

Transport 2021



THE ROLE OF THE AUDITOR-GENERAL

The roles and responsibilities of the Auditor-General, and hence the Audit Office, are set out in the *Government Sector Audit Act 1983* and the *Local Government Act 1993*.

We conduct financial or 'attest' audits of state public sector and local government entities' financial statements. We also audit the Consolidated State Financial Statements, a consolidation of all state public sector agencies' financial statements.

Financial audits are designed to add credibility to financial statements, enhancing their value to endusers. Also, the existence of such audits provides a constant stimulus to entities to ensure sound financial management.

Following a financial audit the Audit Office issues a variety of reports to entities and reports periodically to Parliament. In combination, these reports give opinions on the truth and fairness of financial statements, and comment on entity internal controls and governance, and compliance with certain laws, regulations and government directives. They may comment on financial prudence, probity and waste, and recommend operational improvements.

We also conduct performance audits. These examine whether an entity is carrying out its activities effectively and doing so economically and efficiently and in compliance with relevant laws. Audits may cover all or parts of an entity's operations, or consider particular issues across a number of entities.

As well as financial and performance audits, the Auditor-General carries out special reviews, compliance engagements and audits requested under section 27B(3) of the *Government Sector Audit Act 1983*, and section 421E of the *Local Government Act 1993*.

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In accordance with section 52B of the *Government Sector Audit Act 1983*, I present a report titled '**Transport 2021**'.



Margaret Crawford

Auditor-General for New South Wales 6 May 2022





The Audit Office of New South Wales pay our respect and recognise Aboriginal people as the traditional custodians of the land in NSW.

We recognise that Aboriginal people, as custodians, have a spiritual, social and cultural connection with their lands and waters, and have made and continue to make a rich, unique and lasting contribution to the State. We are committed to continue learning about Aboriginal and Torres Strait Islander peoples' history and culture.

We honour and thank the traditional owners of the land on which our office is located, the Gadigal people of the Eora nation, and the traditional owners of the lands on which our staff live and work. We pay our respects to their Elders past and present, and to the next generation of leaders.



contents

Transport 2021

Section one – Transport 2021	
Introduction	1
Financial reporting	3
Audit observations	25
Section two – Appendices	
Appendix one – Misstatements in financial statements submitted for	
audit	49
Appendix two – Early close procedures	50
Appendix three – Financial data	52

Section one

Transport 2021

This report analyses the results of our audits of the Transport cluster agencies for the year ended 30 June 2021.

1. Introduction

This report provides Parliament and other users of the Transport cluster (the cluster) agencies' financial statements with the results of our audits, our observations, analysis, conclusions and recommendations in the following areas:

- financial reporting
- audit observations.

1.1 Snapshot of the cluster

Transport Cluster

Aims to plan and deliver infrastructure and integrated services across all modes of transport, including road, rail, metro, bus, ferry, light rail, cycling and walking.

State Outcomes



Connecting our customers' whole lives

Delivering transport solutions catering for the range of journey types needed by people and freight.



Successful places for communities

Create places that integrate the right mix of infrastructure, services, access and experiences for communities, supporting them to achieve their desired social, cultural and economic outcomes.



Sustainable transport systems and solutions supporting economic activity

Powers and connects a globally competitive, inclusive and sustainable NSW, driving economic growth and improving quality of life for the people of NSW.

Key Agencies



Source: NSW Budget Papers 2021-22.

Transport for NSW is the lead agency in the cluster. It is responsible for the coordination, funding allocation, policy and planning and other delivery functions for transport services. Department of Transport is the entity that employs the Secretary.

The *Transport Administration Act 1988* states that the affairs of Transport for NSW are to be managed and controlled by the Secretary of the Department of Transport. Transport for NSW is therefore a controlled entity of Department of Transport. Consistent with the Secretary's power of direction under the *Transport Administration Act 1988*, Department of Transport and Transport for NSW controls all the cluster agencies except the Transport Asset Holding Entity of New South Wales (TAHE), Chief Investigator of the Office of Transport Safety Investigations and the Port Authority of New South Wales.

TAHE and Port Authority of New South Wales, as State-Owned Corporations, are agencies in the Transport cluster.

1.2 Changes to the cluster

The former Rail Corporation New South Wales transitioned to the Transport Asset Holding Entity of New South Wales

On 1 July 2020, the former Rail Corporation New South Wales (RailCorp) was renamed Transport Asset Holding Entity of New South Wales and transitioned to a for-profit statutory State-Owned Corporation pursuant to the *Transport Administration Act 1988* and the *State Owned Corporations Act 1989*.

TAHE ceased being a controlled entity of the Department of Transport (the department) as at 1 July 2020. This is because the department no longer had:

- power over key relevant activities of TAHE
- exposure to risks and returns from TAHE
- the ability to affect the amount of TAHE's returns.

For further details refer to Section 3 in the Report on State Finances, tabled on 9 February 2022 and to Section 3 'Audit observations' below.

2. Financial reporting

Financial reporting is an important element of good governance. Confidence and transparency in public sector decision making are enhanced when financial reporting is accurate and timely.

This chapter outlines our audit observations related to the financial reporting of agencies in the cluster for 2021.

Section highlights

- Unqualified audit opinions were issued on all Transport agencies' financial statements.
- An 'Emphasis of Matter' paragraph was included in the Transport Asset Holding Entity of New South Wales' (TAHE) Independent Auditor's Report to draw attention to significant uncertainty associated with the judgements, estimates and assumptions supporting the valuation of TAHE's property, plant and equipment (PPE) and intangible assets.
- In 2020–21, the former RailCorp transitioned to TAHE, a for-profit State Owned Corporation. When TAHE became a for-profit entity, it was required to change its valuation approach. The value of a for-profit entity's assets cannot exceed the cash flows they might realise either through their sale or continued use. This change in the basis of valuation resulted in a decrease of \$20.3 billion in the fair value of the assets. The decrease in fair value was because the cash flows, which support measurement under the income approach, were insufficient to support the previous valuation based on the current replacement cost of those assets.
- TAHE also corrected a misstatement of \$1.2 billion relating to the valuation of its assets after significant deliberation on key judgements and assumptions, with TAHE adopting higher risk assumptions in its valuation when compared to the relevant market benchmarks.
- On 18 December 2021, a Heads of Agreement (HoA) was signed between TAHE, Transport for NSW, Sydney Trains and NSW Trains. This HoA reflected TAHE's intention to negotiate higher access and licence fees in order to meet the Shareholding Ministers' revised expectation of a higher rate of return. This matter resolved the treatment of a significant accounting issue in the State's consolidated (whole-of-government) financial statements. Refer to the Report on State Finances tabled on 9 February 2022. The expectation of an additional \$5.2 billion in fees added to the valuation of TAHE's PPE and intangibles, with a final value of \$17.15 billion.
- The implementation of AASB 1059 'Service Concession Arrangements: Grantors' resulted in a net increase in assets of \$23.5 billion across the cluster. AASB 1059 had a significant impact on Transport for NSW, Sydney Metro, Sydney Ferries and TAHE's 2020–21 financial statements.
- TAHE corrected a misstatement of \$97.2 million relating to the application of AASB 1059 'Service Concession Arrangements: Grantors' for the Airport Link Company Contract.

2.1 Cluster financial information 2021

Agency	Total assets \$m	Total liabilities \$m	Total income*	Total expenses** \$m
Principal agencies				
Department of Transport (Parent Entity)			1	1
Transport for NSW	146,847	26,141	24,485	20,087
Other cluster agencies listed in Append	ix A of Treasu	ry Direction TD21	-02	
NSW Trains	198	359	910	854
State Transit Authority of New South Wales	100	272	468	434
Sydney Ferries	152	9	8	13
Sydney Metro	24,059	4,027	4,709	789
Sydney Trains	3,150	3,627	3,776	3,802
Transport Asset Holding Entity of New South Wales***	22,133	3,563	349	17,880
Other cluster agencies				
Port Authority of New South Wales	660	284	182	155
Transport Service of New South Wales	572	572	2,244	2,256

Total revenue includes other gains, gains on disposal, government and other contributions and reversal of impairment losses, which are shown separately on the financial statements.

Note: Chief Investigator of the Office of Transport Safety Investigations and Residual Transport Corporation of New South Wales have assessed and determined they met the reporting exemption criteria under the GSF Regulation, and therefore were not required to prepare annual financial statements. Source: Agencies audited 2020–21 financial statements.

2.2 Quality of financial reporting

Audit opinions

Unqualified audit opinions were issued on agencies' financial statements

Unqualified audit opinions were issued on all cluster agencies' 30 June 2021 financial statements. Sufficient and appropriate audit evidence was obtained to conclude the financial statements were free of material misstatement.

TAHE's Independent Auditor's Report includes an emphasis of matter and was issued on 24 December 2021

An 'Emphasis of Matter' paragraph was included in TAHE's Independent Auditor's Report for its 30 June 2021 financial statements to draw attention to significant uncertainty associated with the judgements, estimates and assumptions supporting the valuation of TAHE's property, plant, and equipment (PPE) and intangible assets.

^{**} Total expenses includes other losses, income tax equivalent expense and impairment losses on financial assets, which are shown separately on the financial statements.

^{***} On 1 July 2020, the former RailCorp transitioned to the Transport Asset Holding Entity of New South Wales (TAHE), to a for-profit statutory State-Owned Corporation pursuant to the *Transport Administration Act 1988* and *State Owned Corporations Act 1989*.

Our review of all evidence received prior to 14 December 2021 indicated the General Government Sector's (GGS) expected returns on its investment in TAHE were below the long-term inflation rate. The levels of projected returns did not support Treasury's proposed accounting treatment of the GGS's cash contribution of \$2.4 billion to TAHE as an equity injection.

On 14 December 2021, a government decision was made resulting in the TAHE Shareholding Ministers requesting that TAHE re-negotiate the access fees and license fees payable under the Operating Agreements between TAHE and the public operators (Sydney Trains and NSW Trains). The renegotiation was to target an average return to the GGS of 2.5 per cent on the equity contributed, increased from a previous expectation of 1.5 per cent. The revised shareholder expectations for TAHE were published in the 2021–22 'NSW Budget Half Yearly Review' on 16 December 2021. On 18 December 2021, Transport for NSW, TAHE and the operators, Sydney Trains and NSW Trains, entered into a Heads of Agreement (HoA). This HoA forms the basis of negotiations to revise the pricing within the existing 10-year contracts and deliver upon the shareholders' expectation of a return of 2.5 per cent per annum of contributed equity. For further details refer to the Report on State Finances tabled on 9 February 2022.

TAHE's valuation of assets is based on an income approach, using a discounted cash flow (DCF) model. The DCF method uses the expected future cash inflows and outflows generated by the use of the assets and applies a discount rate to these cash flows to calculate the present value of the assets. One of the key inputs to the DCF model are the access and licence fees, which are charged to TAHE's key customers, Sydney Trains and NSW Trains. The final DCF model reflects the higher revised access and licence fees in the HoA, rather than those in the original contracts.

There is uncertainty with regards to the judgement to using the access and licence fees in the HoA because:

- TAHE's future estimated access and licence fees, which are critical to the ability to earn the
 expected 2.5 per cent rate of return, are subject to re-negotiation and re-signed access
 agreements, based on proposed indicative future access and licence fees set out in the
 Heads of Agreement, which will form the basis of the re-negotiation
- \$1.1 billion in additional funding for TAHE's key customers was provided in the 2021–22 'NSW Budget Half Yearly Review' consistent with the terms in the Heads of Agreement, but this funding only extends out to the end of the forward estimates period in 2024–25. There is an additional \$4.1 billion over the following six years outside of the forward estimates period (up to the end of the 10-year contract period), which has been communicated to the Expenditure Review Committee, but is yet to be provided for in government budget figures
- a significant portion of the fair value of TAHE's non-financial assets is reflected in the terminal value, which is outside the 10-year contract period (terminating 30 June 2031). There is a risk that, in the years beyond the forward estimates period, TAHE will not be able to negotiate contract terms for access and licence fees at a level to support the terminal value. There is also a risk that funding for TAHE's key customers will not be sufficient to fund payment of access and licence fees at a level that is consistent with current projections. TAHE has included an asset specific risk premium in the discount rate to reflect this risk.

