Section 1 provides an introduction, including the scope of the Assessment.

Section 2 provides a brief background to the formation of TAHE and the process that led to it being stood up on 1 July 2020.

[8] A list of the Auditor-General's findings and recommendations are appended to this report.

Section 3 explains the key accounting issues, noting the interaction between the Australian Accounting Standards and the Government Finance Statistics when assigning transactions to economic entities. It is provided as a lay-person's, rather than an expert's, guide to the issues.

Section 4 lies at the heart of the Assessment. It considers the interactions between the Audit Office and Treasury in the lead up to the finalisation of the 2021 TSSA, in light of the Auditor-General's observations in Chapter 3 of her *State Finances 2021* report to Parliament, considers lessons that should be learnt, and makes findings and recommendations.

Section 5 provides a summary of my findings and recommendations.

Lastly, the Appendices provide supporting documentation and a list of abbreviations.

Acknowledgement and thanks

I acknowledge and am grateful for the openness and candour with which all involved have approached this task, including during interviews. I also acknowledge the significant support provided especially by Treasury, the Audit Office, TfNSW, and the Department of Premier and Cabinet (DPC) to identify and supply documents. Treasury provided significant resources to support the Assessment. Special thanks are due to the Treasury Information Management team for their efforts to locate historical records and ensure we had access to Treasury systems as required.

This process involved complex subject matter and was conducted over a relatively short period of time, which has only been possible because of the openness of interviewees and the professional support available to me. I acknowledge, with grateful thanks, the support, professional expertise and good humour provided by the members of my Secretariat, Cheryl Drummy, Ketvi Roopnarain and Diana Saada.

All parties have respected the independence of this Assessment. Of course, the opinions contained herein are my own.

This Assessment has been prepared for the Secretary of NSW Treasury, Dr Paul Grimes. It is based on information from those whom we have interviewed and the documents that have been provided, which I have assumed for the purposes of this Assessment are accurate and complete. However, neither I nor any other person involved in the preparation of this Report takes responsibility in any way for any reliance placed by a third party on it. Any such reliance is that party's sole responsibility.

2 TAHE

TAHE issues significantly affect the State budget

The events of 2020 and 2021 have their origins years before. In some respects, they date to micro-economic public transport service reforms that had been undertaken from 2011, including establishing TfNSW to be responsible for transport service delivery.

The decision to establish a commercial transport asset holding entity was taken in the 2015-16 budget context.[9] The proximate cause of the creation of what became known as TAHE was that the ABS had signalled an intention to reclassify, from mid-2015, RailCorp, the predecessor of TAHE, as an entity within the General Government Sector - the State budget sector (GGS).[10] In previous years, RailCorp had been classified as a not-for-profit (NFP) Public Non-Financial Corporation (PNFC).[11]

As a NFP PNFC, capital contributions by the State to fund rail infrastructure investment had been classified as grants and thus part of the State's budget expenses. Depreciation was not recognised as a GGS (budget) expense. The imminent reclassification of RailCorp to the GGS would have a significant net adverse impact on the budget. In accounting terms, creation of a commercial RailCorp/TAHE as a 'for profit' PNFC[12] would lead to the reclassification of income earning capital contributions as equity investments, rather than being capital grant expenses in the GGS.

To that point, RailCorp had operated as an integrated asset manager and rail services provider. RailCorp was responsible for the acquisition and management of railway assets. Rail passenger services were provided by its subsidiaries, Sydney Trains and NSW Trains.[13]

In response to the potential reclassification, a high-level model was conceived by Treasury and TfNSW for (what eventually became known as) TAHE, to replace RailCorp as a public trading enterprise asset manager, to achieve twin objectives. TAHE would be given a commercial (for profit) mandate and sufficient independence from government to enable it to apply commercial rigour, improve operational efficiency, and secure better economic value from the management of the rail infrastructure (including, for example, the management of land and other space around stations); and, critically, enable the government to avoid the potentially significant adverse budgetary impact if RailCorp was reclassified to the GGS in 2015.

The government authorised Treasury and TfNSW to further investigate this conceptual model. Thereafter, in May 2015 the ABS confirmed its in-principle support that the commercial RailCorp/TAHE model would remain classified to the PNFC sector if certain conditions were met, consistent with information provided by Treasury.

The information Treasury conveyed to the ABS included the government's preliminary proposals regarding TAHE's structure, its intended independence from government, and that it would charge

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[9] Indeed, reference to the government considering a commercial asset holding entity having been included in the 2013-2014 Half-Yearly Review (Box 2.1 Rail reform).

[10] This change in classification related to the GFSM criteria requiring RailCorp to be a 'market producer', which was impacted by its dependence on government subsidies and its ability to demonstrate a satisfactory recovery of production costs (as a monopoly provider).

[11] See Section 3 for more detail.

[12] Depreciation, a non-cash expense, is not included in the GGS budget result for any PNFC, whether NFP or for profit.

[13] Sydney Trains and NSW TrainLink (NSW Trains) had been established as subsidiaries of RailCorp from July 2013.

‘economically significant prices’ and provide returns (dividends) to government ‘comparable to an equivalent private sector business’. The latter included that newly commercial RailCorp would provide a dividend from after-tax profit equivalent to a 7 percent return on equity in 2016-17 and that a dividend policy would be created.[14] Implementation was foreshadowed to take three to five years.

TAHE was not formally established until 1 July 2020 (a year later than the latest date originally expected). RailCorp continued to manage the state’s rail assets in the meantime. Consistent with the 2015 ABS determination, RailCorp continued to be classified as a PNFC in the TSSA and for the purposes of the State’s budget.

Considerable work was required to develop a detailed business model that met TfNSW’s legitimate concerns to ensure the maintenance of high safety standards while securing TAHE’s commercial remit and avoiding unnecessary additions to the state’s budget expenses. The Assessment’s examination of the decision-making processes prior to 2020 has necessarily been limited. That said, the available evidence shows a consistent focus on both safety and financial concerns while the TAHE business model and governance were refined. It has not been possible to establish whether unreasonable delays were encountered in discharging these legitimate responsibilities.[15]

Although TAHE’s business model had not yet been established in detail, with the proposed creation of RailCorp/TAHE as a for profit PNFC, the 2015-16 budget, and all subsequent budgets, were constructed on the basis that RailCorp (and, ultimately, TAHE) were classified as being outside the GGS budget sector. Funding for future capital projects (capital contributions) was recorded in RailCorp’s financial accounts and the TSSA as equity injections rather than grants. If RailCorp had been reclassified to the GGS in 2015, these capital contributions would have remained as grants and the depreciation on assets would, for the first time, have been recorded as a (non-cash) budget expense.[16]

This treatment improved the budget result by $1.8 billion in that year.[17] It also supported the government’s efforts to maintain expenses growth to within the limits set in the *Fiscal Responsibility Act* 2012, the object of which is to maintain the AAA credit rating of the State.

As time passed, understanding changed about the dominant ‘fiscal risks’ that needed to be managed. Initially, the focus was on avoiding adverse outcomes for the State’s budget (if RailCorp/TAHE was classified as an entity within the GGS, as discussed above. Later, the issue became the level of budget support to providers of passenger railway services (recorded as expenses in the budget) necessary to ensure the commerciality of TAHE’s operations.[18] This issue lay at the heart of exchanges between Treasury and TfNSW about fiscal impacts between 2017 and 2019. The

[14] ‘in line with the NSW *Commercial Policy Framework: Guide for Boards of Government Businesses* (NSW Treasury 2009)’ as outlined in correspondence dated 29 May 2015 from the ABS to Treasury confirming its determination of the classification of TAHE.
[15] The delay in establishing TAHE is considered, later in this Report, in relation to the issues that arose during the 2021 TSSA audit
[16] See Appendix 6.5.
[17] “The establishment of the *Transport Asset Holding Entity* (TAHE) from 1 July 2015 improves the budget result by an estimated $1.8 billion in 2015-6 and $1.9 billion per annum, on average, over the forward estimates.” (NSW *Government Budget Statement* 2015-16, Budget Paper No. 1, p 5-1.) By 2021, a cumulative $11.1 billion in contributed equity had been provided to TAHE (*State Finances 2021*, p 10).
[18] Budget grants to rail operators underpin their payments to TAHE to meet its commercial targets.

Audit Office's questioning of Treasury in 2020 and 2021 put both aspects of this debate back into play (discussed below, in Section 4).

The issues were complex, but they were well understood from a very early stage. What took time was resolving the issues. Treasury was a key player – but far from the only player involved in resolving the outstanding issues.

Prior to 2020, TfNSW was both responsible for establishment of TAHE and *questioner in chief*. This Assessment has not had the time, nor the authority[19] to investigate whether TfNSW's approach to this role unnecessarily held up the establishment of TAHE. The Audit Office took up the *questioner* role subsequently (Sections 3 and 4).

Standing up TAHE

Implementation after 2015-16 was slow, arguably too slow.

Establishment of TAHE did not ultimately occur until 1 July 2020[20] and, in the intervening period, there were significant debates between Treasury and TfNSW about how to ensure that the railways were operated safely and efficiently, how to address governance and regulatory concerns, and how to satisfy the ABS tests for TAHE to remain classified as a for profit PNFC.

Once a decision had been taken by the NSW government, in 2015, to develop a commercial asset holding entity, formulation of its business model and its transition rested principally with TfNSW. Treasury was involved in identifying the governance arrangements for TAHE with TfNSW, as it would be a State Owned Corporation (a SOC) for which Treasury has responsibilities.[21] Treasury's principal responsibilities, however, related to the appropriate fiscal treatment of TAHE, and to ensuring that the State's economic policy objectives were realised.

It had been some years since NSW had set up a SOC of the scale and complexity of TAHE. There was much *learning by doing*.

The appropriate governance structure for TAHE appears to have been settled and agreed reasonably early, certainly before the legislation was tabled in Parliament in March 2017. TAHE's governance essentially remains as it was conceived, including:

- The Treasurer and another Minister (to be nominated by the Premier under the *State Owned Corporations Act* 1989 (SOC Act)) as voting shareholders, jointly owning TAHE on behalf of the Crown.
- A Board of Directors comprising a majority of independent Directors appointed by the voting shareholders, with the Transport Secretary a statutory appointment.
- The TAHE Board operating according to commercial principles, at arm's length from government control, but subject to the standard powers (including transparency requirements) of Ministerial direction and accountability to the voting shareholders, in accordance with the SOC Act and TAHE's constitution.
- TAHE's day-to-day management and operations overseen by a chief executive officer in accordance with general policies and specific directions of the Board.

[19] See Terms of Reference, Appendix 6.2.
[20] Even then, transitional arrangements remained for significant aspects of its business operations, including its access and licence fee pricing arrangements.
[21] Treasury would ultimately be responsible for advising the Treasurer regarding responsibilities as a shareholder of the State Owned Corporation, in accordance with the *State Owned Corporations Act* 1989 (the SOC Act).

- TAHE's corporate authority defined and governed in accordance with:
    - its constitution
    - its operating licence
    - the SOC Act (and, ultimately, Part 2 of the *Transport Administration Act* 1988, which was amended in 2017 to establish TAHE and provided its foundation Charter).

Transition period

Implementation of TAHE was overseen by the TAHE Advisory Board, chaired by the Secretary of TfNSW, with representation from Treasury and DPC. Treasury, in consultation with TfNSW, established a Steering Committee (to report to the TAHE Advisory Board) which was responsible for operationalising TAHE in accordance with the legislation.

The transition took a further 5 years. Personnel changes[22] and competing priorities (including natural disasters and the COVID-19 pandemic) contributed to the delays. Significant practical and policy issues were under discussion throughout (some of which were only finally resolved during the 2021 TSSA audit process). As noted above, while responsibility for fiscal policy matters rested principally with Treasury, TfNSW, through the Advisory Board, was charged with establishment and implementation of TAHE including the governance, safety, budgetary and pricing questions. The Assessment has not conducted a thorough review of this governance nor the debates through the transition period. It is evident, however, that the different perspectives and responsibilities of Treasury and TfNSW led to some tension and, potentially, to some of the delay.

Safety and independence

Concerns about TAHE's independence from government and the principles of safety and operational integrity featured prominently from the outset. TfNSW was concerned that the requirement to operate TAHE on a commercial basis, and provide a regular dividend to government, would lead to decisions that were inconsistent with government policy objectives for passenger services and the prioritisation of maintenance and safety. NSW had experienced two significant rail safety events prior to the development of RailCorp as a unified service provider and asset manager in 2003.[23] A key lesson was the importance of an integrated decision-making and governance framework across the asset lifecycle (planning, acquisition, maintenance, operational and disposal). With the proposed separation of asset ownership and management from rail service delivery, that appeared to be a serious possibility in 2015, this issue needed to be considered.

Moreover, to be classified as a PNFC, the ABS required TAHE to operate as a separate institutional unit with limited intervention powers – meaning that the Board had to be independent of significant government intervention.

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[22] Notably, in 2015, Andrew Constance replaced Gladys Berejiklian as Minister for Transport and Infrastructure, who became Treasurer; in 2017, Gladys Berejiklian replaced Mike Baird AO as Premier, with Dominic Perrottet becoming Treasurer; Rob Whitfield AM was replaced by Mike Pratt AM as Treasury Secretary and Tim Reardon was appointed as DPC Secretary with Rodd Staples replacing him as TfNSW Secretary. In 2021, Dominic Perrottet was appointed Premier, Matt Kean Treasurer, Michael Coutts-Trotter replaced Tim Reardon as DPC Secretary, Robb Stokes and then David Elliot were Minister for Transport and Roads; significantly for TAHE, Rodd Staples was replaced as TfNSW Secretary from November 2020, with Rob Sharp commencing in February 2021; and, in early 2022, Dr Paul Grimes PSM replaced Mike Pratt as Treasury Secretary.