State Transit Authority of New South Wales' Independent Auditor's Report includes an emphasis of matter

The NSW Government put the State Transit Authority of New South Wales' three bus contract regions, Regions 7, 8 and 9, out to competitive tender as part of wider changes to the Sydney bus network, with the new operators announced by the date of this report.

These contracts were the main activities of substance for the State Transit Authority of New South Wales. Accordingly, management assessed the State Transit Authority of New South Wales' principal activities are not expected to operate for a full 12 months after 30 June 2021 and determined that the going concern basis of preparation of the financial statements for 30 June 2021 was not appropriate.

We included an 'Emphasis of Matter' paragraph in the Independent Auditor's Report for State Transit Authority of New South Wales' 30 June 2021 financial statements. This was to draw users' attention to management's disclosures that State Transit Authority of New South Wales' financial statements for the year ended 30 June 2021 were not prepared on a going concern basis as the Authority's principal activities will not operate for the entire 2021–22 financial year.

Refer to 'key accounting issues' below.

Unqualified audit opinions were issued on all 30 June 2021 acquittal audits

Acquittal audits ensure that financial information or special purpose financial statements prepared by agencies for certain grant programs comply with the terms and conditions of the grant funding agreements.

The following acquittal audits were completed during 2020–21:

- Transport for NSW an audit was conducted to determine if the special purpose financial statements prepared for the Local Roads and Community Infrastructure Program were prepared in accordance with the requirements of the COVID-19 Local Roads and Community Infrastructure Program Guidelines.
- Transport for NSW an audit was conducted to determine if the Investment Projects Annual Financial Statement, was prepared in accordance with the requirements of Section 21(b) of the *National Land Transport Act 2014.*
- Transport for NSW an audit was conducted to determine if the special purpose financial statement presented in Part 1 - Chief Executive Officer's Financial Statement for the Roads to Recovery Program, was prepared in accordance with the requirements of Section 90 of the National Land Transport Act 2014.
- Transport for NSW an audit was conducted to determine if the Financial Statement of Black Spot Projects, was prepared in accordance with the requirements of Section 82(a) of the National Land Transport 2014.

The total number of identified monetary misstatements with a gross value of over \$5 million increased from 2019–20

The number of monetary misstatements identified during the audit of the financial statements for the cluster decreased from 27 in 2019–20 to 26 in 2020–21. A monetary misstatement is an error in an amount recognised in the financial statements initially submitted for audit.

Reported corrected misstatements increased from 22 in 2019–20 to 24 with a gross value of \$2.2 billion in 2020–21. Reported uncorrected misstatements decreased from five in 2019–20 to two with a gross value of \$29.2 million in 2020–21.

The table below shows the number and quantum of monetary misstatements for the past two years.

Year ended 30 June		2021		2020
	©	0	Ø	•
Less than \$50,000				
\$50,000 to \$249,999				
\$250,000 to \$999,999	1		1	
\$1 million to \$4,999,999	2	1	4	3
\$5 million and greater	21	1	17	2
Total number of misstatements	24	2	22	5
Key Corrected misstatements	Uncorrected misstatements			

Source: Engagement Closing Reports issued by the Audit Office of New South Wales.

Refer to Appendix one for details of corrected and uncorrected monetary misstatements by agency.

Of the 24 corrected misstatements, 21 had a gross value of greater than \$5 million and primarily related to:

Agency

Description of corrected misstatements > \$5 million

Transport Asset Holding Entity of New South Wales

- TAHE's property, plant and equipment was understated by \$1.2 billion as a result of incorrect assumptions applied to its revaluation. For more details see Section 2.4 below.
- TAHE's financial liabilities in relation to its obligations to compensate the Airport Link Company for the removal of its Station Access Fees were understated by \$289 million at 1 July 2019. This was corrected retrospectively as a prior period error. For more details see Section 2.4 below.
- TAHE's property, plant and equipment was understated by \$97.2 million as a result of the Airport Link Company assets not appropriately accounted for as a service concession arrangement under AASB 1059 ' Service Concession Arrangements: Grantors'.
- TAHE's property, plant and equipment was overstated by \$72.5 million as a result of incorrect reporting of assets constructed by Transport for NSW on behalf of TAHE.
- TAHE's property, plant and equipment was understated by \$33.5 million as a result of lack of timely reporting of assets constructed by Sydney Metro on behalf of TAHE.
- TAHE's deferred grant revenue was understated by \$30.7 million as a result of recognition of assets constructed by Sydney Metro on behalf of TAHE free of charge. As a for-profit-entity, TAHE recognises the revenue relating to assets received free of charge over the useful life of the assets.
- Provision for refunds was understated relating to refunds TAHE is liable for in relation to overcharging, by the former RailCorp, of access fees to freight customers by \$11 million.

Transport for NSW

- Transport for NSW overstated its major rail expenses (capital works constructed on behalf of TAHE) and revenue (recoveries from TAHE) by \$66.5 million following a review of the nature of works completed and who controlled the works in progress.
- Transport for NSW understated its capital works in progress assets by \$33 million as it had incorrectly charged the costs of the works to TAHE.
- Transport for NSW overstated its valuation of toll roads assets for NorthConnex by \$44.9 million due to an error in the revaluation spreadsheets which impacted the calculations.
- Transport for NSW overstated its work-in-progress assets for WestConnex 3A by \$26.2 million due to change in interpretation by NSW Treasury of accounting treatment under AASB 1059 of calculation method to recognise the current replacement cost of assets.
- Transport for NSW understated its personnel services payable by \$9.5 million as it did not assess the impact of its obligations to provide for redundancy payments as a result of organisational restructure.
- Transport for NSW understated its loss on revaluation of assets by \$7.1 million as it had incorrectly classified the decrease in fair value of its roads, bridges and traffic control network assets against its asset revaluation reserves rather than through expenses.

Agency	Description of corrected misstatements > \$5 million		
Department of Transport	 Department of Transport overstated its consolidated asset revaluation reserve by \$144 million, which should have been transferred to consolidated retained earnings. 		
	 Department of Transport overstated its consolidated asset revaluation reserve of \$19.1 million, as the decrease in fair value of its bridges on consolidation was incorrectly classified as a movement through expenses, rather than asset revaluation reserves. 		
Sydney Metro	 Sydney Metro overstated its major rail expenses (capital works constructed on behalf of TAHE) and revenue (recoveries from TAHE) of \$30.7 million following a review of the nature of works completed and who controlled the works in progress. 		
	 Sydney Metro misclassified \$19.5 million of capital grants as major rail expenses. This was due to work constructed on behalf of TAHE that was not recoverable. 		
	 Sydney Metro understated its work-in-progress assets by \$12.2 million due to change in interpretation by NSW Treasury of accounting treatment under AASB 1059 of calculation method to recognise the current replacement cost of assets, which was received after Sydney Metro had submitted the 30 June 2021 draft financial statements to the Audit Office and Treasury. 		
	 Sydney Metro's capital work-in-progress at 30 June 2020 was overstated by \$11.3 million due to lack of timely reporting of assets constructed on behalf of TAHE. This was corrected retrospectively as a prior period error. 		
	 Sydney overstated its infrastructure assets by \$5.6 million due to an error in the revaluation spreadsheets which impacted the calculations. 		
Transport Service of New South Wales	 Transport Service of New South Wales understated its provision for redundancies by \$10.8 million as it did not assess the impact of its obligations to provide for redundancy payments as a result of organisational restructure. 		

Of the two uncorrected misstatements, one had a gross value of greater than \$5 million relating to:

Agency	Description of uncorrected misstatements > \$5 million		
Transport for NSW	 Transport for NSW understated its valuation of Sydney Light Rail assets by \$27.5 million as a result of applying a general construction index as opposed to specific indices relating to each component of the assets, such as electrical and computer components. 		

New financial reporting provisions became effective from 1 July 2021

The financial reporting provisions in Division 7.2 of the *Government Sector Finance Act 2018* (GSF Act) commenced on 1 July 2021. Agencies prepared their annual GSF financial statements for the 2020–21 financial year under Division 7.2 of the GSF Act.

Two agencies were exempted from financial reporting in 2020-21

Part 3A Division 2 of the 'Government Sector Finance Regulation 2018 (GSF Regulation)' prescribes certain kinds of GSF agencies not to be a reporting GSF agency. For 2020–21, the following cluster agencies have assessed and determined they met the reporting exemption criteria under the GSF Regulation, and therefore were not required to prepare annual financial statements:

Exempted agencies	GSF Regulation reference	Basis for reporting exemption
Small agencies	-	
Residual Transport Corporation of New South Wales	Part 3A, Division 2, Section 9D of the GSF Regulation	GSF Regulation prescribes a GSF agency meeting all the following requirements not to be a reporting GSF agency:
Chief Investigator of the Office of Transport Safety		 the assets, liabilities, income, expense, commitments and contingent liabilities of the agency are each less than \$5 million
Investigations		 the total cash or cash equivalent held by the agency is less than \$2.5 million
		 at least 95 per cent of the agency's income is derived from money paid out of the Consolidated Fund or money provided by other GSF agencies
		 the agency does not administer legislation for a minister by or under which members of the public are regulated.
		The department has assessed these two agencies against the above criteria and concluded they have met all the requirements. Hence, they were not required to prepare financial statements in 2020–21.

In 2019–20, both cluster agencies were exempted from financial reporting under Schedule 2 of the Public Finance and Audit Regulation 2015.

2.3 Timeliness of financial reporting

Early close procedures

Early close mandatory procedures were submitted on time for all cluster agencies

NSW Treasury introduced early close procedures to improve the quality and timeliness of year-end financial statements. In March 2021, NSW Treasury reissued Treasurer's Direction TD19-02 'Mandatory Early Close as at 31 March each year' (TD19-02) and issued TPP21-01 'Agency Direction for the 2020–21 Mandatory Early Close', requiring GSF agencies listed in Appendix A of TD 19-02 to perform early close procedures and provide the outcomes to the audit team by 26 April 2021.

Cluster agencies met the statutory deadlines for submitting their 2020–21 early close financial statements and other mandatory procedures.

The table below summarises the agencies' completion of the 16 mandatory early close procedures, noting that some procedures are not relevant to all agencies. The 16 procedures are listed in Appendix two.

A	Completed	Not completed	Not applicable		
Agency	igoremsize	1	•		
Principal agencies					
Department of Transport	11		5		
Transport for NSW	14		2		
Other cluster agencies listed in Appendix A of Tre	easury Direction	TD19-02			
NSW Trains	11		5		
State Transit Authority of New South Wales	13		3		
Sydney Ferries	13		3		
Sydney Metro	12		4		
Sydney Trains	12		4		
Transport Asset Holding Entity of New South Wales*	13		3		
Other cluster agencies					
Port Authority of New South Wales	13		3		
Transport Service of New South Wales	10		6		

On 1 July 2020, the former RailCorp was renamed Transport Asset Holding Entity of New South Wales (TAHE) and converted to a for-profit statutory State-Owned Corporation pursuant to the Transport Administration Act 1988 and State Owned Corporations Act 1989.

Note: Chief Investigator of the Office of Transport Safety Investigations and Residual Transport Corporation of New South Wales have assessed and determined they met the reporting exemption criteria under the GSF Regulation, and therefore were not required to prepare annual financial statements. Source: Reports on early close procedures 2021 issued by the Audit Office of New South Wales.

Certain mandatory early close procedures are not applicable to agencies. For instance, if an agency did not have changes in accounting policy or a correction of material prior period error, those procedures would be considered as not applicable to the agency.

Year-end financial reporting

NSW Treasury extended financial reporting deadlines

Due to the COVID-19 pandemic, NSW Treasury extended the year-end financial reporting deadline for agencies listed in Appendix A of Treasury Direction TD21-02 'Mandatory Annual Returns to Treasury' (TD21-02) to 2 August 2021.

During May and June 2021, NSW Treasury issued a suite of Treasurer's Directions, Treasury Circular and policy papers for 2020–21 financial reporting requirements and timetables:

- Treasurer's Direction TD21-02 and Treasury Policy Paper TPP21-04 'Agency Direction for the 2020–21 Mandatory Annual Returns to Treasury' require agencies listed in the Appendix A of TD21-02 to submit their 2020–21 financial statements to both NSW Treasury and the Audit Office by 26 July 2021
- Treasury Circular TC21-04 '2020–21 Mandatory Annual Returns to Treasury for non-GSF agencies' requires New South Wales public sector agencies not listed in Appendix A of TD21-02 to submit their draft 2020–21 financial statements to NSW Treasury by 26 July 2021
- Treasurer's Direction TD21-03 'Submission of Annual GSF Financial Statements to the Auditor-General' requires reporting GSF agencies that are not listed in Appendix A of TD21-02 to submit their annual financial statements within six weeks after the year end.

The following agencies obtained NSW Treasury's approval to further extend submission of their 30 June 2021 financial statements:

Cluster agencies	Revised deadline	Reason
Transport Asset Holding Entity of New South Wales	16 August 2021	Additional time requested to address accounting issues around valuation of assets and implementation of AASB 1059.
Department of Transport	20 August 2021	The Department of Transport can only start to prepare its consolidated financial statements after all its controlled entities have submitted their financial statements. The usual process is three to four weeks after the controlled entities submit their financial statements.
		The controlled entities submitted their financial statements on 26 July 2021.

Financial statements were submitted on time for all cluster agencies

Cluster agencies met the revised or approved reporting deadlines for submitting their 2020–21 year-end financial statements.

On 1 July 2021, the *Public Finance and Audit Act 1983* (PF&A Act) was renamed the *Government Sector Audit Act 1983* (GSA Act). Whilst the PF&A Act required the Auditor-General to audit agencies' financial statements within ten weeks of their receipt, the GSA Act does not specify the statutory deadline for issuing the audit reports.

The table below shows the timeliness of the year-end financial reporting for cluster agencies.

Timeliness of financial reporting

Cluster agencies	Financial statements submission	Date audit report was issued
Department of Transport		21 October 2021*
Transport for NSW		7 October 2021
NSW Trains		11 October 2021
Port Authority of New South Wales		7 September 2021
State Transit Authority of New South Wales		6 September 2021
Sydney Ferries	igoremsize	7 October 2021
Sydney Metro	igoremsize	27 September 2021
Sydney Trains		8 October 2021
Transport Asset Holding Entity of New South Wales		24 December 2021**
Transport Service of New South Wales	•	1 October 2021



Original reporting deadline, including Treasury's revised reporting deadline was met.



Treasury's approved extension timeframe was met.



Treasury's reporting deadline was not met.

2.4 Key accounting issues

Accounting for assets

Valuation of assets

Prior to transitioning to TAHE (a for-profit entity), the former RailCorp (a not for-profit entity) had valued its assets on a current replacement cost (CRC) approach. At 30 June 2020, RailCorp reported asset values totalling \$41 billion. TAHE became a for-profit entity on 1 July 2020.

Treasury Policy Paper TPP 21-09 'Valuation of Physical Non-Current Assets at Fair Value' recognises that for for-profit entities holding infrastructure assets, the appropriate fair value will be limited to the lower of the income approach and the cost approach.

The most common income approach applied is a present value technique based on discounted cashflows referred to as the discounted cashflow method (DCF). This valuation technique is subject to significant judgement and assumptions.

Finalisation of access and licence agreements with the operators, Sydney Trains and NSW Trains, prior to 30 June 2021 provided a basis for TAHE to develop financial forecasts as inputs to the DCF approach. As the CRC of TAHE's assets exceeded the DCF, TAHE valued its property, plant and equipment and related intangibles as at 30 June 2021 based on its DCF. TAHE determined the fair value of its property, plant and equipment (PPE) and related intangibles was \$12.8 billion. This resulted in an initial write-down of \$24.8 billion, including a write-down of the Country Regional Network to nil book value.

The audit of Department of Transport was completed on 21 October 2021, following completion of the audit of all of its controlled entities. The Transport Asset Holding Entity of New South was no longer a controlled entity of the Department of Transport (Refer Section 1.2 above).

^{**} The resolution of significant issues delayed the signing of the Independent Auditor's Report for TAHE until 24 December 2021. These are discussed further below (Refer Section 3 'Audit Observations').

The judgements and assumptions used by TAHE to determine the initial fair value of \$12.8 billion (being the mid-point of management's range of \$10.5 billion to \$14.15 billion) were not assessed as reasonable to the Audit Office. The reason we felt TAHE's valuation was not reasonable related to the discount rates TAHE applied to its expected cash flows.

Based on our assessment, which used assumptions based on relevant benchmark entities, there was a material understatement of asset values of \$1.2 billion. A discount rate reflects the compensation a market participant will seek for bearing uncertainty inherent in expected cashflows. Discount rates increase, as the risk of achieving forecast cash flows increases. In a DCF valuation, higher discount rates drive lower values for assets, reflecting prima facie, a reasonable market participant will pay a higher price for an asset whose cash flows bear lower uncertainty than an asset whose cash flows bear greater uncertainty. TAHE initially applied an overall discount rate that we considered high compared to relevant market benchmarks. The audit evidence presented to us indicated the risk TAHE's expected cash flows would not be achieved was comparatively lower, relative to management's assessment of risk. Consequently, lower discount rates were more appropriate in the circumstances and in line with comparable benchmarks.

In our view, TAHE's cash flows should be considered at the lower end of the risk spectrum warranting the application of a lower discount rate, because TAHE:

- is the monopoly provider of rail infrastructure assets to Sydney Trains and NSW Trains (both NSW Government entities). Both public sector operators are reliant on TAHE's assets to conduct their operations. No alternative suppliers are available, nor are other participants likely to enter the market
- retains limited operational and maintenance capital expenditure risk as the public rail
 operators are required to fund the operational maintenance costs for TAHE's assets and
 NSW Treasury funds the capital maintenance expense through equity injections
- has contractual cashflows for its regulated and unregulated assets under 10-year Track Access Agreements and Licence, Agency and Maintenance Deeds
- has not identified any risks that are not relevant to any other comparable regulated businesses.

Using inputs at the lower end of the risk spectrum when compared to relevant market benchmarks, we assessed the appropriate valuation range was between \$14.0 billion and \$17.3 billion.

Management subsequently increased their valuation by \$1.2 billion to \$14.0 billion. This avoided a qualified opinion within the Independent Auditor's Report for TAHE's financial statements for the year ended 30 June 2021. For further details refer to the 'Audit Observations' section below.

On 18 December 2021, a Heads of Agreement (HoA) was signed between TAHE, Transport for NSW, Sydney Trains and NSW Trains. This HoA reflected TAHE's intention to negotiate higher access and licence fees to deliver on its Shareholding Ministers' expectations to earn a return of 2.5 per cent on contributed equity, increased from a previous 1.5 per cent. The access and licence agreements have not been revised to reflect these increased fees. TAHE management has advised these will be updated and formalised as soon as possible. The additional \$5.2 billion in access and license fees was added to the discounted cash flow valuation model, resulting in an upward revaluation of TAHE's PPE and related intangibles to \$17.15 billion. The updated value resulted in a final overall write-down of the assets by \$20.3 billion. For further details on the HoA, refer to the Report on State Finances 2021.

For further details on the risk assumptions and implications of the asset write-down refer to the Report on State Finances 2021 and the 'Audit Observations' section below.

Transfer of assets constructed on behalf of third-parties at Sydney Metro

As part of project delivery, Sydney Metro is required to undertake works to build assets for third parties such as councils, utility providers and other government agencies, and once completed, the assets are transferred or handed over to the third parties.

The cost of constructing these assets is initially capitalised as part of the work in progress in Sydney Metro. Management reviewed its capital works in progress at 30 June 2021 and identified \$11.3 million of capital works constructed on behalf of the Transport Asset Holding Entity of New South Wales (TAHE), where control was transferred in 2019–20.

The loss of control over the assets was retrospectively corrected as a prior period error in Sydney Metro's financial statements at 30 June 2020.

Recognition of the financial liability under the Airport Link Company Contract

Understated financial liability for TAHE's contractual obligation to compensate the Airport Link Company Contract for the removal of Station Access Fees

In 2013, the Restated Stations Agreement was amended requiring TAHE to pay a Shadow Station Access Fee to compensate the Airport Link Company for the removal of the user paid Station Access Fee charged at Green Square and Mascot stations. The fee was set on a contracted rate on exit and entry at these stations. The total amount payable by TAHE as compensation to the Airport Link Company is dependent on the patronage at each of these stations.

TAHE was required to recognise a financial liability at the time of the contract variation under AASB 9 'Financial Instruments' and AASB 132 'Financial Instruments: Presentation' to reflect its contractual obligations over the payment of the Shadow Station Access Fees. However, this obligation was only recognised in the current year.

TAHE recognised the prior period adjustments retrospectively in relation to the recognition of the financial liability in the financial statements. TAHE recognised a financial liability of \$289 million at 1 July 2019, which was the opening balance of the comparative 2019–20 financial year. The recognition resulted in an increase in liabilities of \$260 million, a reduction in operating expenses of \$35.8 million and an increase in finance costs during the 2019–20 financial year.

Franchising of bus operations

Impact of franchising of bus operations on State Transit Authority of New South Wales' financial statements

On 24 October 2019, the NSW Government announced the State Transit Authority of New South Wales' three bus contract regions, Regions 7, 8 and 9, would be put out to competitive tender as part of wider changes to the Sydney bus network, with the new operators planned to take over operations in three stages.

At the date of this report, external operators for all three regions were announced.

These contracts were the main activities of substance for the State Transit Authority of New South Wales. It was determined any unsettled assets and liabilities are expected to be transferred to Transport for NSW. Accordingly, State Transit Authority of New South Wales' principal activities are not expected to operate for a full 12 months after 30 June 2021. Accordingly, management determined that the going concern basis of preparation of the financial statements was not appropriate for the 30 June 2021 financial statements for State Transit Authority of New South Wales.

We included an 'Emphasis of Matter' paragraph in the Independent Auditor's Report for State Transit Authority of New South Wales' 30 June 2021 financial statements. This was to draw users' attention to management's disclosures that State Transit Authority of New South Wales' financial statements for the year ended 30 June 2021 were not prepared on a going concern basis as the Authority's principal activities will not operate for the entire 2021–22 financial year.

Implementation of new accounting standard

Agencies implemented AASB 1059 'Service Concession Arrangements: Grantor' in 2020–21

AASB 1059 became effective for all New South Wales public sector agencies for the 2020–21 financial year. It applies to arrangements which may involve a private sector operator designing, constructing, or upgrading assets used to provide public services, and operating and maintaining those assets for a specified period of time. In return, the private sector operator is compensated by the public sector entity (the grantor). AASB 1059 may result in agencies recognising service concession assets and liabilities in their financial statements which were previously not on the balance sheet.

The implementation of AASB 1059 had a significant impact on Transport for NSW, Sydney Metro, Sydney Ferries and Transport Asset Holding Entity of New South Wales's 2020–21 financial statements. This is because transport agencies often engage operators to provide many of the public transport services on their behalf. The cluster includes many privately financed projects, where a private sector company constructs and then operates the service for a set amount of time. Such arrangements include:

- toll roads
- Sydney Light Rail services
- Sydney Metro Northwest Line and Sydney Metro City and Southwest
- Airport Link stations
- Ferry system contract
- B-line carparks.