[23] Rail safety reform in NSW followed the Glenbrook rail accident (in December 1999) with the *Special Commission of Inquiry* into the accident reporting in April 2001, and the Waterfall rail accident in January 2003 which the *Special Commission of Inquiry* reported on in January 2005.

Although debates continued for some years over some details, these issues appear to have begun to be addressed relatively early:

- TAHE was to focus on a commercial strategy for the use of non-regulated assets, such as property, and assist government in achieving more productivity from such assets, enabling TfNSW to focus on passenger service delivery.
- TfNSW and rail operators were to assume responsibility for railway operations and maintenance of the heavy rail assets they used, preserving the vertical integration of operations and maintenance (consistent with the views of the two Special Commissions of Inquiry following the earlier rail safety events).
- TfNSW, rail operators and TAHE would be subject to rail safety legislation and regulatory oversight by the Office of the National Rail Safety Regulator.[24]
- TAHE's Board would operate independently but ultimately be subject to Ministerial direction through, for example, Statements of Expectation, and its Statement of Corporate Intent (SCI) agreed by the shareholders, including safety outcomes that TAHE was expected to secure when performing its functions.[25]
- An operating model was to be agreed with TfNSW to include safety of operations, with TAHE to develop a safety and assurance framework.
- TAHE's Operating Licence, issued by the portfolio Minister, would also provide details about safety integrity.

While these provisions were considered to address safety governance concerns, TfNSW continued to engage experts to consider this issue into 2020.

As the Auditor-General noted in *State Finances 2021*, the Office of Transport Safety Investigations conducted a review in November 2021 of the TAHE mitigation and governance arrangements to manage potential conflicts of interest for operating rail assets. It is understood that the review did not propose any changes but recommended a further review post-implementation to coincide with renewal of the 2-year operating licence.

Commerciality

After the budget benefit of TAHE had been booked in 2015-16, the development of a business model that would minimise fiscal risk (ie the risk of reclassification of TAHE to the GGS) became a critical consideration. Reclassification would have added significantly to budget expenses because the GGS accounts would then include capital funding and depreciation of TAHE assets as expenses.

The commercial viability of TAHE is an important element of the ABS' consideration of whether to classify it as a PNFC, or as part of the GGS based on consideration of Government Finance Statistics and the International System of National Accounts. A judgement about whether a capital contribution from government is reasonably expected to earn a sufficient return is also a key consideration for the Auditor-General when forming a view about whether, under the Australian Accounting Standards, to classify such contributions as an equity injection or a grant to be expensed. (Section 4 provides greater detail.)

TAHE's commerciality was expected to be phased in over time. Financial benefits from a commercial TAHE were to be realised through continued payments from government to rail operators and from

[24] Including the *Transport Administration Act* 1988 and *Rail Safety National Law* (adopted by NSW - *Rail Safety Law (NSW)* 2012) and the *National Rail Safety Regulator*.

[25] Any relevant directions, notification or approval given by the voting shareholders or portfolio Minister in the exercise of such a function under the SOC Act must be transparent.

commercial freight providers for access to the assets, and from improved asset management. At the time of establishment, over 80 percent of TAHE's revenue was from government rail operators.[26]

An enduring element of the TAHE debate concerned what scale of fiscal support rail operators (which rely significantly on budget funding through grants channelled through TfNSW) would be needed to enable them to provide sufficient revenue to TAHE to ensure its commerciality.

TAHE holds two broad classes of assets. Regulated assets are those within the operational rail network. TAHE collects access fees from rail operators for their use. Unregulated assets primarily comprise property holdings around stations and rolling stock including stations, plant and equipment. TAHE derives licence fees from operators for the use of these assets, and from the commercial returns generated from innovative usage of the property portfolio.[27]

The Independent Pricing and Regulatory Tribunal (IPART) NSW Rail Access Undertaking sets out the pricing principles that TAHE must apply when setting fees charged to rail operators for access to the network (the regulated, not unregulated assets). These principles guide the calculation of both a low and a high (floor and ceiling) price.[28] TAHE's operating licence, issued by the Minister for Transport, is expected to include a pricing regime or structure related to assets leased or made available by TAHE that is consistent with these principles.

Grants to rail operators to support payment of fees to TAHE are classified as an expense in the state budget and the TSSA, which has implications for one of the objectives that underpinned the establishment of TAHE, namely, to meet the requirements of the *Fiscal Responsibility Act*. This issue was revisited several times during the TAHE transition period, with TfNSW consistently receiving advice in favour of higher budget support than was Treasury's preference. It ultimately also became a point of contention between Treasury and the Audit Office in the 2021 TSSA audit. This is discussed in sections following.

RailCorp had operated without a commercial charter. The Auditor-General has observed that the access fees agreed between TAHE and the government operators, Sydney Trains and NSW Trains, from 1 July 2021, were well below the maximum price established by IPART (less than 50 percent of the ceiling price with maintenance charges) and, while IPART does not determine a regulatory ceiling for licence fees for access to unregulated assets, these were not increased.[29]

Section 4 outlines the Auditor-General's concerns about this aspect of TAHE's operations which led to TAHE, Sydney Trains and NSW Trains on 18 December 2021 agreeing to negotiate higher access/licence fees to be effective from 1 July 2022.

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[26] TAHE *Annual Report*, Volume 1 2020-21, p 4.
[27] Ibid.
[28] Rail owners and the access seekers negotiate on prices and other conditions in accordance with the Undertaking. The Undertaking requires rail access owners to charge no more than the full economic costs providing access. IPART determines certain inputs to how the full economic costs are calculated every 5 years (currently applying until 30 June 2024). IPART is currently reviewing the Undertaking with the final report due to the Minister for Customer Service by November 2022.
www.ipart.nsw.gov.au/Home/Industries/Transport/Rail-Access
[29] *State Finances 2021*, p 12 and see *Transport 2021*, analysis at p 37 with table at 36.

TAHE Legislation

Legislation establishing TAHE was intended, under the timetable originally agreed with the ABS, to be tabled in Parliament by mid-2016. The ABS twice agreed to extend this, ultimately to 30 April 2017. Assent was finally secured on 11 April 2017.[30]

The first stage, establishing Sydney Trains and NSW Trains as stand-alone entities[31], commenced on 1 July 2017. The second stage converted RailCorp to TAHE and allowed TAHE to be established as a statutory SOC from a date to be determined by the Government.

This legislation was not intended to result in immediate fundamental operating changes to RailCorp or to Sydney Trains and NSW Trains. A significant transitional period was envisaged, during which informed judgements could be made about the development of the final governance, management, operational, safety and contractual arrangements necessary to establish TAHE as a commercial entity. The legislation was designed to be flexible in accommodating TAHE's final business model (as a SOC).

Establishment

The second stage of the legislation's introduction was more than 3 years later, being proclaimed on 10 June 2020 with TAHE replacing RailCorp from 1 July 2020 (a year later than intended).

The SOC Act and the *Transport Administration Act* 1988, as amended, jointly govern TAHE's operations. These Acts detail TAHE's functions and provide its principal objectives, including to undertake its activities in a safe and reliable manner and to be a successful business maximising the net worth of the State's investment in rail assets. The Acts provide, as noted above: for TAHE's operations to be decided by the Board of Directors; its day-to-day management to be the responsibility of a chief executive officer; and for the Minister for Transport (as portfolio Minister[32]) to administer TAHE's Charter, to issue operating licence/s authorising TAHE to perform its functions (with the SOC Act providing potential terms and conditions including pricing regimes and safety integrity) and to give directions necessary (including in respect of the public interest). The legislation identifies the voting shareholders (the Treasurer and a Minister nominated by the Premier); provide for shares to be issued to them and for a share dividend scheme to be established in a form approved by the Treasurer; and require the Board to provide shareholders with a SCI for their comment and consultation.

On 4 June 2020, the voting shareholders (the Treasurer and the Minister for Finance and Small Business) appointed TAHE's Chair and the initial (independent) directors. An acting CEO commenced around this time, a month prior to TAHE being set up in July 2020, with the permanent CEO not commencing until 1 September 2021.

Key corporate and commercial policy arrangements were agreed by the voting shareholders on 30 June 2020. The Constitution was signed (a requirement under the SOC Act); it was agreed how the

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[30] *Transport Administration Amendment (Transport Entities) Act* 2017, amending the *Transport Administration Act* 1988 (the *TA Act*).

[31] Constituted under the *TA Act* as NSW Government agencies and creating a *Residual Transport Company* (RTC) to manage assets not suitable for TAHE ownership.

[32] Utilising the current portfolio title.

Commercial Policy Framework would transitionally apply[33]; and the Board Charter and the Directors Code of Conduct were put in place.

Existing governance components applying to RailCorp (such as risk management, compliance frameworks and other statutory requirements) continued, to be progressively confirmed or modified for the commercial TAHE, with other aspects to be developed by the Board during the 12 to 18 months after establishment.

The Minister for Transport issued an Operating Licence to TAHE on 1 July 2020, initially for 12 months. This provided for a phased implementation of functions, subject to review in January 2021. The Licence detailed the limits of TAHE's operations and functions and identified a significant focus on safety.

However, significant requirements for the establishment of TAHE and, relevantly for its financial accounts, remained to be settled. For example, TAHE still needed to finalise its commercial strategy and, in consultation with Treasury, its SCI. The SCI is the mechanism for detailing and agreeing funding mechanisms between the SOC and shareholder, concerns about which subsequently featured prominently in the discussions between the Audit Office and Treasury.

TfNSW continued to raise concerns about the risks attached to the establishment of TAHE. A basic SCI for 2020/21 was only tabled in Parliament (having been agreed to by TAHE and the voting shareholders) on 4 February 2021.[34] It noted that a commercial strategy would be developed over the next year, observing:

> *We know that our business will continue to change. We are confident in our ability to navigate this changing environment and will continue towards our objective of building a strong organisation.*

The simplified financial performance estimates in the SCI included EBITDA[35], core gross borrowings[36], capital equity injections, and capital expenditure. These were consistent with the Budget estimates, noting that there was still "further work to developing long term strategic business plan and commercial arrangements to be completed by mid-2021".[37]

Indeed, important positions were still to be finalised and approved by the TAHE board as at July 2021, including the 2022-24 SCI (which was endorsed on 20 September 2021), its business plan, and the approach to review the fair value of TAHE assets following the transition to a for profit entity, amongst others.

[33] *The Commercial Policy Framework* is a suite of policies aiming to replicate in commercially-focused government businesses the disciplines and incentives that lead private sector businesses toward efficient commercial practices. TAHE was exempt from full compliance for 12 to 18 months, as its operations were still being developed and anticipated to change as it transitioned fully, and the administrative burden on the new organisation would be counter to efficient commercial practices.
[34] Section 21 of *SOC Act* provides that the Board must prepare and submit a completed SCI to voting shareholders within 3 months after commencement of the financial year. TAHE was granted an extension by the voting shareholders.
[35] Earnings Before Interest, Tax, Depreciation and Amortisation.
[36] Includes both short-term and long-term borrowings, separate to cash held (at a bank or in deposits).
[37] *Transport Asset Holding Entity of NSW Statement of Corporate Intent,* Version 1 2020-21, p 5 and 6. The 2021 non-financial KPI targets relating to establishment of a safety assurance framework were also included.

Higher access and licence fees would be charged to Sydney Trains and NSW Trains from 1 July 2021. These were intended to be the subject of annual review.[38] As noted previously, access fees that applied from July 2021 remained low within the IPART approved range and it was expected that TAHE would transition over a couple of years to more commercial arrangements.

The delays in setting up TAHE and settling its longer-term business plan and operating model would impact the finalisation of TAHE's 2021 financial statements and the conduct of the 2021 TSSA audit. For example, establishing the fair value of TAHE's assets could not be finalised until the future access and licence fee arrangements had been agreed in mid-December 2021. Although other factors were at play, it is difficult to avoid the conclusion that these delays contributed significantly to the angst expressed by the Auditor-General about the delays in receiving important information relevant to the resolution of some issues that became controversial during the audit of the 2021 TSSA. Those processes are discussed in Section 4.

As such, this Assessment has found that the time taken to establish TAHE was excessive. It has not been possible to undertake a forensic analysis of how the processes unfolded to establish TAHE. It is later argued that Treasury should look more deeply into that.

> **A key finding is that, while considerable thought had been given, conceptually, to how TAHE might operate, which informed the ABS ruling in 2015, the precise details of the business model required to support that concept (and its accounting treatment) had neither been settled nor implemented before the 2015-16 budget – indeed before 2021. The gap between concept and execution dramatically raised the stakes when questions were posed subsequently of the commerciality of the proposed approach.**
>
> **Indeed, this Assessment believes that the transition to fully establish TAHE as an effective business took far too long.**

[38] These are dependent on appropriations from the Budget to TfNSW, which would have a direct impact on the GGS.

3 Key Accounting issues

TAHE treatment in government financial statistics

As noted previously, the ABS currently classifies TAHE in the PNFC sector, therefore outside the GGS and State budget. The interaction between the Australian Accounting Standards, which inform the judgements of the Auditor-General when auditing the TSSA, and the criteria that inform judgements made by the ABS in allocating entities to sectors for the reporting purposes of Government Finance Statistics (GFS) is complex. Guidance to inform the preparation of GFS is found in the Government Finance Statistics Manual 2015 (GFSM), and its predecessor.