Upon initial adoption of AASB 1059 on 1 July 2019, these agencies collectively recognised:

- an increase in service concession assets of \$23.5 billion, which was mainly due to:
 - \$20.4 billion net increase in infrastructure assets, land and plant and equipment assets relating to toll roads
 - \$2.9 billion increase in infrastructure assets, land and plant and equipment relating to the Sydney Light Rail assets
 - \$185 million increase in assets relating to the Airport Link stations.
- a reclassification of \$9.1 billion relating to infrastructure assets, land and plant and equipment to service concession assets relating to Northwest Metro
- a reclassification of \$108 million in land, plant and equipment and ferries to service concession assets relating to Sydney Ferries' assets
- a reclassification of \$42.4 million in land and buildings to service concession assets relating to B-line car parks
- a net increase in liabilities of \$17.8 billion.

There were significant deliberations on TAHE's accounting treatment of the Airport Line Company (ALC) arrangement under AASB 1059

The contractual arrangement between TAHE and ALC outlines the requirement for ALC to construct, operate and maintain the four stations on the Airport Line Link for a 30-year concession period. In the prior year, TAHE had concluded the ALC arrangement was within the scope of AASB 1059 'Service Concession Arrangements: Grantors'. Subsequently, management, led by NSW Treasury revisited the arrangement and concluded the arrangement does not fall within the scope of AASB 1059 for TAHE. Instead, it was assessed as a service concession arrangement in the whole-of-government accounts and a lease arrangement under AASB 16 'Leases' for TAHE. The key point of deliberation was whether the ALC was performing these services on behalf of TAHE as the grantor.

Management's revised interpretation was based on a narrow interpretation of the relevant legislation. Section 11(1) of the *Transport Administration Act 1988* outline TAHE's function to hold, manage, operate and maintain certain transport assets. However, Section 11(3) specifies these functions can only be exercised under the authority of an Operating Licence. The Operating Licence prohibits TAHE from carrying out 'railway operations' without approval from the Portfolio Minister. Railway operations is defined under the 'Rail Safety National Law (NSW) No 82a of 2012' and includes conducting railway operations and managing associated railway track structures such as stations and platforms. Management believed the operation of the train stations on the Airport Link line is not performed on behalf of TAHE as TAHE does not have the function to operate the train station due to the restrictions set out in the Operating Licence.

Audit concluded the arrangement does fall within the scope of AASB 1059 for TAHE. Our view considered the legislative requirements and the substance of the arrangements and is that the private operator was performing these services on TAHE's behalf, because TAHE's legislative functions include operating and maintaining transport assets, such as train stations. Although the operating licence restricts TAHE's ability to operate these assets, they still retain this legislative function, and can contract others to perform it, but need permission from the Portfolio Minister to exercise it themselves.

The Operating Licence does not negate the functions set out in Section 11(1) of the *Transport Administration Act 1988*, but, by virtue of Section 11(3) states that it is unable to directly exercise that function themselves. The Operating Licence does not preclude TAHE from entering into contractual arrangements with third parties to carry out these functions. In addition, Section 20ZB of the *State Owned Corporations Act 1989* outlines that TAHE can only enter into contractual arrangement in relation to the performance of its functions. Therefore, TAHE has entered into a contractual arrangement to grant ALC the right to operate four train stations on the Airport Line Link and provide public services (access to passenger rail services) on behalf of TAHE.

Under AASB 1059, service concession assets are required to be valued under the current replacement cost method. In the initial submission of financial statements, TAHE valued these stations under the DCF method, resulting in a misstatement of \$97.2 million for 30 June 2021. After significant deliberations and discussions, management agreed to correct the misstatement and related disclosures.

This matter was important because, while not individually material to TAHE it could have created an accounting precedent for the future. Under AASB 1059, the assets are required to be measured at current replacement cost which produces a higher value and related depreciation expense compared to the income approach.

2.5 Key financial statement risks

The table below details our specific audit coverage and response over key areas of financial statements risks that had the potential to impact the financial statements of cluster agencies:

Transport for NSW

Transport for NSW is the lead agency of the cluster. Its role is to lead the development of a safe, efficient, integrated transport system that keeps people and goods moving, connects communities and shapes the future of New South Wales' cities, centres and regions.

Transport for NSW is responsible for strategy, planning, policy, regulation, funding allocation and other non-service delivery functions for all modes of transport in New South Wales including road, rail, ferry, light rail, point to point, regional air, cycling and walking.

Property, plant and - \$140 billion

\$29.5 billion

\$20.4 billion

Key financial statement risk

Transport for NSW's property, plant and equipment consists of specialised assets such as roads, bridges and tunnels, rail systems and specialised land and building assets, which are measured at fair value based on their current replacement cost.

Our audit risk rating for property, plant and equipment is higher because these assets are proportionately significant to the financial statements of Transport for NSW and are subject to management judgements and estimates when determining their fair values. These judgements and estimates often require the assistance of a qualified valuer upon revaluation.

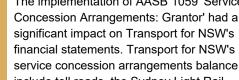
The implementation of AASB 1059 'Service Concession Arrangements: Grantor' had a include toll roads, the Sydney Light Rail Services and B-Line Car Parks.

Our audit risk rating for service concession assets and related financial liabilities is higher because of:

- underpinning key assumptions used in the valuation process
- sensitivity of service concession assets and liabilities to changes in key
- complexity of recognising and measuring Toll Road assets for the first time under AASB 1059
- in the financial statements.

Audit response

Our audit procedures included testing the accuracy and completeness of the asset register; reviewing the appropriateness of the valuation approach; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.



financial significance of the service concession assets and liabilities

- extent of significant judgements
- assumptions
- the additional disclosure requirements

Our audit procedures included reviewing management's assessment of contracts to ensure the scoping assessment for AASB 1059 is appropriate and complete; examining the appropriateness of management's valuation methods for assets; ensuring assumptions and judgments applied are reasonable; assessing the reasonableness of calculation methodology for liabilities recognised under AASB 1059; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

Transport Asset Holding Entity of New South Wales

The Transport Asset Holding Entity of New South Wales is a statutory State Owned Corporation and owner of rail property assets including property, rolling stock and rail infrastructure in the Sydney metropolitan area and country locations in New South Wales.

These assets are made available to Sydney Trains and NSW Trains for their operations. The Transport Asset Holding Entity of New South Wales also provides rail infrastructure to third party operators under the terms of track access agreements.

Key financial statement risk

Property, plant and equipment

- \$21.8 billion

TAHE's property, plant and equipment consists of specialised assets such as track work and infrastructure, rolling stock, land, buildings and plant and machinery at fair value based on the income approach.

Our audit risk rating for property, plant and equipment is **higher** because these assets are proportionately significant to the financial statements of TAHE, and are subject to management judgements and estimates when determining their fair values. These judgements and estimates often require the assistance of a qualified valuer upon revaluation.

Furthermore, a change in classification to for-profit, from the not-for-profit status of the former RailCorp, requires a review of all TAHE's accounting policies including its valuation approach. Previously, as a not-for-profit, the infrastructure assets were valued using a cost approach. Treasury Policy Paper TPP 21-09 'Valuation of Physical Non Current Assets at Fair Value' recognises that for for-profit entities holding infrastructure assets, the appropriate fair value will be limited to the lower of the income approach and the cost approach.

Audit response

Our audit procedures included testing the accuracy and completeness of the asset register; engaging a valuation expert to assess the appropriateness of the valuation model; reviewing the appropriateness of the valuation approach; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

We reviewed the reasonableness of the judgements and assumptions used by TAHE in determining the fair value. We had differences in key assumptions which resulted in a material misstatement of \$1.2 billion in the TAHE financial statements. The differences related to the discount rates that were applied to the expected cash flows. For further details see 'Audit Observations' section below.

The original value adopted of \$12.8 billion was amended to \$14 billion. We reported this as a corrected misstatement.

Key financial statement risk



Property, plant and equipment – \$21.8 billion



concession assets - \$168 million



concession liabilities - \$243 million

Audit response

On 18 December 2021, a Heads of Agreement was signed between TAHE and its key customers to reflect TAHE's intention to negotiate higher access and licence fees to deliver on its shareholding ministers' expectations to earn a return of 2.5 per cent on contributed equity (inclusive of recovering the revaluation loss incurred in 2020-21), increased from a previous 1.5 per cent. The actual access and licence agreements have not been updated for these fees. TAHE management have advised these will be updated and formalised as soon as possible. The additional \$5.2 billion in access and license fees were added to the discounted cash flow valuation, resulting in an upward revaluation of TAHE's PPE and intangibles to \$17.15 billion. The updated value resulted in a final overall write-down of the assets by \$20.3 billion.

We have reported a high risk observation in our Management Letter over the valuation of assets.

Our audit procedures included reviewing management's assessment of contracts to ensure the scoping assessment for AASB 1059 is appropriate and complete; examining the appropriateness of management's valuation methods for assets; ensuring assumptions and judgments applied are reasonable; assessing the reasonableness of calculation methodology for liabilities recognised under AASB 1059; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

There was a difference of opinion between audit and TAHE management which was subsequently resolved and resulted in a correction of \$97.2 million misstatement and disclosure deficiencies in the TAHE financial statements. Refer above for discussion on the differences.

The implementation of AASB 1059 'Service Concession Arrangements: Grantor' had a significant impact on TAHE's financial statements. TAHE's service concession arrangements balance included the Airport Link contract.

Our audit risk rating for service concession assets and related financial liabilities is **higher** because of:

- financial significance of the service concession assets and liabilities
- extent of significant judgements underpinning key assumptions used in the valuation process
- sensitivity of service concession assets and liabilities to changes in key assumptions
- the additional disclosure requirements in the financial statements.

Control of assets - \$21.8 billion

Key financial statement risk

At 30 June 2021, TAHE's statement of financial position reported \$21.8 billion in property, plant and equipment and \$1.5 billion in depreciation expenses.

To recognise an asset, an entity must demonstrate that it controls the future economic benefits embodied in the asset. Indicators of accounting 'control' include the ability to direct the use of the asset and/or prevent other entities directing its use, and obtain substantially all of the economic benefits from the asset.

TAHE has agreements with other parties:

- that provide exclusive or non-exclusive rights to use assets vested in TAHE
- to manage the use of its assets as an agent.

TAHE is also subject to an Operating Licence issued by the Portfolio Minister for the periods 1 July 2020 to 30 June 2021 and 1 July 2021 to 30 June 2023, which impose limits on its legislative functions detailed in the *Transport Administration Act 1988*.

Our audit risk rating for control over assets is **higher** because significant judgements required to determine 'control' over assets, including:

- how this interacts with TAHE's legislative functions and Operating Licence
- the determination of principal and agent under the relevant agreements.

Audit response

Our audit procedures included reviewing relevant professional accounting advice, to assess the reasonableness of the accounting treatment against the requirements of applicable Australian Accounting Standards; examining relevant legislation and regulations and contractual agreements, including the Operating Licence to assess indicators of control against relevant Australian Accounting Standards; reviewing the presentation of the financial statements against the requirements of applicable Australian Accounting Standards.

For the current year, the legal form of the arrangements established in its first year of operation imply TAHE has control over the assets. This was based on the various legal agreements and implementation deed established in the first year of operations. However, risks remain as TAHE is in its early stages, and the actual substance of operations will need to be observed and considered. This was included as a high risk management letter finding. Whilst we accepted TAHE's position on control for the current year, this will remain an area of audit focus in future years as the substance of the arrangements put into place need to be confirmed by observation.

Future limitations to the degree of control TAHE, and its Board, can exercise over its functions may impact the degree of control TAHE has over its assets going forward. As part of the 2021–22 audit, we will monitor and assess whether, in substance, these assets continue to be controlled by TAHE and whether, in substance, TAHE can operate as an independent SOC. We require management continue to demonstrate that TAHE continues to maintain control over its assets and has the ability to operate as an independent SOC.

For further details on this matter refer to the 'Audit Observations' section below.

Department of Transport

The Department of Transport is a NSW Government entity controlled by the NSW Total State Sector. The *Transport Administration Act 1988* states that the affairs of Transport for NSW are to be managed and controlled by the Secretary. The Secretary is defined as the Secretary of the Department of Transport.

The Department of Transport consolidates Transport for NSW, NSW Trains, State Transit Authority of New South Wales, Sydney Ferries, Sydney Metro, Sydney Trains, Transport Service of New South Wales and the Residual Transport Corporation which are under its control.

Loss of control of TAHE

- \$37.7 billion

Key financial statement risk

On 1 July 2020, the former Rail Corporation New South Wales (RailCorp) was renamed the Transport Asset Holding Entity of New South Wales (TAHE) and converted to a statutory State Owned Corporation pursuant to the *Transport Administration Act* 1988 and the *State Owned Corporations Act* 1989. The Department of Transport assessed that TAHE is not a controlled entity.

Our audit risk rating for the loss of control over TAHE is **higher** because the impact of loss of control over TAHE is proportionately significant to the financial statements of the Department of Transport, and is subject to accounting interpretation.

Audit response

Our audit procedures included evaluation of management's assessment over the loss of control over TAHE; review of the governance arrangements of TAHE and its relationship with the Department of Transport; evaluation of legislative and regulatory frameworks; assessing the completeness and accuracy over the net impact of the loss of control as at 1 July 2020; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

Sydney Metro

Sydney Metro is a NSW Government agency constituted to deliver safe and reliable metro passenger services in an efficient, effective and financially responsible manner, and to facilitate and carry out the orderly and efficient development of land in the locality of metro infrastructure.



Key financial statement risk

Sydney Metro's property, plant and equipment consists of specialised assets such as infrastructure assets, rolling stock and land and buildings, which are measured at fair value based on their current replacement cost.

Our audit risk rating for property, plant and equipment is **higher** because these assets are proportionately significant to the financial statements of Sydney Metro, and are subject to management judgements and estimates when determining their fair values. These judgements and estimates often require the assistance of a qualified valuer upon revaluation.

Audit response

Our audit procedures included testing the accuracy and completeness of the asset register; reviewing the appropriateness of the valuation approach; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.



Service concession assets \$10.1 billion



Service concession liabilities - \$2.3 billion

Key financial statement risk

The implementation of AASB 1059 'Service Concession Arrangements: Grantor' had a significant impact on Sydney Metro's financial statements. Sydney Metro's service concession arrangements balance includes the Northwest Rapid Transit relating to the Sydney Metro North West Line and the Sydney Metro City and Southwest project.

Our audit risk rating for service concession assets and related financial liabilities is **higher** because of:

- financial significance of the service concession assets and liabilities
- extent of significant judgements underpinning key assumptions used in the valuation process
- sensitivity of service concession assets and liabilities to changes in key assumptions.
- the additional disclosure requirements in the financial statements.

Audit response

Our audit procedures included reviewing management's assessment of contracts to ensure the scoping assessment for AASB 1059 is appropriate and complete; examining the appropriateness of management's valuation methods for assets; ensuring assumptions and judgments applied are reasonable; assessing the reasonableness of calculation methodology for liabilities recognised under AASB 1059; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

Sydney Trains

Sydney Trains is a statutory authority and operates rail services across the metropolitan Sydney area. Its objective is to deliver safe, customer focused, reliable and clean rail services in an efficient, effective and financially responsible manner.



Provision for redundancy – \$20.4 million

Key financial statement risk

Sydney Trains reported a provision for the cost of its redundancy programs as a result of various initiatives and reform activities.

Our audit risk rating for provision for redundancy is **higher** because these liabilities are proportionately significant to the financial statements of Sydney Trains, and are subject to management judgements and estimates. The exact timing and amount of the payment is also subject to uncertainty.

Audit response

Our audit procedures included testing the accuracy and completeness of the employee masterfile; reviewing the appropriateness of the calculation for provision for redundancy; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

NSW Trains

NSW Trains is a statutory authority and manages the operation of NSW TrainLink, providing services between Sydney and the Hunter, Central Coast, Blue Mountains, Southern Highlands and Illawarra and South Coast regions. Its principal objective is to deliver safe and reliable railway and coach passenger services in New South Wales in an efficient, effective and financially responsible manner.

Provision for redundancy – \$1.8 million

Key financial statement risk

NSW Trains reported a provision for the cost of its redundancy programs as a result of various initiatives and reform activities.

Our audit risk rating for provision for redundancy is **higher** because these are subject to management judgements and estimates. The exact timing and amount of the payment is also subject to uncertainty.

Audit response

Our audit procedures included testing the accuracy and completeness of the employee masterfile; reviewing the appropriateness of the calculation for provision for redundancy; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

State Transit Authority of New South Wales

State Transit Authority of New South Wales is a statutory authority and provides bus services in metropolitan Sydney under the Sydney Metropolitan Bus Service Contracts. It operated under five year contracts with the NSW Government in three contract regions.



Franchising of bus operations

Key financial statement risk

State Transit Authority of New South Wales operated three contract regions under contract from the NSW Government. On 24 October 2019, the NSW Government announced that the State Transit Authority of New South Wales' three bus contract regions, Regions 7, 8 and 9, would be put out to competitive tender as part of wider changes to the Sydney bus network, with the new operators planned to take over operations in three stages. State Transit Authority of New South Wales will not be taking part in the tender.

Our audit risk rating for preparation of the financial statements under a going concern basis is **higher** because of the significance of the impact that the franchising of bus contracts will have on the going concern assertion for the preparation of the financial statements. Furthermore, it will have a pervasive impact on the disclosures in the financial statements.

Audit response

Our audit procedures included evaluation of the appropriateness of management's assessment that the financial statements should not be prepared under a going concern basis; assessing the appropriateness of management's estimate of liabilities; reviewing the appropriateness of management's assessment of the impact on the fair value and impairment of assets; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

Sydney Ferries

Sydney Ferries is a statutory corporation initially established to deliver public ferry services in Sydney. Since July 2012, an external operator was awarded a contract to operate ferry services on Port Jackson and the Parramatta River. The external operator leases the vessels, land and buildings from Sydney Ferries.

Property, plant and equipment – \$82.3 million

Key financial statement risk

Sydney Ferries' property, plant and equipment consists of ferries, land and buildings and property, plant and equipment, which are measured at fair value based on their current replacement cost.

Our audit risk rating for property, plant and equipment is **higher** because these assets are proportionately significant to the financial statements of Sydney Ferries, and are subject to management judgements and estimates when determining their fair values. These judgements and estimates often require the assistance of a qualified valuer upon revaluation.

The implementation of AASB 1059 'Service Concession Arrangements: Grantor' had an impact on Sydney Ferries' financial statements, resulting in a reclassification of assets. Sydney Ferries' service concession arrangements balance includes the Ferry system contract.

Our audit risk rating for service concession assets is **higher** because of:

- financial significance of the service concession assets
- extent of significant judgements underpinning key assumptions used in the valuation process
- sensitivity of service concession assets to changes in key assumptions
- the additional disclosure requirements in the financial statements.

Audit response

Our audit procedures included testing the accuracy and completeness of the asset register; reviewing the appropriateness of the valuation approach; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.



Service concession assets – \$108.7 million Our audit procedures included reviewing management's assessment of contracts to ensure the scoping assessment for AASB 1059 is appropriate and complete; examining the appropriateness of management's valuation methods for assets; ensuring assumptions and judgments applied are reasonable; and reviewing the presentation of the financial statements in accordance with the Australian Accounting Standards.

3. Audit observations

Appropriate financial controls help ensure the efficient and effective use of resources and administration of agency policies. They are essential for quality and timely decision making.

This chapter outlines our observations and insights from our financial statement audits of agencies in the cluster.

Section highlights

- The number of findings reported to management increased from 56 in 2019–20 to 73 in 2020–21.
- Thirty-seven per cent were repeat findings. Many repeat issues related to
 information technology controls around user access management and payroll
 processes. These included deficiencies in the monitoring of privileged user
 access to key financial systems, review of user access to key financial systems
 and segregation of duties between preparer and reviewer for new employee
 hires
- Six new high risk issues were identified in 2020–21, an increase of three compared to last year.
- One high risk issue related to conflicts of interests not being declared by all
 officers involved in the land acquisition process at Transport for NSW.
- Five of high risk issues arose from the audit of TAHE, with respect to:
 - control over TAHE assets and operations
 - asset valuations
 - access price build up
 - detailed business modelling to support returns
 - conflict of interest management.
- Based on the access and licence agreements signed at 30 June 2021 between TAHE, Sydney Trains and NSW Trains, our review of the expected returns calculated by NSW Treasury did not support the assumption that there was a reasonable expectation that a sufficient rate of return could be achieved from the NSW Government's investment in TAHE.
- On 14 December 2021 the shareholding ministers increased their expectations as to TAHE's target average return from 1.5 per cent to the expected long-term inflation rate of 2.5 per cent.
- On 18 December 2021 the revised shareholder expectations were confirmed in a signed Heads of Agreement. The Heads of Agreement will increase access fees paid by rail operators to TAHE by \$5.2 billion.
- TAHE's access and licence agreements specified fees that were well short of the IPART regulated maximum (ceiling price).
- The finalisation of the access and licence agreements with Sydney Trains and NSW Trains resulted in a significant write-down of TAHE's asset value by \$20.3 billion. The revaluation loss will need to be recovered as part of the shareholders' rate of return of 2.5 per cent in order to sustain the whole-of-government accounting treatment of cash contributions recorded as an equity contribution and not a grant expense.
- There was a significant adjustment to TAHE's valuation between the financial statements originally submitted for the audit and the final, signed financial statements due to differences in risk assumptions resulting in a correction of a \$1.2 billion misstatement.

Findings reported to management

The number of findings reported to management has increased, and 37 per cent of all issues were repeat issues

Breakdowns and weaknesses in internal controls increase the risk of fraud and error. Deficiencies in internal controls, matters of governance interest and unresolved issues were reported to management and those charged with governance of agencies. The Audit Office does this through management letters, which include observations, related implications, recommendations and risk ratings.

In 2020–21, there were 73 findings raised across the cluster (56 in 2019–20) and 37 per cent of all issues were repeat issues (43 per cent in 2019–20).

In view of the recent performance audit 'Managing Cyber Risks' and compliance audit 'Compliance with the NSW Cyber Security Policy' involving the cluster, it is noted with concern that the most common repeat issues related to weaknesses in controls over information technology user access administration and password management. Moderate risk issues included completeness and accuracy of contract registers, accounting for assets and management of supplier and payroll masterfiles.

A delay in implementing audit recommendations increases the risk of intentional and accidental errors in processing information, producing management reports, and generating financial statements. This can impair decision-making, affect service delivery and expose agencies to fraud, financial loss and reputational damage. Control deficiencies may also mean agency staff are less likely to follow internal policies, inadvertently causing the agency not to comply with legislation, regulation, and central agency policies.

The table below describes the common issues identified across the cluster by category and risk rating.

Risk rating Issue

Information technology



Moderate: 7 new, 4 repeat



Low: 4 new, 1 repeat

The financial audits identified opportunities for agencies to improve information technology processes and controls that support the integrity of financial data used to prepare agencies' financial statements. Of particular concern are issues associated with:

- · monitoring of privileged user access
- user access management
- password configuration management.

Internal control deficiencies or improvements



High: 1 new



Moderate: 15 new, 8 repeat



Low: 2 new, 5 repeat

The financial audits identified internal control deficiencies across key business processes, including:

- declarations of conflicts of interest over land acquisitions (see further details below)
- · management of contracts and agreement register
- · accounting for assets
- management of payroll and supplier masterfiles
- · payroll processes.

Risk rating Issue

Financial reporting

High:

High: 3 new

Moderate: 3 new, 1 repeat



Low: 2 new

The financial audits identified opportunities for agencies to strengthen financial reporting, including:

- asset valuations (see further details below)
- detailed business modelling to support returns (see further details below)
- access price build-up (see further details below)
- · timely capitalisation of completed assets.