The ABS independently determines in which sector a government entity belongs, for their classification in official statistics, utilising the GFSM and International System of National Accounts manual which provide the standards for measuring the financial activities of government. The key factors that the ABS considered in relation to TAHE were:

- its status as an institutional unit in its own right;
- whether it is a market or non-market producer (whether it is charging economically significant prices ie prices that have a significant effect on the amounts producers are willing to supply and amounts consumers choose to purchase); and
- whether it is controlled by government.[39]

ABS' judgement in 2015 was informed by information supplied by Treasury**.**[40] This included assurances regarding commercial TAHE's independence from government and a commitment to develop a policy for TAHE consistent with an expectation that the entity would provide a return to government in the form of dividends, comparable to an equivalent private sector business. Treasury specifically noted that the expected return in 2016-17 would be 7 percent on the investment.

It was also anticipated that TAHE would be fully functioning within 3 to 5 years.

The 2015-16 budget treatment reflected the agreement with the ABS. Although the Auditor-General's contemporary public statements signalled clear interest in the evolution of this entity, the Audit Office appears not to have challenged the classification of capital contributions as equity at that point.

Interaction between GFS & AASBs

The preparation and fair presentation of the State's financial statements in accordance with Australian Accounting Standards lies with the NSW Treasurer.[41] The TSSA are general purpose financial statements that are prepared in accordance with the applicable Australian Accounting Standards (AASB). AASB 1049, *Whole of Government and General Government Sector Financial Reporting*, requires that the TSSA is prepared in accordance with the GFSM provided it does not

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[39] ABS letter to Treasury dated 29 May 2015.

[40] ABS letter to Treasury dated 29 May 2015. As noted previously, prior to 1 July 2015 capital contributions were provided to RailCorp without an expectation that they would earn a return. As TAHE would replace RailCorp to become a for-profit entity it would be expected to earn a return on equity injections from that date.

[41] Section 7.17 of the *Government Sector Finance Act* 2018.

conflict with Generally Accepted Accounting Principles.[42] Where there are differences, professional judgement is applied to ensure the TSSA follows the AASB guidance that harmonise with the GFSM. The interaction between the GFSM and the AASB framework is a relatively specialised element of the public sector accounting environment. This is further explored below.

Changes in accounting standards

Adding to the complexity during the 2021 TSSA process was changes to certain accounting standards and the introduction of new standards.[43] Implementation of some, originally intended to take effect in 2019, was delayed to 2020 which meant their impact would be reflected for the first time in the 2021 public sector financial accounts. The details are not important for this Assessment. Their significance lies, particularly, in the increased workload they generated while Treasury assessed their implications for the preparation of public sector financial statements, including supporting agencies in their adoption of them, and assessing their implications on the 2021 TSSA. Treasury enlisted the expertise of external consultants in March 2019 to support the assessment of these changes.

TAHE classification

The complex technical accounting issues relevant to the classification of TAHE as a for profit PNFC were well known from at least 2017[44] when consultants were engaged by Treasury and TfNSW to provide advice in relation TAHE's establishment as a for profit entity.

These accounting questions were critical to the Auditor-General's assessment in 2021 of the reasonableness of Treasury and TAHE's view that cash contributions should be classified as equity injections rather than capital grants. There was much debate in relation to concepts like a "reasonable expectation" of a sufficient rate of return and the valuation of TAHE assets. Discussions between the Audit Office and Treasury primarily involved:

- The scale of the revaluation decrement (write-down) of the fair value of assets transferred from RailCorp to TAHE.
- Whether that write-down should be treated as a holding loss or a volume/quantity change.
- Whether TAHE had to earn sufficient revenue over time to recoup any such holding loss.
- Whether capital contributions from the government to TAHE (and to RailCorp from 2015-16) were equity injections or grants, including
    - The rate of return on contributed capital which would be sufficient for TAHE to justify their classification as equity under the accounting standards (and, for ABS, to support classification of TAHE as a PNFC under the GFSM criteria).
    - The time period over which TAHE would have to demonstrate that it satisfies the rate of return criterion.
- What payments by TAHE to the government would count as part of the return on the government's investment.

[42] A rules-based framework of accounting principles and procedures issued by the Financial Accounting Standards Board, often used in conjunction with the principles-based International Financial Reporting Standards.
[43] Notably AASB 1059 Service Concession Arrangements: Grantors and withdrawal of TPP 0608 Accounting for Privately Financed Projects, AASB 15 Revenue from Contracts with Customers, AASB 16 Leases and AASB 1058 Income of Not-for-Profit Entities.
[44] The related classification issues arose earlier with engagement with the ABS occurring in 2015.

Resolution of some, such as those related to the recalculation of the fair value of TAHE's assets, rested principally with TAHE (meaning TAHE and TfNSW engaged with the Audit Office about this aspect of TAHE's accounts). Resolution of most, however, were principally the responsibility of Treasury in the context of preparation of the state Budget and the 2021 TSSA audit (but would require engagement with the TAHE Board, rail operators, TfNSW and the government more generally before the audit was finalised).

Fair value of TAHE Assets

It had been expected from at least 2018[45] that, once TAHE was formally established, a new calculation of the fair value of TAHE's assets would be necessary under the AASBs. A shorthand explanation is that, in the transition from RailCorp to TAHE, the entity had changed from NFP to for profit status. RailCorp, as a NFP PNFC, had been required to value its assets under the cost approach or current replacement cost (CRC) methodology. TAHE, as a for profit PNFC, would need to value its assets under the income approach or discounted cash flow method (DCF).

Under the DCF method, TAHE measured the assets (received from RailCorp) by way of calculating the sum of its future cashflows, discounted to the present day. That future value is based on the revenue to be made from the rail operators, who would now be paying *commercial* access and licence fees for the use of these assets. The fair value measurement of TAHE's assets would therefore be based on the value indicated by current market expectations about TAHE's future revenues.

Assessment of these aspects is a complex exercise that is highly dependent on assumptions and professional judgement.

As at 30 June 2020, RailCorp held (restated) assets of $41.1bn, of which property, plant and equipment (PPE) were $40.6bn. TAHE and its new Board were formed on 1 July 2020 and the Board commissioned expert valuers to assess the fair value of TAHE's assets, under the DCF method.

TAHE's initial calculation of the revaluation resulted in a $24.8bn write-down of its assets. The outcomes of the revaluation exercise became a source of contention during the 2021 Audit processes, with two notable revisions:

- The Audit Office (who had engaged their own expert valuers) questioned the discount rate TAHE had applied in its initial calculations, arguing that TAHE's status as a natural monopoly justified a lower risk premium, meaning a lower discount rate. This reduced the original write-down by $1.2bn and was reflected in TAHE's annual report and, accordingly, in the TSSA 2021.
- The Audit Office also considered that the return that TAHE expected to earn from the revenue agreements in place with the operators was insufficient for it to be classified as a for profit SOC. Following discussions between the Audit Office, TAHE, and Treasury about the adequacy of the expected return to be earnt by TAHE over time, TAHE and the rail operators reached an in-principle agreement and signed Heads of Agreements on 18 December 2021 to increase the revenue from future access and licence fees, resulting in an additional $5.2bn reduction in the asset write-down (discussed in Section 4).

This change in methodology, using the DCF income approach, would ultimately result in a $20.3bn write-down in the value of TAHE's assets. Overall, the fair value for TAHE's assets, as at 30 June 2021, was $22.1bn, of which PPE was valued at $21.8bn. These assets were consolidated as part of

[45] It featured prominently in expert reports from this date (details of which are discussed later in this report).

the TSSA 2021 as well as the associated depreciation of $1.1bn for the year. Hence, the write-down or revaluation decrement in TAHE's assets would also decrease the state's net worth by the same amount.

The Audit Office argued that this write-down should be recouped from future revenue streams, which had major implications for its assessment of whether a reasonable expectation existed that TAHE would earn a sufficient return to enable capital contributions to be classified as equity increases rather than grants.

Holding Loss or Other Volume Change

Further debate between Treasury and the Audit Office involved whether the write-down in the value of TAHE's assets should be viewed under the GFSM as a holding loss/gain or an 'other volume change' (OVC). To understand this debate, it is necessary to understand the distinction drawn in the GFSM between types of 'other economic flows' (OEF).

For the purposes of this Assessment, a precise technical explanation of the debate is not required; and an assessment of the relative merits of the different positions taken by Treasury and the Audit Office is outside its scope**.** Moreover, the technical papers Treasury's experts developed to elucidate their position were substantial, nuanced documents, which cannot be reproduced here or summarised easily. The following is, therefore, a highly simplified explanation intended purely to assist the inexpert reader to acquire a 'lay' understanding of the nature of the debate.

OEFs are defined in the GFSM as changes in the volume or value of assets or liabilities that do not result from transactions.[46] These are classified as either OVC (where there is a change to the quantity or quality of the asset) or classified as revaluations[47] or as a holding gain/loss (if there is no change in quantity or quality of the asset).

Treasury experts took the view that the change in methodology from CRC to DCF and the subsequent decrement in TAHE's asset values could be classified as an OVC. In essence, they said that the purpose of the assets had changed from income producing to also meeting the more challenging objective of producing a surplus sufficient to support future dividends to the government and other distributions. They also said that the asset market price hadn't changed. The reasoning was that, as a product of the government's economic reform of transport service delivery arrangements that had played out over several years, productivity had risen, with TAHE's infrastructure assets already providing increased benefits to the state. As the adjustment in fair value had, arguably, occurred during these transition years, under the accounting standards they would not be revalued (classified as a holding loss), but treated as an OVC.

However, the Audit Office classified the $20.3bn write-down in the fair value of TAHE's assets as a holding loss. The Auditor-General's view was summarised in her *State Report 2021:*[48]

> *The write down in the value of TAHE's assets represents a holding loss because the fair (or market) value of TAHE's assets fell because of a change in the level and structure of prices. The access prices and licence fees TAHE negotiated with the operators were well below the ceiling price under the pricing principles set by Independent Pricing and Regulatory Authority (IPART) under the NSW Rail Access Undertaking, and recommendations external consultants made to Transport for NSW in 2020.*

[46] ABS GFSM 2015, para 3.34.
[47] ABS GFSM 2015, para 3.36.
[48] *State Finances 2021*, p 10.

These lower fees were used in TAHE's discounted cash flow calculation, driving the significant write down in its asset value.

Having determined that the revised asset valuation gave rise to a holding loss, the Auditor-General also took the view that, under the GFSM, the loss should be recouped before TAHE could make a claim to having a reasonable expectation of obtaining a sufficient return.

In December 2021, this position was ultimately adopted by Treasury and reflected in the TSSA 2021.

Equity or grant

As noted in Section 2, if TAHE had been reclassified from the PNFC to the GGS, any government contributions to support investments in increased rail infrastructure would be classified as grants (rather than equity). As such, the contribution would be expensed in the State's accounts and budget along with large non-cash expenses such as depreciation.[49] Partly in response[50], Treasury and TfNSW developed a reform agenda which included the creation of TAHE to replace RailCorp.

The GFSM is clear that capital contributions to TAHE by the government should be classified as equity unless it failed certain tests, notably related to earning a sufficient return on that investment. Treasury's proposal (as expressed to the ABS in 2015) included a 7 percent expected return on investment for TAHE in 2016-17. A return on the government's future investments was also expected in later years.

Sufficient return

The GFSM states that "a realistic rate of return on funds is indicated by the intention to earn a rate of return that is sufficient to generate dividends or holding gains at a later date and includes a claim on the residual value of the corporation".[51]

No NSW government policy existed at the time of the finalisation of the 2021 TSSA (or in the years that preceded it) to guide decisions on what a sufficient rate of return should be.[52] Treasury officers submitted to this Assessment, as they had to the Audit Office during the 2021 TSSA audit, that the GFS criteria only required an intention to earn a 'sufficient' return over time.

Indeed, Treasury officers submitted that the GFSM is principles based and, in the absence of formal guidance by the NSW government, in principle, a return to the government of $1 would suffice. Nonetheless, Treasury modelling provided to the Audit Office in the second half of 2021 was based on meeting a target over time of 1.5 percent, equivalent to the 10-year Commonwealth bond rate at the time.

Alternately, the Audit Office's preferred rate of return, expressed most formally to Treasury in early December 2021, was a dollar value equal to or exceeding the Reserve Bank's expected long term inflation rate of 2.5 percent. This was in line with Commonwealth Department of Finance guidance on the expected long-term return on government investments in other sectors.[53]

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[49] The fiscal impact would have been significant, noting that depreciation is not included in the GGS budget result for PNFCs, whether NFP or for profit.

[50] As noted in Section 2, Treasury also had certain micro-economic reform objectives linked to achieving better economic value from more commercial application of heavy rail assets such as property holdings.

[51] ABS GFSM 2015, para 13.63.

[52] Although the ABS, in its 2015 correspondence to Treasury confirming its favourable determination for RailCorp/TAHE, noted that a dividend policy would be developed.

[53] Resource Management Guide - Commonwealth Investments (RMG 308).

Section 4 includes how this (and other arguments) played out between the Audit Office and Treasury in 2021.

In mid-December 2021, TAHE shareholding Ministers provided revised Statements of Expectations to the Board of TAHE, aligning with the Audit Office's preferred 2.5 percent expectation for TAHE's target average long-term rate of return. This was enabled by TAHE signing new Heads of Agreement with rail operators to facilitate negotiation of sufficiently increased access fees and licence fees, in the expectation that the revised agreements would be in place by 1 July 2022.

Considering the substantial externalities associated with the operations of the public transport system, farebox revenues world-wide are typically supplemented by substantial budget support, whether the provider operates for profit or otherwise. The NSW government supported these adjustments to access fees and licence fees with commitments to increased budget support for rail operators, initially in respect of the budget and 'forward estimates' years.

Although the accounts that comprised the 2021 TSSA were unqualified, the Auditor-General included an 'Emphasis of Matter' in S*tate Finances 2021* [54] relating to the following risks to the continued commerciality of TAHE:

- TAHE not being able to re-contract with the rail operators for access and licence fees at a level that is consistent with current projections.
- Future government's funding to TAHE's key customers, the rail operators, may not be consistent with the current shareholding ministers' expectations.
- TAHE may be unable to grow its non-government revenues.

What counts as a return on equity?

It was agreed that assessments of the sufficiency of TAHE's expected rate of return should be calculated with reference to the shareholder's contributed equity as the denominator. It was common ground that this applied only to equity contributions since 2015-16 because earlier capital contributions from government had been regarded as 'gifts' to a NFP entity (the then RailCorp) that were not required to earn a return.

More contentious was the definition of returns to be included in the numerator. Returns unambiguously include dividends, holding gains, and payments in lieu of income tax. Treasury officers initially submitted that, in some circumstances, part of the owner's residual claim of the entity was part of the return on equity. However, the Audit Office strongly maintains that residual claims are more properly regarded as a withdrawal of equity, rather than a return on equity.

While both parties held firm in their respective positions, it was eventually agreed that the modelling done for the purposes of satisfying the reasonable expectation of a sufficient return on the government's investment in TAHE (agreed to be 2.5 percent) in the TSSA 2021 would not include the claim on residual value.

Another contentious point was whether it is reasonable to include government guarantee fees in the rate of return calculation. This is charged by the government to TAHE on competitive neutrality grounds to offset the advantage wholly government owned entities experience in credit markets because of the credit rating of their owners. The Audit Office argued against the inclusion of these fees as a return, which was ultimately adopted in the rate of return modelling.

[54] P 17.

4 Interactions with the Audit Office

The Auditor-General had been registering interest in the accounting treatment of TAHE/RailCorp in comments in the TfNSW audit reports since 2016. The nature of her commentary has intensified over time, with a clear indication in comments in her *State Report 2020* (on her audit of the 2020 TSSA) that she was looking for more substantive validation of the proposed treatment of TAHE, noting that TAHE had been formally established on 1 July 2020 and would feature in the 2021 TSSA. This reflected also in correspondence to Treasury in July 2020 requesting, amongst other things, information about the timeframe for TAHE's establishment and evidence of calculations that support the government's intent to generate commercial returns from TAHE. This Section describes the subsequent engagement between the Audit Office and Treasury in the process that led to the finalisation of the 2021 TSSA and the Auditor-General's *State Report 2021* to Parliament.

Philosophical Approaches

> **Treasury and the Audit Office took significantly different philosophical approaches to the 2021 TSSA Audit.**

This was a slightly surprising finding. Both Treasury and the Audit Office sought to deliver accounts that comply with the relevant accounting standards and satisfy best practice benchmarks for public sector reporting consistent with GFSM principles. However, they took slightly different views of their respective responsibilities during the audit. In the end, the Auditor-General expressed concern in her *State Report 2021*, provided to Parliament in February 2022, about the timeliness and comprehensiveness of the material Treasury had made available to her.

At the time of the audit of the 2021 TSSA, Treasury was firmly of the view that the task of an auditor in such circumstances is to provide an opinion about management's preferred accounting treatment. It believed its responsibility was to supply the Audit Office with documents and such other material as is 'relevant' and 'material' to forming a view about the adequacy of management's preferred accounting treatment.

The Auditor-General, in addition to the evidence of calculations of the expected returns to be earned by TAHE requested in July 2020, sought access to significant categories of other documents and reports relevant to her forming a view about the proposed accounting treatment, especially in respect of TAHE. The Annual Engagement Plan, issued in March 2021, was followed with a letter to Treasury on 15 June 2021 (and similar correspondence to TAHE and TfNSW on the same date), which specifically requested access to any document relevant to the TAHE operating model, and all TAHE related advice (draft or finalised) requested by Treasury, TfNSW or TAHE from accounting, legal or other professional service firms. This broad scope in respect of TAHE was also reflected in the terms the Audit Office sought to include in Treasury's Management Representation Letter in December 2021.[55]

[55] Auditing Standard ASA210 - Agreeing the Terms of Audit Engagements: the auditor needs to ensure that Management is aware of the requirement to provide the auditor with "Access to all information of which management is aware is relevant to the preparation of the financial report such as records, documentation and other matters" and **"**Additional information that the auditor may request from management for the purpose of the audit".

Both sides agree the 15 June letter was somewhat unusual. Both argue their approach is supported by the auditing standards.

Often, these central agencies are *comrades in arms* working together to achieve a common goal in support of transparency and adherence to best accounting and reporting practices of another party within the NSW public sector. Occasionally though, Treasury is the 'other party' responding to an independent statutory officer who has specific legislated responsibilities to discharge. Accounting for the creation of TAHE in the 2021 TSSA was such a case.

In many respects, the circumstances were unique – including the long lag between the decision to establish TAHE and its full execution, the complexity of the issues, the almost 'perfect storm' of other events that occupied senior Treasury officials at the key times, and the high stakes consequences of any departure from by then long-established budget practices.

In this instance the Treasury position was in defence of a long-standing government policy with substantial budget consequences that had become the subject of adverse public debate.

As the discussions progressed in relation to the Audit Office's consideration of the accounting treatment of TAHE, Treasury was concerned that, although the Audit Office gave indications of how its thinking was evolving, it did not explain the rationale for their emerging thinking. Those we interviewed who worked with or for Treasury at the time expressed the view that Audit Office 'held its cards close to the chest', which made it difficult to engage in professional dialogue. Both parties report frustrations with the process.

The Assessment understands the evident frustrations of both parties.

It also appreciates that auditors, public and private, traditionally avoid stating a firm position during a debate about accounting issues until they have considered all the available information and have reached a final position. This tendency also supports the Assessment's view that Treasury should have engaged the Audit Office, and secured a resolution of issues of principle, earlier (as discussed below).

The differences in philosophy significantly affected the approach Treasury took to the provision of information and the way debates were conducted in meetings between the two agencies. Although the evidence is clear that Treasury's internal discussions at times sought to understand and examine the Audit Office's emerging position, its many technical position papers and the conduct of Treasury representatives at meetings portray a consistent preoccupation with defending their own position (sometimes strongly) and delivering government policy, rather than engaging with possible arguments from the Audit Office or examining the pros and cons of the emerging perspective of the Audit Office.

Treasury's dominant culture was to 'get it done' with a strong focus on delivering government policy which in the case of establishing TAHE had been in place since 2015. This may have reduced Treasury's capacity to view the issues through the eyes of the Auditor-General during the audit, and apparently affected the approach taken in interactions with the Audit Office. It is doubtful that the Audit Office saw much evidence of dispassionate engagement in Treasury's arguments in the responses presented to it. This issue is further explored below in respect of specific matters.

By 2021, the matter was controversial and in the public domain, and substantial budgetary benefits (booked over many years) were at risk, which intensified the pressures faced by Treasury officers when they were implementing policy, or considering the application of the accounting treatment, of TAHE as a new for profit PNFC.

The Assessment has found that Treasury's culture at the time was so heavily focused on delivery of government policy that key officials did not sufficiently consider the benefits of making policy adjustments in order to more securely achieve the intended outcomes.

Recommendation 1: *to reduce the risk of similar events occurring, in future, Treasury culture should be infused more overtly with a professional curiosity and a willingness to both reassess the appropriateness of policy positions over time and to examine issues from the perspective of their counterparty in any dispute.*

In fairness it should be recorded that Treasury also perceived the Audit Office's attitude to harden as discussions continued and the mutual frustration increased in this period.
The evidence is clear that from 2020, Treasury devoted substantial staff time and consulting resources to preparing technical and other papers and, from mid-2021, having regular meetings (at the end almost daily) as well as email exchanges with the Audit Office to discuss the issues raised by the establishment of TAHE.

However, it is a finding that Treasury's interactions with the Audit Office were heavily conditioned by Treasury's philosophical approach to an audit and its commitment to implementing the decisions of the government and they took place under unnecessary time pressures.

Timeliness of the provision of information and documents to the Audit Office

Significantly, the Auditor-General expressed concern in *State Finances 2021* about delays in receiving documents and other material from Treasury necessary to enable her to progress the 2021 TSSA Audit in a timely manner. In the event, the 2021 TSSA was not signed off until virtually Christmas Eve 2021, rather than on 14 October 2021 as had been anticipated in the original Audit Engagement Plan.

Treasury officers reasonably note that there were several major, challenging, issues on foot during 2019 and 2020, including substantial challenges posed by natural disasters and the COVID-19 pandemic, which commanded substantial swathes of the time of senior policy makers and of the finance teams in Treasury and across agencies. Moreover, as discussed in Section 3, two significant accounting standards had been amended and had to be analysed, and their impact for the State's accounts determined during the early months of 2021 which, it is clear, stretched their capability at senior levels.

The Assessment also appreciates that other government agencies were involved, some of which faced their own pressures. For example, both TfNSW and TAHE needed to be engaged to provide information to the Audit Office for consideration in relation to TAHE's accounts and the impact on the TSSA, and to Treasury for input to the changing budget figures and to answer and address Audit Office questions and concerns. This involved the Board and Executive considering and agreeing changes which might substantially affect their operations and accounts.

However, Treasury and TfNSW had been aware of the TAHE-related accounting issues for some time – in a general way from 2015 and more specifically since 2017-18, after which time there were several debates between the agencies about these matters and the fiscal and other risks attached to them.

Whether TAHE met the criteria to be classified as a for profit PNFC was bound to be an issue that the Audit Office needed to be satisfied about (independently of the ABS), because of its focus on the Australian Accounting Standards and the need for the Auditor-

General to satisfy herself that the $2.4bn capital contributions to TAHE in 2020-21 were correctly classified as equity rather than a budget expense (amongst other matters). The Auditor-General had been signalling that she would be interested in the accounting treatment of TAHE since 2016.

This interest was more sharply expressed in the request for information in the correspondence to Treasury in July 2020; and in the Auditor-General's *State Finances 2020* report (provided in conjunction with the audit of the 2019-20 TSSA and contemporary TfNSW/RailCorp accounts).

Treasury provided some information in August 2020 in response to the Audit Office's request, including draft preliminary reports by KPMG regarding TAHE's proposed for profit status and some issues relevant to an assessment of whether any third parties exercised 'control' over TAHE. Modelling to demonstrate that TAHE could earn a reasonable return was not provided at this time.[56] The timeliness of the supply of some documents and financial modelling was also constrained by the fact that some that had been requested were marked Cabinet in Confidence, which necessitated the involvement of DPC to authorise their release.

Partly, Treasury's capacity to progress certain matters was also adversely affected by the late stand up of TAHE and gaps in the development of TAHE's longer-term business model and policies (as discussed in Section 2), since TAHE and its Board had only been established in July 2020 and transitional arrangements were in place until at least July 2021.[57] Indeed, it is arguable that a significant number of major operational issues remained unresolved when TAHE was established for which Treasury was significantly reliant on the work of others. For example, policy statements may have addressed critical issues at the level of principle – but the new TAHE Board still had to translate principle into practice.

Moreover, early in the first half of 2021, Treasury's accounting expertise, with consultancy support, seemed to be more devoted to assessing the implications of changes in the Accounting Standards that potentially could have significant implications for the public sector more generally than it was on responding to the Audit Office's interest in TAHE.

The most substantive engagements (including with respect to financial projections) did not commence until 2021. Earlier engagement and resolution of outstanding matters regarding TAHE's business model could have significantly reduced the time pressure all parties faced in late 2021.

Timeliness of engagement - why so late?

An issue that the Assessment has considered is why this substantive engagement was left so late, given the significance and complexity of the issues?

It is a major finding of this Assessment that Treasury's engagement with the Audit Office in respect of the classification issues associated with TAHE began too late, given their significance and complexity (and the responsibilities of both Treasury and the Auditor-General).

Arguably the issues of *principle* were well enough known that Treasury could have more substantively engaged the Audit Office any time after receiving the Audit Office's letter of July 2020

[56] As the relevant budget estimates were Cabinet in Confidence, in mid-2020 Treasury informed the Audit Office that and they needed to contact DPC to request access to the modelling.

[57] I comment elsewhere about whether it was best practice to establish TAHE with such significant gaps in its operating modus operandi.

seeking specific information (or, indeed, at any time after the relevant accounting issues had been substantively identified in 2018).

It is relevant, however, that Treasury believed that the 2015 agreement with the ABS regarding the classification of TAHE to the PNFC sector remained in place and that, while Treasury had not formally engaged the ABS on the issues as at mid-2021, the ABS had publicly confirmed this fact. [58]

In seeking specific information in July 2020, the Auditor-General had identified TAHE as a matter that could need more than the standard time to resolve.

The circumstances of TAHE are relatively uncommon. Issues that complex do not emerge every year. Nor do issues typically emerge with 6 years notice.