Governance and oversight

High: 1 new



Moderate: 2 new

The financial audits identified opportunities for agencies to improve governance and oversight processes, including:

- control over TAHE assets and operations
- governance over Cyber Security.

Non-compliance with key legislation and/or central agency policies

High: 1 new

Moderate: 4 new, 1 repeat

Low: 1 new, 7 repeat

The financial audits identified the need for agencies to improve its compliance with key legislation and central agency policies, including:

- conflict of interest (COI) management
- · outdated policies and procedures
- · incomplete probation procedures.



Extreme risk from the consequence and/or likelihood of an event that has had, or may have a negative impact on the entity.



High risk from the consequence and/or likelihood of an event that has had, or may have a negative impact on the entity.



Moderate risk from the consequence and/or likelihood of an event that has had, or may have a negative impact on the entity.

Low risk from the consequence and/or likelihood of an event that has had, or may have a negative impact on the entity.

Note: Management letter findings are based either on final management letters issued to agencies.

2020-21 audits identified six high risk findings

High risk findings were reported at the following cluster agencies.

Agency Description

2020-21 findings

Transport for NSW (new finding)

Declaration of conflicts of interest in the land acquisition process

In 2021, we conducted a performance audit over the Acquisition of 4–6 Grand Avenue, Camellia which examined:

- whether Transport for NSW conducted an effective process to purchase 4–6 Grand Avenue, Camellia
- whether Transport for NSW has effective processes and procedures to identify and acquire property required to deliver the NSW Government's major infrastructure projects.

The report made several recommendations over Transport for NSW's internal policies and procedures to guide the land acquisition process. As part of the financial audit, we obtained an understanding of key controls and processes relating to the acquisition of land, relevant to the audit of the financial statements. We found that conflicts of interests were not always declared by all officers involved in the land acquisition process. Furthermore, processes for declaring conflicts of interests are not consistently applied across cluster agencies.

2020-21 findings

Out of a sample of 19 land acquisitions tested, we identified:

- 14 instances where there was no evidence of declarations of conflicts of interests made by the team members involved in the acquisition process
- 2 instances where conflicts of interest declarations were completed by key members of the acquisition team only at a project level
- 1 instance where conflicts of interest declarations were only completed by the property negotiator and the valuer, but not the other members of the acquisition team.

Management advised that the land acquisition processes, at the time of the land acquisitions, did not require formal conflicts of interests to be declared as they believe that as per Transport for NSW code of conduct, declaration is only required where the staff member considers that a potential or perceived Conflict of Interest exists. However, Transport for NSW's Procurement Policy requires the documentation of formal declarations from all staff involved in procurement activities to formally disclose any conflicts of interest or state that they do not have a conflict of interest.

This matter has been included as a high risk finding in the management letter as absence of rigorous and consistent management of conflicts of interests, and non-compliance with established policies increases the risk that Transport for NSW may be exposed to reputational damage or financial losses in relation to land acquisitions. Furthermore, this may result in lack of probity or value-for money considerations during the land acquisition process.

Further details are elaborated below under 'Land acquisitions'.

Transport Asset Holding Entity of New South Wales (new finding)

Control over TAHE assets and operations

The State Owned Corporations Act 1989 maintains that all decisions relating to the operation of a statutory State Owned Corporation (SOC) are to be made by or under the authority of the board. However, under the *Transport Administration Act 1988* (TAA), the functions of TAHE may only be exercised under one or more operating licences issued by the Portfolio Minister. The current Operating Licence confers terms and conditions for TAHE to carry out its functions, and imposes constraints on TAHE, including (but not limited to):

- · railway operations not permitted
- transport services not permitted
- TAHE must not carry out maintenance of its assets.

Such operating licences are short term in nature, and the TAA allows the Transport Minister (Portfolio Minister) to grant one or more operating licences to TAHE and may amend, substitute, or impose, amend or revoke conditions of the operating licence.

For the current year, the legal form of the arrangements established in its first year of operation imply TAHE has control over the assets based on the Implementation Deed and the agreements signed with the public operators.

However, risks remain as TAHE is in its early stages, and the actual substance of operations will need to be observed and considered.

2020-21 findings

Given the restrictions that can be placed on the entity through the Operating Licence, and the ability to make further changes to the Operating Licence and Statement of Expectations set by the Portfolio Minister, there is a risk there could be limitations placed on the Board of Directors to operate with sufficient independence in its decision-making with respect to the operations of TAHE. Over time, this may further impact the degree of control required by TAHE to satisfy the recognition criteria over its assets. It may also fundamentally change the presentation of TAHE's financial statements.

Future limitations to the degree of control TAHE, and its Board, can exercise over its functions may impact the degree of control TAHE has over its assets going forward. As part of the 2021–22 audit, we will monitor and assess whether, in substance, these assets continue to be controlled by TAHE and whether, in substance, TAHE can operate as an independent SOC. We require management continue to demonstrate that TAHE continues to maintain control over its assets and has the ability to operate as an independent SOC. Further details are described below under 'Transport Asset Holding Entity'.

Transport Asset Holding Entity of New South Wales (new finding)

Asset valuation

The final updated valuation was based on cash flows that were in a signed Heads of Agreement, which stated that it set out the proposed indicative future access and licence fees which will form the basis of the negotiations between TAHE, Transport for NSW, Sydney Trains and NSW Trains, who will work together to review access fees and licence fees payable under the agreements and to make all necessary changes to the Operating Agreements by 1 July 2022.

This adds uncertainty in the cash flows. It is crucial that TAHE formalises these updated fees in legally binding signed access and licence agreements with the relevant parties as soon as possible.

Refer below for further details on the Heads of Agreement.

Transport Asset Holding Entity of New South Wales (new finding)

Conflict of interest (COI) management

For procurement transactions through direct negotiation with single quotes, there was no evidence of COI declarations obtained from the consultants and contractors regarding involvement in other engagements. Contractors and consultants are required to declare actual COI. However, there was no requirement to confirm nil conflict of interest. In addition, there is a risk that perceived COI may not be adequately assessed or managed. TAHE is expected to operate as an independent SOC and would need to ensure any perceived or actual conflict of interest is adequately addressed.

Management should implement a process to:

- ensure conflicts of interest declarations are completed when engaging all consultants and contractors (including involvement with other engagements and confirmation of nil conflicts of interests)
- ensure probity is undertaken to identify any actual or perceived conflicts of interest.

The declarations should consider individuals and relationships that may create, or may be perceived to create, conflicts of interest.

2020-21 findings

Transport Asset Holding Entity of New South Wales (new finding)

Detailed business modelling to support returns

On 18 December 2021, Transport for NSW, TAHE and the operators, Sydney Trains and NSW Trains entered into a Heads of Agreement (HoA). This HoA forms the basis of negotiations to revise the pricing within the existing 10-year contracts and deliver upon the shareholders' expectation of a return of 2.5 per cent per annum of contributed equity, including recovering the revaluation loss incurred in 2020–21.

TAHE needs to revise its business plan and include detailed business modelling that supports the shareholding ministers' revised expectations of return (2.5 per cent return on the State's equity injections and recovery of the write-down of assets over the average useful life of those assets) and align the business plan and Statement of Corporate Intent. This requires more detailed projections, estimates and plans that support how TAHE expects to recover the asset write-down and expected returns to government. The current modelling for ten years needs to be enhanced with modelling over the expected recovery period of approximately 33 years.

Transport Asset Holding Entity of New South Wales (new finding)

Access price build-up

Management explained that in determining access and licence fees for the agreements with Sydney Trains and NSW Trains, assets prior to the commencement of equity injections in 2015–16 were excluded from the calculations. Management explained the premise being that these assets were previously funded by government through capital grants. The replacement and refurbishment of these assets is expected to be through government funded maintenance performed through the public rail operators and/or the equity injections from NSW Treasury rather than through access and licence fees.

The number of moderate risk findings increased from prior year

Forty-five moderate risk findings were reported in 2020–21, representing a 73.1 per cent increase from 2019–20. Of these, 14 were repeat findings, and 31 were new issues.

Key moderate risk findings related to:

- weaknesses in user access management to key financial systems
- management of contracts and agreements register
- management of supplier and payroll masterfiles
- accounting for assets
- control deficiencies at service organisations
- segregation of duties relating to the hiring of employees
- conflict of interest management
- annual leave management
- review of internal audit charter
- disaster recovery planning.

Transport Asset Holding Entity of New South Wales

Background

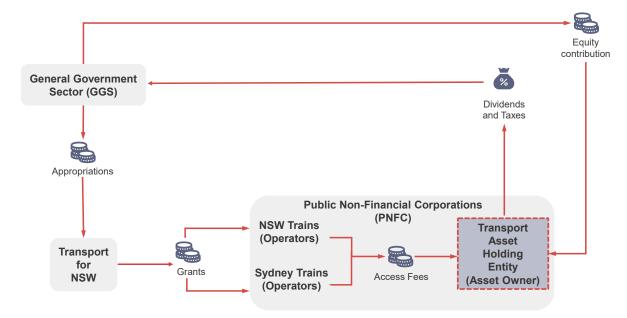
The establishment of TAHE was originally announced by the NSW Government in the 2015–16 State Budget. On 1 July 2020, the former Rail Corporation New South Wales (RailCorp), a not-for-profit entity, transitioned to the Transport Asset Holding Entity of New South Wales (TAHE), a for-profit statutory State-Owned Corporation under the *Transport Administration Act 1988*. There was no change in the structure of TAHE as a new entity was not created. Ownership remains fully with the government. TAHE, and the former RailCorp, were both classified as Public Non-Financial Corporation (PNFC) entities within the Total State Sector Accounts.

Prior to 1 July 2015, the government paid appropriations to Transport for NSW, a General Government Sector (GGS) agency, to construct transport assets. When completed, these assets were granted to the former RailCorp, a not for-profit entity within the PNFC sector. The grants to the former RailCorp were recorded as an expense in the State's GGS budget result.

From 1 July 2015, the government announced the creation of TAHE (a dedicated asset manager). Funding for new capital projects was to be provided through equity injections and was no longer recorded as an expense to the GGS budget, even though the business model was yet to be determined. The change, as explained in the 2015–16 State Budget, was due to the expectation that the former RailCorp will transition to TAHE, which was intended, over time to provide a commercial return. That Budget also highlighted how the change, which was largely a change in the basis of accounting, was intended to improve the GGS budget result each year. In total, the GGS has contributed approximately \$11.1 billion to TAHE since 2015–16. This includes the equity injections from the GGS to TAHE made in the current year of \$2.4 billion.

NSW Treasury initially set a timetable for the stand-up of TAHE of 1 July 2019, which included finalising the business model, operating model and contracts for the use of TAHE's assets. The enactment of the *Transport Administration Act 1988* resulted in RailCorp transitioning to TAHE on 1 July 2020, 12 months after its originally planned operational date. Contributions paid to the former RailCorp and subsequently to TAHE by the GGS were treated as equity investments from July 2015 forward. This treatment continued, despite delays in settling the business model. In 2020, the Audit Office raised a high risk finding due to the significance of the financial reporting impacts and business risks for NSW Treasury and TAHE.

The business model adopted and the flow of funds between transport agencies in the GGS and PNFC sectors is shown in the diagram below. For further details refer to the Report on State Finances 2021.



The premise of the change from grants expense to equity injections was based on the expectation that TAHE would provide a sufficient rate of return in the future. For further details on the discussion on sufficient rate of return, refer to the Report on State Finances 2021.

NSW Treasury has not developed a formal policy or benchmark to guide its expectations for returns on GGS investments in State Owned Corporations (including TAHE). In our view, the concept of a 'sufficient rate of return' should be considered to be at least equal to the long-term inflation rate. In the absence of a NSW Treasury formal policy or benchmark as to what is a sufficient rate of return for GGS investments in other sectors, we had regard to guidance provided by the Australian Government's Department of Finance (Finance). Finance published in its July 2018 Finance Advice Paper that for an investment to be fully regarded as equity, it should expect to earn a rate of return at least equal to the long-term inflation rate (i.e. currently 2.5 per cent) and there should be a reasonable expectation that the investment will be recovered.