Early each year Treasury writes to each entity covered by the TSSA requiring the recipients to identify, by late February, issues that they believe will be of interest in the TSSA Audit. Treasury compiles a list of what it calls 'Emerging Issues', which is shared with the Audit Office (and may inform the Audit Engagement Plan, issued in March). The focus of this canvass is inherently short term – namely the issues likely to be of interest in the Audit to be concluded in a few months' time – and the implicit assumption is that the Emerging Issues identified by either the agency or the Auditor-General are capable of resolution within the standard timetable for the audit of the TSSA and associated entities. Importantly, this process does not rely on Treasury's understanding of such issues. The list is compiled drawing on the knowledge of all agencies that Treasury consults.

The scale of the work required to resolve the TAHE issues and the impact of this work in delaying the finalisation of the TSSA suggest that TAHE was not a 'standard' Emerging Issue.

A key lesson, perhaps for all parties, is to triage issues sufficiently well to understand when the 'standard' timetable (see Appendix 6.4) is unlikely to be sufficient for resolving complex or novel accounting issues.

> **The Assessment finds that there is an asymmetry of information available between Treasury and the Audit Office. Treasury (and TfNSW) were arguably initially better acquainted with the complexities of the TAHE model than the Audit Office, especially before TAHE was established. As a matter of practice, therefore, Treasury should accept the responsibility to initiate an engagement with the Audit Office early, when necessary.**
>
> ***Recommendation 2:*** *Accepting that some important details of the TAHE business model were only settled well after TAHE was established in July 2020, the Assessment recommends that, if similarly complex circumstances arise in future, Treasury (and agencies) should seek to engage the Audit Office earlier on the issues of principle than the standard processes would suggest.*

An option to facilitate such an approach would be for Treasury to expand the scope of its canvass of 'Emerging Issues' each year to include, on an exception basis, a forecast of *significant* issues that need to be progressed with the Audit Office before the conclusion of the *following* year's audit

[58] Following public commentary, the ABS issued a media statement on 2 June 21 that included: "Classifications may be reviewed if the ABS becomes aware of a change to structure, operating environment or other circumstances including legislative changes. The ABS is not aware of any changes that would require a review of TAHE. When new entities are being established, or changes made to them, the State Treasuries inform the ABS of the characteristics of the entities. The NSW Treasury has not advised the ABS of any changes to how TAHE operates as an entity of the NSW Government, nor have we identified any information."

cycle.[59] The Audit Office, Treasury and the relevant agency should then agree a cooperative work plan to begin immediately after the conclusion of the current year's audit cycle to get a 'head start' on more complex matters that need to be addressed for the following year's audit. For those very few issues, work would commence earlier than the traditional cycle, providing at least 6 months additional time for engagement with the Audit Office.

> ***Recommendation 3:*** *Treasury's engagement with the Audit Office should have a multi-year focus. Treasury's approach to the identification and dissemination to the Audit Office of "Emerging Issues" needs to include, on a selective basis, a longer-term focus than just the next TSSA.*

The external environment made sensitive matters worse

The evidence suggests that dialogue between the Audit Office and Treasury about some of the key issues began substantively in 2020, however these initial interactions were preliminary, on both sides.

> **By the time Treasury began to actively engage the Audit Office on the substance of the for profit PNFC and 'capital contributions as equity' issues, the matter was in the public domain – initially because of newspaper articles and subsequently through parliamentary proceedings - which raised the stakes for all involved.**

Earlier engagement could have avoided this additional stress on relationships.

Moreover, by 2020-21, considerable political capital had been invested in the TAHE approach to the management of rail assets and the substantially lower budget expenses that it had facilitated. Substantial Information Technology or capital projects are required to pass through multiple project gateways before a government becomes irrevocably committed. As Section 2 explains, TAHE was partly conceived in order to prevent a change in the accounting treatment of RailCorp that would have had significantly adverse consequences for the state budget. The government's (the Audit Office's and ABS') consideration at that point had been informed by statements of principles, the practical expression of which took years to resolve.

It had been known, since about 2015, that there would be risks to the accounting treatment when TAHE was initially approved, and the budget benefit included in the TSSAs. They had not been finally resolved when the enacting legislation was passed in 2017. The further passage of time had not resolved the difficulties and could be seen to have made it more difficult to consider any alternative to the, by then, 'status quo' by the time that TAHE was stood up in 2020. These issues would only be resolved in late 2021 as part of the TSSA audit.

The Assessment has not had the time to do a forensic examination of the governance of the TAHE transition to understand well enough why it took so long. It is acknowledged that the process involved several players, with a complex set of dependencies to work through, and that formal responsibility for the establishment of TAHE rested with TfNSW. However, the assessment suggests that an examination of the TAHE experience could identify useful lessons for future complex projects.

[59] The Assessment has been informed that Treasury already has arrangements in place whereby working groups are formed to work through significant issues. Adoption of this suggestion may lead to an earlier engagement with the Audit Office on some matters that Treasury would typically progress internally for longer.

The Assessment finds that Treasury made a large commitment to a particular treatment of TAHE in the State budget and, subsequently, TSSA accounting before a sufficiently detailed business model has been developed.

***Recommendation 4**: Treasury review the governance and the conduct of the TAHE transition arrangements to establish whether unnecessary time was taken to complete it and what lessons should be drawn to avoid a repetition.*

A more cautious approach to the budget in 2015-16 could have provided greater incentives to settle the outstanding policy and practical issues earlier and reduced the risk that Treasury and others could become 'locked in' to their positions because of the scale of the budget adjustment at risk if TAHE's classification reverted to the GGS.

My Assessment is that Treasury's engagement with the Audit Office about the accounting issues of principle raised by TAHE began far too late, given their significance and complexity and the responsibilities of both Treasury and the Auditor-General. The TSSA 2021 audit processes took place under unnecessary time pressures.

***Recommendation 5**: If similar circumstances arise in the future, Treasury should revisit the wisdom of making so large a commitment to a specific budget and TSSA accounting approach before a sufficiently detailed business model has been developed.*

Comprehensiveness of information and documents provided to the Audit Office

I have noted previously that the Audit Office and the relevant Treasury officers held different views about what documents should be provided and when. In addition, the Auditor-General expressed a view that Treasury only provided documents that supported its argument.

Previous sections have examined Treasury's philosophy and its culture, and their impacts on interactions with the Audit Office during the 2021 TSSA Audit. This section looks specifically at two matters raised by the Auditor-General in *State Finances 2021* concerning the comprehensiveness of the material provided by Treasury.

"Gold"

The Auditor-General has levelled specific criticism related to the provision of a copy of a 2018 report, which has been identified as the 'Gold Report'.[60] The Auditor-General firmly believes that this report should have been provided some years previous, and certainly in response to the Audit Office's request on 15 June 2021 for "all TAHE related advice (in draft or finalised) requested by Treasury, TfNSW, or TAHE from accounting, legal or other professional service firms".

A copy of the Gold Report was provided to the Audit Office by TfNSW on 25 August 2021. Treasury did not supply a copy to the Audit Office.

The Gold Report was prepared by the Funds Flow Working Group (FFWG), which had been established by TfNSW to support the TAHE Advisory Board. TfNSW led the FFWG, with KPMG member/s and a regular Treasury participant.[61]

[60] "Transport Asset Holding Entity ('TAHE') Accounting, Tax and Financial Gold Report, Version 1.1, 25 January 2018".

[61] This participant left Treasury in mid-2020.

The Assessment has sighted email exchanges involving Treasury members of the FFWG in 2017 relating to the work embodied in the Gold Report and its two predecessors (the "Silver Report" and "Bronze Report"[62]). The final version of the Gold Report was dated 25 January 2018.

The Assessment understands that the Gold Report was provided to TAHE Advisory Board members by email with the papers for a Board meeting on 6 February 2018.

The records accessed by the Assessment confirm that the Treasury member of the Advisory Board (from the Policy & Budget team) attended the meeting where the Gold Report was tabled, together with Treasury's FFWG member. However, extensive searches of Treasury's electronic records, conducted by Treasury's Information Management experts, for this Assessment, were unable to locate a copy of the report on Treasury's systems.

Treasury's Advisory Board member does not recall seeing the Gold Report or sharing it within anyone in Treasury.

Treasury's IT capability does not allow for recovery of deleted items prior to April 2018, when they changed systems. The Treasury Information Management team has searched the records to establish whether any copy of the Gold Report was deleted from the Treasury system after that date. No evidence has been found that such deletion(s) occurred.

The primary Treasury participant in the FFWG no longer worked in Treasury from mid-2020 and has not been interviewed as part of the Assessment in the time available. It is rather confounding that IT searches have not identified or recovered a copy of the Gold Report on Treasury's system. However, Treasury IT are also unable to search inactive email accounts. For completeness, the digital records of this staff member were searched by Treasury's shared services IT provider and that search confirmed that the FFWG member had received a copy of the final version of the Gold Report. The records indicate that they provided it to one other person, who was a short term contractor working on the project for 3 months from November 2017.

In August 2021, TfNSW shared with Treasury a list of documents that had been requested by the Audit Office during 2021 and a zip file that contained the documents to be provided in response. This included the Gold Report. When interviewed, the Treasury officer who was given access to the zip file (who left for other employment in early December 2021) recalls that they were asked by TfNSW to confirm that Treasury was happy for them to provide the documents to the Audit Office. This former employee said their concern was with documents that might have been Treasury documents and the check performed was cursory. It did not involve reading any documents not identified as a Treasury document.[63] Nor, it was said, was the file shared with anyone else.[64]

No Treasury officer in place in 2020 and 2021 that was interviewed for this Assessment recalls having been provided with or read the Gold Report. On the evidence available to the Assessment, relevant Treasury staff did not have access to a copy of the Gold Report in 2021. The copy provided

[62] "Transport Asset Holding Entity ('TAHE') Accounting, Tax and Financial Silver Report, Version 1.0, 24 November 2017"; "Transport Asset Holding Entity ('TAHE') Accounting, Tax and Financial Draft Bronze Report, October 2017".

[63] The Gold Report was a TfNSW document.

[64] For completeness, the Assessment asked Treasury Information Management to examine this individual's digital records also. The zip file was password protected and Treasury Information Management has indicated that the contents do not appear to have been downloaded to Treasury's system.

by TfNSW in a zip file in August 2021 does not seem to have been read or saved to the Treasury system.

However, the Gold Report was the culmination of a substantial body of work. Without having detailed knowledge of the FFWG project, it is known that their work began in August 2017. The Bronze Report was prepared in October 2017 which considered five potential funds flows scenarios. The Silver Report was prepared in November 2017, which described further analysis of two scenarios from the original five identified in 'Bronze', including potential accounting treatments within the TAHE financial model. The work undertaken in those reports (along with consideration of other workstreams occurring within the TAHE project) culminated in the Gold Report, the working group's final output on 25 January 2018. 'Gold' explored the projected financial impacts of the two scenarios expounded upon in 'Silver', including issues and risks relevant to the financial impact of the establishment of TAHE.

The Assessment has identified that a copy of the earlier working paper – the Silver Report – was provided to Treasury officers for consideration and input in November 2017. Most importantly for the purposes of this Assessment, the Gold and Silver reports canvassed both a range of issues that needed to be addressed if TAHE was to be established with minimum fiscal risks, and a possible business model intended to address them.

A KPMG representative familiar with the report gave evidence to the Legislative Council's Public Accountability Committee (PAC) that the Gold Report was irrelevant to any subsequent consideration of the Advisory Board or Treasury because the solution it had proposed was not adopted.[65] The representative expressed that view when Treasury officers asked about 'Gold' after its existence became public knowledge in November 2021.

Treasury accounting team's understanding of the detail in the Gold Report in 2021 appears to have been limited to the briefing provided by KPMG to the effect that it was not relevant to the (then) current TAHE model and assumptions.[66] The same irrelevance could have been thought to have applied to 'Silver'.

The Assessment's consideration of the issues raised by the Auditor-General in respect of the Gold Report is not, however, straightforward. Clearly, Treasury did not provide a copy of 'Gold', 'Silver' or 'Bronze' to the Audit Office. Yet, the evidence is also that the substantive issues raised by 'Gold' were covered in the discourse between Treasury and the Audit Office in 2021 (as discussed in Section 3). Notwithstanding concerns about timeliness, this suggests that Treasury did not attempt to withhold information from the Auditor. Moreover, the issues raised in 'Gold', and in 'Silver', in 2017-18 were substantively the same as those raised by other reports and documents subsequently prepared that considered the 'fiscal risks' posed by the proposed establishment of TAHE or the risks to the viability of TAHE.

This was substantially true whether the work was commissioned by TfNSW or Treasury. Whether 'Gold' was formally in the possession of Treasury, or not, the issues raised by it, by 'Silver' and by these other reports were both substantial and impactful. As a broad generalisation, whether TAHE was structured to be sufficiently 'commercial' was at the heart of most of these debates, which prompts the question: why wait until 2021 to substantively engage the Auditor-General on an

[65] Including a valuation specific paper from 2018 that was known as 'Mini Gold' - "Transport Asset Holding Entity ('TAHE') Extracts from Accounting, Tax and Financial Gold Report, Version 1.0, Xx xx 2018", which had a focus on the valuation of TAHE assets after transition from RailCorp.
[66] Including as part of a briefing provided on 'Mini Gold' in March 2021.

accounting issue that was so pivotal to the delivery of the government's policy agenda and the management of what became known as 'fiscal risks'?

The Auditor-General's concern about her access to 'Gold' in 2021 stems from her belief that, in principle, she should have been alerted to the issues it raised at least two years earlier, which would have saved her Office substantial time and resources. At that stage her engagement regarding RailCorp/TAHE was principally with TfNSW, which 'owned' the Gold Report. As noted above, Treasury had not provided a copy of the Gold Report to the Audit Office and seems not to have had effective access to it in 2021.

> **My instinct is that the Auditor-General's focus on the Gold Report may have been based on incomplete information regarding Treasury's possession of it. But the principle that animates her concern should not be dismissed**.

Most of the issues of principle considered by 'Gold' were raised consistently by TfNSW from 2018. Treasury was focused on delivering a government policy that had been confirmed several times. However, in my opinion, a curious Treasury officer should have paused for thought and looked for another opinion from another key player, the Auditor-General, well before 2021. This reinforces the case made earlier in support of earlier engagement with the Audit Office in complex or novel cases like TAHE.

The Representation Letter 'document dump'- lessons learnt

The Auditor-General has been very critical of the timeliness and the comprehensiveness of the provision of documents to her Office by Treasury and others. The Auditor-General instanced her lack of access to (what is understood to be) the Gold Report as a specific example of poor practice in this regard. Possession of the Gold Report is addressed in the previous sub-section.

TfNSW provided a copy of the Gold Report to the Audit Office in August 2021, the significance of which did not become apparent to the Auditor-General until the report became the subject of testimony before the PAC in November 2021.

> **The Assessment found no evidence that documents had been deliberately withheld by Treasury. The Auditor-General, however, raises a legitimate concern: how can she be satisfied that Treasury's processes identify documents to which the Audit Office should have access?**

As outlined above, Treasury had proceeded on the basis that it was required to provide documents to the Audit Office that it judged to be 'relevant' and 'material' for the Auditor-General to assess management's proposed accounting treatment; and the Audit Office had specifically requested access to any document relevant to the TAHE operating model, and all TAHE related advice (draft or finalised) requested by Treasury, TfNSW or TAHE from accounting, legal or other professional service firms.

The Audit Office legitimately wants access to all significant reports or advice that can inform its consideration of an issue. It is less likely that it wishes to be inundated with inconsequential email traffic. Operationalising this concept is difficult without a high level of trust between the agencies.

> ***Recommendation 6:*** *Treasury, like all other NSW government entities, should operate on the basis that the Audit Office is entitled to access the full range of documents necessary to undertake the audit, to enable the Auditor-General to form a view about the matters before her.*

This broad scope was also reflected in the terms the Audit Office sought to include in Treasury's Management Representation letter, in respect of TAHE, in late December 2021.

Treasury negotiated revised wording for the Audit Office's draft Representation Letter. Legal advice was that this would limit a perceived risk of inadvertent misrepresentation. Thereafter Treasury conducted a final review of its records. This search identified 1023 pages of documents, some of which had not been provided to the Audit Office previously. They were given to the Audit Office very late on the evening of 23 December 2021.

Treasury argues that a significant amount of this information had previously been provided to the Audit Office in relation to TAHE's impact on the TSSA (briefing papers, reports, modelling, and regular meetings). Treasury officers have advised that this final tranche of documents included final versions of reports, where drafts had been previously provided to the Audit Office, which were not substantively different. The Assessment was informed that such drafts are typically not finalised until after the Audit Office has had the opportunity to comment on them.

It is acknowledged by the Audit Office that none of this last tranche of documents substantively changed their view of the arrangements that had by then been agreed and which, if fully implemented, would meet the Auditor-General's concerns about the TSSA. However, that may well have been because, by that time, the issues had been identified and settled, in which case this is serendipitous rather than the result of a deliberate decision to share documents.

Arguably, processes that would have ensured timelier finalisation and provision of the accounting advice and which had identified 'all documents' provided in Treasury's final tranche would have increased the Audit Office's comfort level and its trust in Treasury's processes.

Treasury is a substantial central agency that receives very many documents incidentally to the performance of its principal functions. Some of the key historical documents the Audit Office ultimately wanted access to had not been commissioned by Treasury. Email traffic can involve a substantial number of repetitive and often inconsequential documents. However, the 'Gold' story is instructive. It was a significant report that raised major issues of principle (as did 'Bronze' and 'Silver'). Similar issues were raised in subsequent reports, which were not supported by the relevant Treasury officers, including because the level of fiscal support proposed was inconsistent with government policy. There was a real risk that the lessons learned in 2017 and 2018 would be lost to the organisation with staff or consultant turnover.

> ***Recommendation 7:*** *Treasury should assure itself that it has in place an organisational culture and knowledge transfer protocols, practices and systems that maximise the likelihood that important insights can be captured, retained, and shared.*

'Errors' or 'professional disagreements?

The Auditor-General's *State Report 2021* stated that the Audit Office's assessments "were hindered by errors and omissions in information and models provided by NSW Treasury to demonstrate expected returns from TAHE", that "NSW Treasury presented late, unsophisticated, and inaccurate forecasts to the Audit Office, all of which sought to support the desired outcome of higher projected returns" and that "(t)here were significant adjustments to TAHE's valuation between the financial statements originally submitted for the audit and the final, signed financial statements"**.**

The Audit process identified several areas of significantly different interpretation of the Accounting Standards between the Audit Office and Treasury experts.

While accepting the prerogative of the Auditor-General to decide otherwise, Treasury accounting experts still consider that their positions regarding interpretation of the GFS, the TAHE asset revaluation decrement/holding loss, and their position in regard to the rate of return/target rate of return were at least arguable – in other words these were professional disagreements and not 'errors'.

Although initially formally requested by the Audit Office in mid-2020,[67] financial modelling was provided to the Audit Office in 2021. Treasury initially provided budget data, described as a draft for consideration, in June 2021. Treasury later utilised funds flow data (modelled over 10 years) generated by TAHE to develop their own 10-year model to engage the Audit Office on the question of what would constitute a sufficient rate of return.

Ultimately this model was extended to beyond 30 years to respond to the Audit Office's requirement to have evidence that TAHE could recover its holding loss and achieve a return that at least preserved the real value of its assets within the average useful life of TAHE's assets (see Section 3).

The Auditor-General, in *State Finances 2021*, includes:[68]

> *Between 9 July and 1 December 2021, NSW Treasury submitted three versions of estimated returns with respect to the GGS's investment in TAHE. All of these models were unsophisticated, containing errors, omissions, and/or poor logic. Most importantly, none were able to demonstrate that a realistic rate of return would be derived from the GGS's investment in TAHE*.

Relevant Treasury experts argue that the modelling progressed through several iterations, which evolved to respond to specific requests from the Audit Office. This included:

- Adjustments to accommodate the Audit Office's view that a holding loss had arisen after the revaluation of TAHE's assets.
- Adjustments to the assessed loss in response to the Audit Office interactions with TAHE (which led to a billion-dollar upwards revision to the assessed value of the assets initially determined by the TAHE Board, which had previously been written down substantially).
- Larger adjustments after the government had agreed to provide additional funds to rail operators (through TfNSW) to support TAHE's higher target rate of return (eventually set at an average 2.5 percent pa after discussions with the Audit Office, as discussed above).

Given that the scale of the budget support required to satisfy the commerciality criteria of the GFS had been debated several times between 2018 and 2020, it was surprising that Treasury's modelling evolved as much as it did once formal engagement with the Audit Office began in 2020 and 2021. The nature of the quality assurance processes applied while responding quickly to enquiries from the Audit Office is unclear.

The Auditor-General has recommended that Treasury develop a clear policy in respect of the target rate of return that commercial SOCs should earn. In the absence of such a policy the Auditor-General adopted the approach of the Commonwealth Department of Finance, which argues that for commercial publicly owned entities the "expected return on capital must be at least equal to the long-term inflation rate and there should be a reasonable expectation that the investment will be recovered."[69]

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[67] As noted above, Treasury informed the Audit Office that relevant budget estimates were Cabinet in Confidence in mid-2020 and they needed to contact DPC to request access to the modelling.
[68] p 11.
[69] p 16.

I am aware that Treasury is engaging with the Auditor-General's recommendation to develop a policy in respect of the target rate of return that commercial SOCs should earn (and with her other recommendations). Indeed, it appears that Treasury informed the ABS, in 2015, that a dividend policy would be developed for TAHE.

It is a finding that there would certainly have been less room for contention if such a policy had been in place either when the policy decision was taken in 2015-16 to establish TAHE or when the debate began in earnest with the Audit Office in 2020-21.

The Audit Office was also critical of the assumptions made to model the potential returns to the government in the later years of the projections. Relevant Treasury experts are of the view that numbers so far into the future are speculative, but defend the modelling on the basis that it had assumed, for this extended future period, that the government would seek to maintain TAHE's asset base over time. This assumption informed their estimates of future capital injections or of changes to the asset revaluation reserve etc (which was referred to colloquially in a meeting with the Audit Office as 'the plug').

The Audit Office was sceptical of what it perceived to be revisions to the projections that conveniently supported achievement of the then target rate of return.

It is understood that debate continues between the parties about which of their differences of position reflect reasonably held differences of interpretation of complex accounting principles by well qualified professionals, and what changes to the modelling were a consequence of Treasury adopting the Audit Office's position rather than their alternative, but arguable, view.

Accepting that there was considerable scope for professional disagreement, it is a finding that some errors had been made.

It is acknowledged, however, that the material provided by Treasury was not totally 'error-free' in lay terms. For example, it is not legitimate to include guarantee fees as part of the return to government, which Treasury initially attempted to do (a clear error).[70]

Challenge or group think?

NSW Treasury is not a monolith. It comprises several groups of specialists that seek to work together to produce an outcome that is 'greater than the sum of its parts'. Importantly for this Assessment two different teams had responsibility for elements of the TAHE matter. Principal carriage for the development and establishment of TAHE, from 2015, had been assigned to the Policy & Budget Team. Their remit was economic policy and the management of the State budget. This team appears to have had principal responsibility for the development and, subject to the formal leadership of TfNSW and the TAHE Advisory Board, the establishment of TAHE. Treasury staff were supported by consultants, principally drawn from KPMG. Responsibility for accounting questions, on the other hand, both generally across public sector entities and specifically in respect of the TSSA and the application of the GFS (at the time of the 2021 TSSA), is vested in the Accounting Policy team. It is unclear from the material available to the Assessment at what point in the evolution of TAHE, the Accounting Policy team became substantively engaged (discussed below).

The government's policy having been settled in 2015, there was little questioning in 2020-21 of the appropriateness of the fiscal objectives that had become uppermost in policy makers' minds since 2015. Senior officials were reportedly instructing those involved in standing up and accounting for

[70] This was accepted in the Gold Report which, as I have noted, had not been seen by the Accounting Policy team who were providing this data.

TAHE to 'get it done' and to 'defend vigorously' the accounting treatment if they believed it to be correct.

Treasury's Accounting Policy team, having discussed the issues, believed that their proposed accounting treatment was correct, which validated the government's policy position. It is doubtful that the Audit Office would have had a sense of how the internal challenge function operated within Treasury in respect of the accounting principles.

There was no serious examination in 2020-21[71] of the possibility of TAHE moving to the GGS, with a grant basis for capital contributions, as the Audit Office's concerns became clear. This was especially the case amongst Treasury's policy officers, who told the Assessment that they operated in 2020-21 on the basis that, as public servants, they do what Cabinet directs them to do. In this case, there were multiple Cabinet decisions, most of long standing, and legislation to be implemented that created TAHE as a commercial SOC requiring it to achieve better value for NSW from the management of the State's rail assets without compromising safety.

In recent years, a focus of internal Treasury culture has been on reaching out to assist agencies to respond to the government's priorities, accepting that sometimes they have a professional responsibility to say 'no' and explain why.

Accounting team involvement

The Accounting Policy Team seeks to discharge their obligation as public servants to respond effectively to the decisions of the government of the day while satisfying their professional obligations as accountants to respect and implement the Australian Accounting Standards. The Accounting Policy team are technical experts and their specific role is to consider and apply the accounting standards and communicate across the sector any changes to the regulatory and accounting framework as they apply to the government sector.

Many organisations struggle to get right the balance between assigning responsibility and authority to individuals on the one hand and ensuring effective cross-team (silo) collaboration on the other.

> **This Assessment cannot be definitive but there is evidence to tentatively suggest that senior management could profitably investigate the effectiveness of cross team collaboration throughout the TAHE transition period. For example, the Treasury Accounting Policy team do not appear to have been majorly engaged in initial decisions regarding the accounting treatment of TAHE (in 2015 to 2019).**

The risks to the accounting treatment were known from 2015 and the Accounting Policy Team's involvement from inception to resolve these would have been of benefit. Clearly, the Accounting Policy team was heavily involved in both internal discussions and the interactions with the Audit Office, which it leads for all TSSA audits, in 2020 and 2021.

> ***Recommendation 8****: Treasury policy areas should consult Treasury Accounting Policy experts early in the development of major proposals, especially those likely to lead to significant changes in accounting treatment.*

Consultants

The Auditor-General has raised significant concerns about the use made of consultants by Treasury and, indirectly, the adequacy of Treasury's staffing.

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[71] The threat that the ABS would reclassify RailCorp to the GGS was a major (not only) consideration that led Treasury and TfNSW to argue for the establishment of TAHE in 2015.