Our review of NSW Treasury's expected returns, which were calculated using the access and licence agreements signed on 30 June 2021 between TAHE, Sydney Trains and NSW Trains, did not support the conclusion that a sufficient rate of return could reasonably be expected

Our review of all evidence received prior to 14 December 2021 indicated the GGS's expected returns were below the long term inflation rate and that there was no expectation it could recover a significant asset revaluation loss. The levels of projected returns did not support the accounting treatment of the GGS's cash contribution of \$2.4 billion to TAHE as an equity injection.

The existing revenue arrangements reflected a shareholders' expected rate of return of only 1.5 per cent per annum of contributed equity and did not include recovery of the revaluation loss of \$20.3 billion incurred in 2020–21.

To support the TAHE structure as a commercial arrangement earning a sufficient rate of return, the NSW Government agreed to commit additional future funding to TAHE's key government customers (Sydney Trains and NSW Trains) to support increases in access and licence fees to be paid to TAHE.

The shareholding ministers increased their expectations as to TAHE's target average return to the expected long-term inflation rate of 2.5 per cent

On 14 December 2021, a government decision was made resulting in the TAHE Shareholding Ministers requesting that TAHE re-negotiate the access fees and license fees payable under the Operating Agreements between TAHE and the public operators (Sydney Trains and NSW Trains). The renegotiation was to target an average return to the GGS of 2.5 per cent on the equity contributed.

The Shareholding Ministers' revised expectations for TAHE were published in the 2021–22 'NSW Budget Half Yearly Review' on 16 December 2021. The revised expectations changed the basis of the expected returns on equity from the 10-year Commonwealth bond rate of only 1.5 per cent, to the expected long-term inflation rate of 2.5 per cent.

The revised shareholders' expectations were confirmed in a signed Heads of Agreement

On 18 December 2021, Transport for NSW, TAHE and the operators, Sydney Trains and NSW Trains entered into a Heads of Agreement (HoA). This HoA forms the basis of negotiations to revise the pricing within the existing 10-year contracts and deliver upon the shareholders' expectation of a return of 2.5 per cent per annum of contributed equity.

The HoA reflects an intention between all parties to revise the contractual agreements to increase future access and license fees by \$5.2 billion. This included \$1.1 billion for the period FY2023–25, which is reflected in the 2021–22 'NSW Budget Half Yearly Review'.

Refer below and the Report on State Finances 2021 for further details and subsequent impacts.

Access and Licence Fees

Access and licence fee agreements were signed between TAHE, Sydney Trains and NSW Trains on 30 June 2021. Subsequently, a Heads of Agreement signed on 18 December 2021 increased the fee structure to provide a sufficient rate of return

On commencement of TAHE on 1 July 2020, key commercial arrangements such as access arrangements between TAHE and the rail operators had not been finalised. TAHE had not established commercial arrangements with the public rail operators, Sydney Trains and NSW Trains, to provide them access to the rail network and heavy rail assets. The legacy arrangements from the former RailCorp transitioned to TAHE, where no network access fees are paid by these rail operators. Maintenance expenses for the TAHE rail assets continue to be paid by the public rail operators.

In our Transport 2020 Report, we recommended TAHE finalise its agreements with the public rail operators. On 30 June 2021, TAHE entered into new agreements with Sydney Trains and NSW Trains effective from 1 July 2021 for a period of ten years. The agreements set out the terms on which TAHE's assets are used, licenced and maintained and provide access rights to the rail network, the stations and the rolling stock. The impact of these agreements in future periods was net cash inflows of approximately \$680 million in 2021–22 and \$11.9 billion over ten years.

In calculating the access and licence fees for the 30 June 2021 agreements, TAHE only sought to recover a return on equity injections made to the former RailCorp from 2015–16 onwards. Its approach excluded consideration of all of the assets previously granted to, or acquired by the former RailCorp prior to 2015. In effect, while the operators access the full network of assets, they would only be required to pay for a portion of it. The cashflows are not reflective of the full asset base, but were used to value the full asset base. The contracted cashflows from the licence and access fees with Sydney Trains and NSW Trains are based on the expected rate of return determined by the shareholding ministers on the equity contributions received from 2015–16 onwards. The remaining asset base is considered to be 'gifted assets' from the government to TAHE. TAHE advised there is no expectation from government for TAHE to generate revenue from access and licence fees from the 'gifted assets'.

Therefore, the 2021–22 access and licence fees were determined based on an asset base of \$7.8 billion (the equity injections from 2015–16 to 2020–21 less any assets still under construction and not in use) and an expected return on these assets of 1.5 per cent. The future year access and licence fees have been determined based on assumed future equity injections and CPI adjustments. We have raised a high risk management letter issue for management to consider whether it is appropriate to only expect a return on the assets capitalised from 2015–16 onwards whilst providing access to the whole network of assets. The access and licence fees set by TAHE have a significant impact on the valuation of its assets as discussed further below.

The Heads of Agreement will increase access fees paid by rail operators to TAHE by \$5.2 billion

Subsequent to the agreements signed on 30 June 2021, on 18 December 2021, TAHE signed a 'Heads of Agreement' (HoA) with Sydney Trains, NSW Trains and Transport for NSW. The HoA set out the parties' intention to revise the original access and licence agreement and to revisit the pricing model. The HoA proposes indicative future access and license fees that will form the basis of negotiations to meet the revised shareholders' expectation of a return of 2.5 per cent per annum of contributed equity and recover the holding (revaluation) loss of \$20.3 billion. This represents an increase from the current contracts that reflect a shareholders' expected rate of return of 1.5 per cent per annum of contributed equity without an intention to recover the holding loss.

The revised HoA covers the period FY2022–FY2031 and includes projected access and license fees totalling \$17.14 billion over this period. This is an increase of \$5.2 billion on the existing commercial agreements between TAHE and Sydney Trains and NSW Trains for the same period, which came into effect from 1 July 2021. The HoA plans to increase access and license fees by \$1.1 billion over the period FY2022–25 as part of the annual renegotiation of prices under the terms of the existing contracts. Funding for the increases was included in the 2021–22 'NSW Budget Half Yearly Review' as part of the forward estimates and approved by government. The remaining \$4.1 billion increase is planned over the period FY2025–31, and is outside of the forward estimates. The revised access fees will significantly increase costs to the GGS budget in future years.

The \$5.2 billion increase in access and license charges by TAHE would appear to need to be funded through additional grants and subsides paid by the GGS to the rail operators. The additional funding may be significant, particularly in the years beyond the current budget estimates period.

The funding burden of higher access and license fees is expected to increase even more beyond the forward estimates period of 2023–2025. Conversely, equity contributions from the GGS to TAHE will significantly decrease over the same period. This means the benefits to the budget result of equity contributions are realised in previous years and over the current budget forward estimates period. Higher expenses are expected in years beyond the forward estimates, which will negatively impact the budget result in those years.

For further details, refer to the Report on State Finances 2021.

TAHE's contracts with its key customers (the two government rail operators Sydney Trains and NSW Trains) specified access and licence fees that were below the regulated maximum

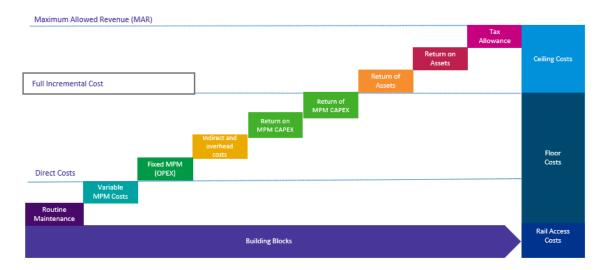
The Independent Pricing and Regulatory Tribunal (IPART) NSW Rail Access Undertaking (NSW RAU) sets out the pricing principles that TAHE needs to apply for access to the regulated assets (rail network). The NSW RAU sets out the principles to calculate a floor and ceiling price. The access fees TAHE sets for the access seekers should be above the floor price and must be below the ceiling price. IPART assess compliance with the ceiling test on an annual basis.

These pricing principles are not required to be applied to the unregulated assets (train stations and rolling stock). This means TAHE does not have to comply with any ceiling tests for its pricing on its licencing arrangements to provide access to its trains stations and rolling stock.

Under the IPART NSW RAU principles:

- The Floor test requires the revenue from access seeker at least meet the direct cost imposed by that access seeker (Access revenue >= Direct costs).
- The Floor test requires the revenue from access seeker should as an objective meet the full incremental cost (Access revenue >= Full incremental cost).
- The Ceiling test requires that revenue from the access seeker must not exceed the Maximum Allowable Revenue (Access revenue <= Maximum Allowable Revenue).

Direct costs are calculated as the sum of routine maintenance and variable major periodic maintenance (MPM) expense. Full incremental costs are calculated as direct costs plus fixed MPM expense, indirect and overhead costs, return on and return of MPM capital expenditure. Maximum allowable revenue (MAR) is calculated as direct costs plus full incremental costs plus a return of the assets (depreciation), return on the assets (based on a rate of return set by IPART) and tax allowance.



Source: TAHE Cost and Pricing Access Model June 2021 (unaudited).

The direct costs for the Metropolitan Rail Network are currently being paid by the public rail operators and not TAHE. In accordance with Rail Safety National Law (NSW) 2012 (RSNL 2012), Sydney Trains is registered as a Rail Infrastructure Manager (RIM) and Rolling Stock Operator under the Rail Safety National Law (NSW) 2012 (RSNL 2012) and are obligated under the legislation to maintain the rail infrastructure (Metropolitan Network) and rolling stock to ensure safe railway operations. NSW Trains is registered as a Rolling Stock Operator under the RSNL 2012 and has the obligation to maintain the rolling stock. Entities are required to register as a RIM and Rolling Stock Operator through Office of the National Rail Safety Regulator (ONRSR). TAHE is not noted as a RIM in the RNSL Act. The registration as RIM requires Sydney Trains to carry out all maintenance activities on the rail infrastructure on the Metropolitan Network and Sydney Trains and NSW Trains to carry out maintenance of the rolling stock. NSW Treasury pays grants to Sydney Trains and NSW Trains annually to pay for these maintenance expenses directly.

As at 30 June 2021, an external third party, John Holland Rail Pty Ltd (John Holland), was accredited as the RIM for the Country Regional Network under the RNSL 2012. As John Holland is not a government agency, NSW Treasury pays grants to TAHE to pay John Holland for these maintenance expenses.

The resulting outcome of Sydney Trains and NSW Trains directly paying for the maintenance expenses is that the majority of the direct costs used to calculate the floor price under the NSW RAU is borne by the public rail operators. Therefore, in comparing access fees charged to Sydney Trains and NSW Trains to floor and ceiling price, the direct costs paid by the public rail operators need to be factored in.

The access and licence fees in the 30 June 2021 agreements were below the regulated maximum. The revised access and licence fees in the Heads of Agreement are also below the regulated maximum based on management's review of TAHE's expected return on assets compared to the IPART regulated rate of return on assets. The following tables compare the access revenue and maintenance costs incurred by public rail operators to the floor and ceiling price.

Access revenue under the current agreements signed on 30 June 2021

Revenue (30 June 2021 agreements)*		Maintenance incurred by public rail operators** Total charges (access revenue plus maintenance expense incurred) i		Floor price (Direct Cost plus full incremental cost)	Ceiling price (maximum allowable revenue)	
	(\$'000)	(\$'000)	(\$'000)	(\$'000)	(\$'000)	
Metropolitan Netw	ork (MPN)					
Sydney Trains	228,200	497,000	725,200	602,613	1,588,312	
NSW Trains	66,600	193,000	259,600	318,195	831,869	
Private operators	54,898		54,898	142,913	340,099	
Country Regional Network (CRN)						
NSW Trains	19,999		19,999	12,130	114,037	
Private operators	6,048			100,369	397,660	

^{*} Revenue based on fees effective on 1 July 2021.