Assembling and accessing sufficient technical capability can be challenging. Consultants have been substantially involved with the policy development and implementation of TAHE from the beginning. Conceptually, consultants can provide external challenge to in-house expertise; they can supplement in-house expertise to address specific gaps; and/or they can provide 'surge capacity' to assist the in-house staff to meet variable workflows and peaks. In each case, management is accountable for demonstrating that recourse to consultants is more cost effective than alternative options such as hiring full time, part time or casual employees.

Treasury took advantage of a long-term relationship with KPMG to assist it in the examination of the accounting and fiscal issues associated with the establishment of TAHE. The lead partner for several Treasury engagements from 2019 to 2021 contributed unique expertise across both the GFS and the Accounting Standards and, as it turned out, was also involved in the preparation of the Gold Report for TfNSW in 2017-18.

> **There is no evidence available to the Assessment that Treasury engaged in 'forum shopping' in respect of the TAHE classification issue**.

However, KPMG seems to have played all three potential consultancy roles at different times in this instance, at least from 2017, notably from 'Gold' and its antecedents, onwards.[72] This blurring of roles may owe something to the tight timeframes within which the TAHE issues were resolved ultimately (though, as previously noted, the Assessment believes that Treasury had some responsibility and should have more effectively sought to accelerate this timeframe).

> **It is unclear whether all in Treasury were sufficiently aware of the associated risks or of how blurred the lines became at times between the roles played by their consultants of 'external advisor' and 'part of team Treasury with an outcome to achieve'.**

> ***Recommendation 9:*** *Treasury should clearly delineate the roles of consultants ie whether their services are to provide: (a) external challenge to an internal view, (b) external supplement to address internal (preferably occasional) capability gaps, and/or (c) surge capacity (to meet seasonal workloads against well-established financial reporting cycles).*

> ***Recommendation 10:*** *Treasury officials should be congenitally curious. Consultants may have restricted Terms of Reference, including because governments legitimately want to control consultancy costs. Nonetheless, it is the responsibility of Treasury policy analysts, accountants and others to look for insights that have application beyond the issue the consultant has been asked to address, including for issues of potential relevance to Audit Office enquiries.*

The Assessment has had neither the time nor the remit to examine the adequacy of the scale of Treasury's accounting policy resources. The scale of the consultancy support sourced over the years of the TAHE transition, however, gives us pause for thought. I have observed clear evidence, however, of the commitment and professionalism of the Accounting Policy team.

> **The Assessment finds that Treasury's accounting expertise is strong. However, it appears that Treasury has a relatively small team of dedicated professionals and a clear key person risk regarding highly specialist areas, for example about the criteria the ABS employs to determine whether an entity should be classified as a PNFC or a GGS entity. Moreover, government accounting is sufficiently specialised to warrant a 'grow your own' approach**

[72] *PAC*, Submission 8 – KPMG, 11 November 2021.

and Treasury is seeking to increase the number of its employees who have the requisite GFS knowledge.

Recommendation 11: *Treasury should actively monitor progress in addressing its key person risk in respect of GFS expertise and ensure that this risk is mitigated as soon as possible. However, it should also ensure that it has sufficient internal capability (and, when necessary, diverse externally sourced capability) to meet predictable but episodic needs.*

Trust has been damaged

The Auditor-General observed, in *State Finances 2021,* that "the challenges encountered in completing this year's audit were extraordinary and tested the constructive partnership between the Audit Office and NSW Treasury".[73] Both the Audit Office and Treasury officers acknowledge that trust has been dented because of the perceptions that each has formed of how the other engaged during their exchanges over TAHE, especially in 2020 and 2021. Moreover, Treasury officers did not expect the strength of the Auditor-General's comments in her report to Parliament once steps had been taken to avoid a qualification.

I am saddened that both parties agree trust has been dealt a blow. Individuals have expressed deep hurt about what happened, and (at times, long standing) personal relationships have been set back.

Both parties argue they are professionals, who share a common desire to achieve the best outcomes for the government and people of NSW. They remain committed to work together to discharge their responsibilities and 'just get on with it'. However, repair of these relationships will take some time. Early and more open engagement from all parties would assist in this endeavour. Both have also noted a more cautious approach in their interactions since February 2022, including more diligent note-taking etc to reduce the risk of miscommunication.

[73] *State Finances 2021*, p 1.

5 Findings and recommendations

Both the Audit Office and Treasury believe that something went wrong in 2020 and 2021. Neither wants a repeat.

Often, these central agencies are *comrades in arms* working together to achieve a common goal in support of transparency and adherence to best accounting and reporting practices of another party within the NSW public sector. Occasionally, though, Treasury is the 'other party' responding to an independent statutory officer who has specific legislated responsibilities to discharge**.** Accounting for the creation of TAHE in the 2021 TSSA was such a case.

In many respects, the circumstances were unique – including the long lag between the decision to establish TAHE and its full execution, the complexity of the issues, the almost 'perfect storm' of other events that occupied senior Treasury officials at the key times, and the high stakes consequences of any departure from by then long-established budget practices. However, this Assessment has also identified lessons that have broader application for Treasury's systems, processes and culture, which I commend for the consideration of Treasury and other NSW agencies.

I was somewhat saddened to learn that trust has been eroded between Treasury and the Audit Office, with key personnel reporting they have been deeply hurt in the process.

> **A finding is that all involved believed they were discharging their responsibilities professionally and acting in the best interests of NSW. Damaged relationships will take some time to repair. Both parties say they are professionals who are committed to working together to advance the interests of the people and government of NSW. I have no reason to doubt that commitment**. **However, adoption of my Assessment's recommendations could reduce the risk of a recurrence in future similarly complex environments.**

Arguably the transition to fully establish TAHE took too long

> **A key finding is that, while considerable thought had been given, conceptually, to how TAHE might operate, which informed the ABS ruling in 2015, the precise details of the business model required to support that concept (and its accounting treatment) had neither been settled nor implemented before the 2015-16 budget – indeed before 2021. The gap between concept and execution dramatically raised the stakes when questions were posed subsequently of the commerciality of the proposed approach.**
>
> **Indeed, the Assessment believes that the transition to fully establish TAHE as an effective business took far too long. The issues were complex, but they were well understood from a very early stage. What took time was resolving the issues**.

The Assessment has not had the time to do a forensic examination of the governance of the TAHE transition to understand well enough why it took so long. It is acknowledged that the process involved several players, with a complex set of dependencies to work through, and that formal responsibility for the establishment of TAHE rested with TfNSW. However, the assessment suggests that an examination of the TAHE experience could identify useful lessons for future complex projects.

> ***Recommendation****: Treasury review the governance and the conduct of the TAHE transition arrangements to establish whether unnecessary time was taken to complete it and what lessons should be drawn to avoid a repetition.*

The Assessment finds that Treasury made a large a commitment to a particular treatment of TAHE in the State budget, and subsequently TSSA accounting, before a sufficiently detailed business model has been developed.

A more cautious approach to the budget in 2015-16 could have provided greater incentives to settle the outstanding policy and practical issues earlier and reduced the risk that Treasury and others could become 'locked in' to their positions because of the scale of the budget adjustment at risk if TAHE's classification reverted to the GGS.

***Recommendation**: if similar circumstances arise in future, Treasury should revisit the wisdom of making so large a commitment to a specific budget and TSSA accounting approach before a sufficiently detailed business model has been developed.*

Treasury's substantive engagement with the Audit Office on the accounting issues came too late for so significant and so complex a case.

It is a major finding of this Assessment that Treasury's engagement with the Audit Office in respect of the issues associated with TAHE began too late, given their significance and complexity (and the responsibilities of both Treasury and the Auditor-General).

Arguably the issues of *principle* were well enough known that Treasury could have more substantively engaged the Audit Office any time after receiving the Audit Office's letter of July 2020 seeking specific information (or, indeed, at any time after the relevant accounting issues had been substantively identified in 2018).

The evidence is clear that from 2020, Treasury devoted substantial staff time and consulting resources to preparing technical and other papers, and from mid-2021 participating in, towards the end, almost daily meetings or email exchanges with the Audit Office to discuss the issues raised by the establishment of TAHE.

However, it is a finding that Treasury's interactions with the Audit Office were heavily conditioned by Treasury's philosophical approach to an audit and its commitment to implementing the decisions of the government and they took place under unnecessary time pressures.

A key lesson, perhaps for all parties, is to triage issues sufficiently well to understand when the 'standard' timetable is unlikely to be sufficient for resolving complex or novel accounting issues.

The Assessment finds that there is an asymmetry of information available between Treasury and the Audit Office. Treasury (and TfNSW) were arguably initially better acquainted with the complexities of the TAHE model than the Audit Office, especially before TAHE was established. As a matter of practice, therefore, Treasury should accept the responsibility to initiate an engagement with the Audit Office early, when necessary.

***Recommendation:** Treasury's engagement with the Audit Office should have a multi-year focus. Treasury's approach to the identification and dissemination to the Audit Office of "Emerging Issues" needs to include, on a selective basis, a longer-term focus than just the next TSSA.*

***Recommendation:** Accepting that some important details of the TAHE business model were only settled after TAHE was established in July 2020, the Assessment recommends that, if similarly complex circumstances arise in future, Treasury (and agencies) should seek to engage the Audit Office earlier on the issues of* principle *than the standard processes would suggest.*

The Auditor-General has been very critical of the timeliness and the comprehensiveness of the provision of documents to her Office by Treasury and others.

At the time, Treasury's philosophical position in respect of an audit of the 2021 TSSA was that they would provide documents to the Audit Office that it judged to be 'relevant' and 'material' for the Auditor-General to assess management's proposed accounting treatment.

> **The Assessment found no evidence that documents had been deliberately withheld by Treasury. The Auditor, however, raises a legitimate concern: how can she be satisfied that Treasury's processes identify documents to which the Audit Office should have access?**

The Audit Office legitimately wants access to all significant reports or advice that can inform its consideration of an issue. It is less likely that it wishes to be inundated with inconsequential email traffic. Operationalising this concept is difficult without a high level of trust between the agencies.

> ***Recommendation:*** *Treasury, like all other NSW government entities, should operate on the basis that the Audit Office is entitled to access the full range of documents necessary to undertake the audit, to enable the Auditor-General to form a view about the matters before her.*

The Auditor instanced her lack of access to a report prepared for TfNSW in 2018 known as the 'Gold' Report as a specific example of poor practice in this regard. TfNSW had provided a copy to the Audit Office in August 2021, the significance of which did not become apparent to the Auditor until the Report became the subject of testimony before the PAC in November. Treasury had not provided a copy of 'Gold' to the Audit Office. The Auditor argued that access to 'Gold' significantly earlier, potentially years earlier, would have saved her Office substantial time and resources. Searches of Treasury's IT records undertaken on behalf of the Assessment did not locate a copy of 'Gold'.

> **My instinct is that the Auditor-General's focus on the 'Gold Report' may have been based on incomplete information regarding Treasury's possession of it. But the principle that animates her concern should not be dismissed**.

Most of the issues of principle considered by 'Gold' were raised consistently by TfNSW from 2018. A curious Treasury should have paused for thought and looked for another opinion from another key player, the Auditor-General, well before 2021. This reinforces the case made earlier in support of earlier engagement with the Audit Office in complex or novel cases like TAHE.

Treasury could have been more open to alternative views

Treasury has a strong culture focused on delivering government policy, which in this case had been in place since 2015. This may have reduced Treasury's capacity to view the issues through the eyes of the Auditor-General during the Audit, and apparently affected the approach taken in their interactions with the Audit Office. By 2021, the matter was controversial and in the public domain, and substantial budgetary benefits were at risk, which intensified the pressures faced by key Treasury officers when they were implementing policy, or considering the application of the accounting treatment of TAHE as a new for profit PNFC.

> **The Assessment has found that Treasury's culture at the time was so heavily focused on delivery of government policy that key officials did not sufficiently consider the benefits of making policy adjustments in order to more securely achieve the intended outcomes.**

> ***Recommendation:*** *to reduce the risk of similar events occurring, in future, Treasury culture should be infused more overtly with a professional curiosity and a willingness to both*

reassess the appropriateness of policy positions over time and to examine issues from the perspective of their counterparty in any dispute.

Recommendation: *Treasury should assure itself that it has in place an organisational culture and knowledge transfer protocols, practices and systems that maximise the likelihood that important insights can be captured, retained, and shared.*

The Audit process identified several areas of significantly different interpretation of the Accounting Standards between the Audit Office and Treasury experts. The Auditor-General has reported to the Parliament that Treasury's work during the Audit included 'errors, misstatements and omissions'.

While accepting the prerogative of the Auditor-General to decide otherwise, Treasury accounting experts still consider that their positions regarding interpretation of the GFS, the TAHE asset revaluation decrement/holding loss, and their position in regard to the rate of return/target rate of return were at least arguable – in other words these were professional disagreements and not an 'error'. Accepting that there was considerable scope for professional disagreement, it is a finding that some errors had been made.

Treasury has accepted the Auditor General's recommendation to develop a policy in respect of the target rate of return that commercial SOCs should earn. I am aware that Treasury is engaging with the Auditor-General's recommendation to develop a policy in respect of the target rate of return that commercial SOCs should earn (and with her other recommendations).

It is a finding that there would certainly have been less room for contention if such a policy had been in place either when the policy decision was taken in 2015-16 to establish TAHE or when the debate began in earnest with the Audit Office in 2020-21.

Assembling and accessing sufficient technical capability can be challenging

Many organisations struggle to get right the balance between assigning responsibility and authority to individuals on the one hand and ensuring effective cross-team (silo) collaboration on the other.

This Assessment cannot be definitive but there is evidence to tentatively suggest that senior management could profitably investigate the effectiveness of cross team collaboration throughout the TAHE transition period. For example, the Treasury Accounting Policy team do not appear to have been majorly engaged in initial decisions regarding the accounting treatment of TAHE (in 2015 to 2019).

Consultants and the Policy and Budget team seem to have been principally involved initially. The risks to the accounting issues were known from 2015 and the Accounting Team's involvement from inception to resolve these would have been of benefit. It is clear that the Accounting Team was heavily involved in both internal discussions and the interactions with the Audit Office, which it led, in 2020 and 2021.

Recommendation*: Treasury policy areas should consult Treasury Accounting Policy experts early in the development of major proposals, especially those likely to lead to significant changes in accounting treatment.*

The Auditor General has raised significant concerns about the use made of consultants by Treasury and, indirectly, the adequacy of Treasury's staffing.

The Assessment finds that Treasury's Accounting Policy expertise is strong. However, it appears that Treasury has a relatively small team of dedicated professionals and a clear key person risk regarding highly specialist areas, for example about the criteria the ABS employs to determine whether an entity should be classified as a PNFC or a GGS

entity. Moreover, government accounting is sufficiently specialised to warrant a 'grow your own' approach and Treasury is seeking to increase the number of its employees who have the requisite GFS knowledge.

Recommendation: *Treasury should actively monitor progress in addressing its key person risk in respect of GFS expertise and ensure that this risk is mitigated as soon as possible. However, it should also ensure that it has sufficient internal capability (and, when necessary, diverse externally sourced capability) to meet predictable but episodic needs.*

Consultants have been substantially involved with the policy development and implementation of TAHE from the beginning. Conceptually, consultants can provide external challenge to in-house expertise; they can supplement in-house expertise to address specific gaps; and/or they can provide 'surge capacity' to assist the in-house staff to meet variable workflows and peaks.

There is no evidence available to the Assessment that Treasury engaged in 'forum shopping' in respect of the TAHE classification issue.

It is unclear whether all in Treasury were sufficiently aware of the risks or of how blurred the lines became at times between the roles played by their consultants of 'external advisor' and 'part of team Treasury with an outcome to achieve'.

Recommendation: *Treasury should clearly delineate the roles of consultants ie whether their services are to provide: (a) external challenge to an internal view, (b) external supplement to address internal (preferably occasional) capability gaps, and/or (c) surge capacity (to meet seasonal workloads against well-established financial reporting cycles).*

Recommendation: *Treasury officials should be congenitally curious. Consultants may have restricted Terms of Reference, including because governments legitimately want to control consultancy costs. Nonetheless, it is the responsibility of Treasury policy analysts, accountants and others to look for insights that have application beyond the issue the consultant has been asked to address, including for issues of potential relevance to Audit Office enquiries.*

The Terms of Reference specifically exclude the Assessment from undertaking an investigation in respect of potential breaches of the NSW Code of Conduct. They leave open the possibility that such an investigation(s) could be a recommendation. The Assessment has made no such recommendation. Indeed, I have been generally impressed by the high standards and commitment exhibited by those with whom we spoke.

Stephen Sedgwick AO
30 June 2022

6 Appendices

6.1 Abbreviations

Acronym	Title
AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
DCF	Discounted Cash Flow
DPC	Department of Premier and Cabinet
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
FFWG	Funds Flow Working Group
GAAP	Generally Accepted Accounting Principles
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual 2015
GGS	General Government Sector
GSF Act	*Government Sector Finance Act* 2018 No 55
IPART	Independent Pricing and Regulatory Tribunal
KPI	Key Performance Indicator
NFP	Not-For-Profit
NTER	National Tax Equivalent Regime
PAFA Act	*Public Authorities (Financial Arrangements) Act* 1987
PF&A Act	*Public Finance& Audit Act* 1983
PRC	Public Financial Corporation
PNFC	Public Non-Financial Corporation
NPAT	Net Profit After Tax
OEF	Other Economic Flows
OVC	Other Volume Change
SCI	Statement of Corporate Intent
SOC	State Owned Corporation
SOC Act	*State Owned Corporations Act* 1983
TA Act	*Transport Administration Act* 1988
TAA Act	*Transport Administration Amendment (Transport Entities) Act* 2017
TAHE	Transport Asset Holding Entity
TER	Tax Equivalent Regime
TfNSW	Transport for NSW
TSS	Total State Sector
TSSA	Total State Sector Accounts

6.2 Terms of Reference

Terms of Reference

This document sets out the Terms of Reference for the Independent Assessment of Treasury's processes in relation to the preparation of the 2021 State Financial Statements ('**Assessment**'). The Assessment was announced by the Secretary of Treasury on 10 February 2022. The Assessment will be undertaken by Stephen Sedgwick AO ('**Independent Assessor**').

Scope of Review

The Assessment will review Treasury's processes for the preparation of the 2021 State Financial Statements as they relate to the specific matters raised by the Auditor General in Chapter 3 of her *Report on State Finances 2021* ("**Report**").

In light of the Auditor General's findings and recommendations, the Independent Assessor will:

a. consider Treasury's processes to support the interaction between Treasury and the Auditor General's Office during the preparation of the 2021 State Financial Statements; identify key lessons learnt; and make recommendations for any improvements required to Treasury's systems, processes or approaches.

b. consider whether there are any matters that require further review.

The Assessment is not to be a formal code of conduct review. However, if considered necessary, the Assessor may make recommendations for such review (or reviews) to be conducted consistent with the provisions of the *Government Sector Employment Act*.

Accounting and Auditing judgements determined by the Auditor General are not in scope of the Assessment.

Process

The Assessment will commence as soon as reasonably practicable. A Review Team in the Office of the Secretary will assist the Independent Assessor along with any other additional support and resources required by the Independent Assessor.

The Assessment will include interviews with relevant staff from Treasury and the Auditor General's Office. The Assessment would consider, and where appropriate, make findings relevant to, the way in which Treasury officers interacted with the Auditor General's Office during the 2021 financial audit process. The Assessment will be undertaken in a manner consistent with principles of procedural fairness and natural justice.

The Assessment will produce a report to the Treasury Secretary summarising the Assessment's findings and setting out recommendations.

The Assessment will report by the 6 May 2022, although the Independent Assessor may request an extension if required.

8 March 2022

6.3 Auditor-General's recommendations from Chapter 3 of *State Finances 2021*

1. NSW Treasury needs to implement effective quality review processes over key accounting information before submitting that information to the Audit Office.
2. NSW Treasury should establish a policy to determine the minimum expected rate of return on its equity injections in other public sector entities; and report on the performance of investments in other public sector entities by presenting information on how much and what type of returns the GGS is obtaining from its investments compared to its targeted return.
3. NSW Treasury should facilitate revised commercial agreements [between TAHE and rail operators] to reflect access and licence fees detailed in the 18 December 2021 Heads of Agreement; and, with TAHE, prepare robust projections and business plans to support returns beyond FY2031.
4. Given the 18 December 2021 [Heads of Agreement], reliance on government funding by the NSW rail operators is most likely. It is therefore recommended that NSW Treasury liaise with the ABS to re-confirm the classification of NSW Trains and Sydney Trains as entities within the PNFC sector
5. Now that TAHE is operating, it is recommended that NSW Treasury liaise with the Australian Bureau of Statistics (ABS) to reconfirm the sector classifications of TAHE.
6. NSW Treasury and TAHE should monitor the risk that control of TAHE assets could change in future reporting periods. TAHE must continue to demonstrate control of its assets or the current accounting presentation would need to be reconsidered.
7. NSW Treasury needs to significantly improve its processes to ensure all key information is identified and shared with the Audit Office on a timely basis. This will ensure the audit has access to complete and accurate information when considering material transactions and balances of the State.
8. NSW Treasury should consider whether there is sufficient competent oversight of its use of consultants and assess the risk of an overdependence on consultants at the cost of internal capability.

The Independent Auditor's Report includes an emphasis of matter drawing attention to uncertainty relating to the General Government Sector's investment in the Transport Asset Holding Entity (TAHE).

6.4 Treasury Early Close and Audit Office 2021 TSSA Engagement Plan timeline

Blue – Treasury Early Close, from TPP21-01 Policy and Guidelines Paper Agency Direction for the 2020-21 Mandatory Early Close, February 2021 (audit engagement highlighted in table)

Yellow - Audit Office Engagement Plan Timeline dated 16 March 2021

Information to Treasury (for Early Close) and the Audit Office (for Audit Engagement Plan)	Date
Audit Office TSSA team planning meeting with NSW Treasury (with the Engagement Plan noting that audit planning had already commenced)	25 February 2021
Agencies to provide Treasury with Emerging Accounting Issues preliminary submission – for early insight and potential impact on year-end projection and forward estimates	26 February 2021
Agencies to **notify Audit Office** as Emerging Accounting Issues arise	
Agencies to provide Treasury with initial returns on the impact of new accounting standard AASB 1059 and withdrawal of TPP 06-8	26 February 2021
Agencies to **provide Audit Office** with position papers, general ledger journals and pro forma disclosures and agreed supporting documentation (including re new accounting standards) and where Audit Office is performing audit procedures at Early Close, key assumptions and judgments and supporting documents	By 26 February 2021
Agency **planning meeting with Audit Office** including to agree timetable, audit procedures planned for Early Close and relevant account area, scope of audit review and impact on Audit Office work at year end	By end of February 2021
Annual Engagement Plan for the year ending 30 June 2021 of the General Government sector and Total State Sector Accounts issued - Includes that, in consultation with Treasury, due to the nature of the TSSA, audit procedures on Early Close would comprise ongoing discussion and resolution of accounting issued throughout the year during fortnightly meetings	16 March 2021
Audit team attends Audit and Risk Committee meeting to present the Annual Engagement Plan	17 March 2021
Interim audit commences	March 2021
General Government Entities agencies provide Treasury with Prime return	14 April 2021
PNFC and PFCs agencies (incl State Owned Corporations) provide Treasury with Prime return	16 April 2021
Early Close information submitted to Treasury • Financial Statements as at 31 March 2021 and accompanying notes • Early Close Procedure Checklist • AASB 1059 Prime Submissions and Other Returns • Commonwealth Funding Agreement – Revenue Assessment • Reconciliation between Prime Data Submission and Agency Financial Statements Return on Emerging Accounting Issues – interim submission	26 April 2021
External valuation reports to be made available to **Audit Office**	30 April 2021
Treasury to provide the Audit Office with proforma financial statements including AASB 1059 transitional balances and disclosures	31 May 2021
Audit Office feedback on agency Early Close audit provided to Treasury via submission of Audit Office Report and interim Management Letter	7 June 2021

Information to Treasury (for Early Close) and the Audit Office (for Audit Engagement Plan)	Date
Agencies to notify Treasury of significant matters requiring resolution at final audit by Early Close end	As soon as identified
Emerging Accounting Issues – final submission to Treasury - updating potential impacts to year-end **incl issues identified by Audit Office** as part of Early Close procedure and resolution of previously identified issues	21 June 2021
Audit Office to provide feedback on proforma financial statements including AASB 1059 transitional balances and disclosures	30 June 2021
Audit Office to make initial information request for the Auditor-General's report to Parliament related to the Report on State Finances	June 2021
Agencies to submit draft 30 June 2021 prime return consistent with the draft financial statements to Treasury	19 July 2021
Agencies to submit 30 June 2021 annual financial statements **to the Audit Office** (including supporting working-papers for the Audit Office) and Treasury	26 July 2021
Agencies to submit preliminary annual return and completed supplementary return to Treasury	26 July 2021
Revisions of data submitted as part of preliminary or final returns to be submitted to Treasury	18 August 2021
Agencies to provide Final Annual Return to Treasury	Within 1 day of receiving the signed Independent Auditor's Report
Treasury to provide information requested for the Auditor-General's report to Parliament relating to the Report on State Finances	By 31 August 2021
Treasury to submit financial statements to the Audit Office with supporting working papers Audit Office commences audit of TSSA	7 September 2021
Treasury to provide draft Report on State Finances	As soon as possible
Audit clearance meeting Audit Office to issue Engagement Closing Report	7 October 2021
Audit team to attend Audit and Risk Committee meeting to present the Engagement Closing Report. Audit and Risk Committee to endorse financial statements.	8 October 2021
Treasury to seek the Auditor-General's approval for changes to the financial statements. Refer to the standard Terms of Engagement for details	12 October 2021
Treasury to approve, and Treasurer to sign, the financial statements Treasury to sign and give Management Representation Letter and the Treasurer's Representation Letter to Audit Office	14 October 201
Audit Office to issue Independent Auditor's Report and other letters to those charged with governance	15 October 2021
Audit Office to provide NSW Treasury with draft Auditor-General's report to Parliament. Separate sections of the draft to be provided progressively to NSW Treasury with a five-day turnaround expected. Audit Office to issue final management letter	After the Treasurer tables his Report on State Finances - October 2021

6.5 Classification of capital expenditure and depreciation expense based on ABS GFSM

Classification	Capital Expenditure (funded from State budget)	Depreciation on Property, Plant and Equipment (PPE)
Agency within GGS	Capitalised in the GGS balance sheet as PPE	Recognised under GG expenses
RailCorp as a NFP PNFC	Recognised under GG expense as Capital grant	Excluded from GG expenses
TAHE as a for profit PNFC	Capitalised in the GGS balance sheet as an investment with expectation of a return	Excluded from GG expenses