Source: TAHE Cost and Pricing Access Model June 2021 (unaudited) and Access and Licence agreements signed on 30 June 2021.

Access revenue under the Heads of Agreement signed on 18 December 2021

	Revenue (heads of agreement)* (\$'000)	Maintenance incurred by public rail operators** (\$'000)	Total charges (access revenue plus maintenance expense incurred) (\$'000)	Floor price (Direct cost plus full incremental cost) (\$'000)	Ceiling price (maximum allowable revenue) (\$'000)
Metropolitan Network (MPN)					
Sydney Trains	350,900	497,000	847,900	602,613	1,588,312
NSW Trains	107,300	193,000	300,300	318,195	831,869
Private Operators	54,898		54,898	142,913	340,099

The Heads of Agreement only impacted Sydney Trains and NSW Trains for their access to the Metropolitan Network (MPN). The Heads of Agreement did not impact the revenues relating to the Country Regional Network (CRN).

Source: TAHE Cost and Pricing Access Model June 2021 (unaudited) and Heads of Agreement signed on 18 December 2021.

A report from an external consultant engaged by Transport for NSW, and considered by the TAHE Advisory Board in 2017–18, also indicated that planned low access and licence fees were not going to be sufficient to maintain the former RailCorp's existing asset values.

The 2015–16 NSW Budget provided \$700 million per year in the forward estimates to be provided to Sydney Trains and NSW Trains (the operators) to meet the cost of expected access charges that would become payable to TAHE, once it was established. In 2020–21, TAHE and the operators agreed actual access and license charges at \$680 million per annum, and increasing thereafter.

Maintenance expense incurred by public rail operators for FY 2021 for regulated assets.

^{*} Revenue based on fees effective on 1 July 2022 as there was no change to fees for 2021–22 under the Heads of Agreement.

^{**} Maintenance expense incurred by public rail operators for FY 2021 for regulated assets.

The fees contracted between TAHE and the operators were significantly lower than the maximum allowable revenue established by the IPART NSW Rail Access Undertaking¹. Furthermore, the licence fees to access stations and rolling stock are not regulated by IPART. Even though there was no regulatory impediment for TAHE to charge higher track access and licence fees, it did not do so. Higher fees would have likely impacted the GGS budget, as these fees are funded by the GGS through grants to the operators (i.e. Sydney Trains and NSW Trains). Based on the floor and ceiling calculated by TAHE in 2020–21 and the maintenance expense paid by operators for 2020–21, the total of maintenance expense and the revised fees in the 18 December HoA would sit below the ceiling price (see table above).

In addition, the current arrangements between TAHE and the private operators result in access prices that are below the floor price in accordance with the IPART NSW Rail Access Undertaking for the Country Regional Network. Furthermore, NSW Trains are charged a very low fee for access to the Country Regional Network. TAHE receives grants from Transport for NSW to cover the shortfall between access fee revenue and the maintenance expense for the Country Regional Network. However, TAHE is required to continue providing access to this network as it is required for the passenger services and freight movements to regional and interstate areas. This results in the Country Regional Network generating income that is far less than what it costs to operate and maintain the network.

Valuation of TAHE assets

The finalisation of the access and licence agreements with Sydney Trains and NSW Trains resulted in a significant write-down of TAHE's asset value

The signing of the access and licence fee agreements on 30 June 2021 and the subsequent Heads of Agreement on 18 December 2021, resulted in significant impacts on the value of TAHE's assets and related depreciation expense.

Prior to 1 July 2020, the former RailCorp was classified as a not-for-profit entity. This was on the basis that making a profit was not a principal objective of the former RailCorp. On transition to TAHE on 1 July 2020, the entity was classified as a for-profit entity. This was based on the Board decision on classification which was based on guidance provided in the Treasury Policy Paper TPP 05-04 'Distinguishing for-profit from not-for-profit entities' in determining the profit status for financial reporting purposes.

In accordance with Australian Accounting Standards AASB 13 'Fair Value Measurement', there are three different approaches to value assets – market, cost and income approach. The market approach is used when there is an active market for the assets. For example, where is an active market for land, land valuation would be determined based on market value of other comparable land sales. However, for specialised assets for which there is no active market, such as rail assets (track, stations and rolling stock), either the cost or income approach is commonly used. The cost approach requires entities to estimate how much it would cost to replace the service potential of the assets in the current environment. The income approach estimates the expected cash inflows and cash outflows associated with the use of the assets and applies a discount rate to estimate a present value of these assets.

The Treasury Policy Paper TPP 21-09 'Valuation of Physical Non-Current Assets at Fair Value' provides guidance on application of the two approaches. For specialised assets, the income approach will generally be appropriate to for-profit entities or if a not-for-profit entity is generating cash from the use of these assets. TPP 21-09 requires for-profit entities to use either the cost approach or income approach, whichever results in a lower value.

Prior to 1 July 2020, the former RailCorp being a not-for-profit entity, applied the cost approach to value its infrastructure assets. Under TPP 21-09, the cost approach is more appropriate for not-for-profit entities not generating cash from the use of these specialised assets. The former RailCorp was not generating significant cashflows from the use of these assets as it did not charge fees from the public rail operators to access to these assets. Under this approach the former RailCorp recognised an asset value of \$41 billion as at 30 June 2020.

¹ Note: This is after adjusting for operating and maintenance costs incurred directly by the operators.

When TAHE became a for-profit entity on 1 July 2020, TAHE management was required to reassess whether these assets should be valued using the cost or income approach. The income approach relies on the cash flows expected to be generated from the use of the assets. On 1 July 2020, TAHE did not have the access and licence agreements with Sydney Trains and NSW Trains. TAHE management did not finalise access agreements with two of the significant access seekers until 30 June 2021. TAHE valued its property, plant and equipment as at 30 June 2021 using a valuation approach based on its discounted cash flows (DCF). Finalisation of access and licence agreements with Sydney Trains and NSW Trains prior to 30 June 2021 enabled TAHE to develop financial forecasts to value its assets under the DCF approach. As a result of applying the income approach using the expected cash flows from the use of these assets, TAHE ultimately recognised \$20.3 billion write-off of its asset value.

Prior to the 18 December 2021 HoA, the cashflows from the existing commercial contracts were used to determine the fair value of TAHE's non-financial assets. TAHE determined the fair value of its property, plant and equipment (PPE) and related intangibles was \$12.8 billion. This resulted in an initial write-down of \$24.8 billion, including a write-down of the Country Regional Network to nil value.

The write-down of these assets has a significant impact on several other factors including the following:

- One of TAHE's principal objectives is to maximise the net worth of the State's investment in TAHE. The write-down has resulted in a \$20.3 billion loss in value of the State's overall assets.
- For the 2020–21 financial year, the total depreciation expense was based on the higher value under the cost approach. However, the lower asset value of \$17.15 billion at 30 June 2021 compared to \$41 billion will result in significant reduction in depreciation expenses from 2021–22 onwards. The depreciation expense for 2020–21 was \$1.6 billion. The forecast depreciation expense for 2021–22 based on the adjusted value is \$685 million. The effect of the significant reduction in depreciation expense is that it will improve TAHE's net profit position in future years and subsequently the returns to the government.
- One of the main factors driving the low value is due to the access and licence fees being determined based on the 2015–16 onwards equity injections and excluding consideration of the assets previously granted to the former RailCorp (discussed above). In effect, the operators are accessing the full network of assets but only paying for a portion of it. The cashflows are not reflective of the full asset base, however, these are cashflows used to value the full asset base. The contracted cashflows from the licence and access fees with Sydney Trains and NSW Trains are based on the expected rate of return determined by shareholding ministers on the equity contributions received from 2015–16 onwards. The remaining asset base is considered to be gifted assets from the NSW Government and management has advised there is no expectation from NSW Government for TAHE to generate revenue from access and licence fees from the gifted asset base.
- TAHE receives grants from Transport for NSW to cover the shortfall between access fee revenue and the maintenance expense for the Country Regional Network. However, TAHE is required to continue providing access to this network as it is required for the passenger services and freight movements to regional and interstate areas. This results in the Country Regional Network generating income that is far less than what it costs to operate and maintain the network. The income approach results in a fair value of nil for the Country Regional Network. Although this outcome is consistent with the accounting standards and NSW Treasury Policy Paper TPP 21-09, it is an unusual outcome for a significant network of assets, which includes land, stations and rail tracks.

There were significant adjustments to TAHE's valuation between the financial statements originally submitted for the audit and the final, signed financial statements

A common valuation approach is the income approach. This is a present value technique based on a business' discounted cashflows. It is referred to as the discounted cashflow method or DCF. The DCF method uses the relevant cash inflows and outflows related to the assets and applies a discount rate to these cash flows to calculate a present value of these assets. The model is subject to judgements and assumptions, particularly those related to the discount rate used within the model.

TAHE used a DCF model to determine the total fair value of its cash generating units (its assets) being Metropolitan Regulated Assets, Metropolitan and Regional Unregulated Assets and the Country Regional Rail Network. Key inputs to the DCF model are the access and licence fees, which are charged to TAHE's key customers, Sydney Trains and NSW Trains, and discount rates to discount the expected cash flows to their present values.

While some inputs to the DCF are known, such as the access and licence agreements signed on 30 June 2021 (effective 1 July 2021) other inputs, such as discount rates are subjective. Therefore, judgments applied in complex valuations are reflected through a high and a low range of valuation outcomes to allow for this level of subjectivity. The width of the range reflects the complexity of the judgments and assumptions and the sensitivity to even small changes to inputs within the DCF model.

TAHE developed a range of estimated outcomes of \$10.5 billion to \$14.15 billion and adopted the midpoint of this range to estimate the value of its assets to be \$12.8 billion. The Audit Office assessed the appropriate valuation range was between \$14.0 billion and \$17.3 billion. This range was based on what we observed to be relevant risk factors appropriate to TAHE's circumstances, the nature of its business and comparable industry benchmarks.

The key differences between management and the Audit Office's ranges related to the application of different discount rates to TAHE's expected cash flows. A discount rate reflects the compensation a market participant will seek for bearing uncertainty inherent in expected cashflows. Discount rates increase, as the risk of achieving forecast cash flows increases. In a DCF valuation, higher discount rates drive lower values for assets, reflecting prima facie, a reasonable market participant will pay a higher price for an asset whose cash flows bear lower uncertainty than an asset whose cash flows bear greater uncertainty. TAHE initially applied an overall discount rate that we considered high compared to relevant market benchmarks. The audit evidence presented to us indicated the risk TAHE's expected cash flows would not be achieved was comparatively lower, relative to management's assessment of risk. Consequently, lower discount rates were more appropriate in the circumstances and in line with comparable benchmarks. In our view, TAHE's cash flows should be considered at the lower end of the risk spectrum warranting the application of a lower discount rate, because TAHE:

- is the monopoly provider of rail infrastructure asset to Sydney Trains and NSW Trains (both NSW Government entities). Both public sector operators are reliant on TAHE's assets to conduct their operations. No alternative suppliers are available, nor are other participants likely to enter the market
- retains limited operational and maintenance capital expenditure risk as the public rail
 operators are required to fund the operational maintenance costs for TAHE's assets and
 NSW Treasury funds the capital maintenance expense through equity injections
- has contractual cashflows for its regulated and unregulated assets under 10-year Track
 Access Agreements and Licence, Agency and Maintenance Deeds
- has not identified any risks that are not relevant to any other comparable regulated businesses.

A wide range is used when valuing assets of this nature to recognise there are judgements and subjectivity in the process. However, in our view, TAHE's valuation range of between \$10.5 billion and \$14.15 billion did not reflect relevant market benchmarks, and was therefore not reasonable. A wide range of valuation, taking into account areas of judgement and subjectivity, that also aligned to the relevant market benchmarks was assessed to be between \$14.0 billion to \$17.3 billion. Management's selected mid-point of \$12.8 billion was outside of this acceptable range. The Audit Office informed TAHE this matter was material and would have resulted in the opinion in our Independent Auditor's Report for TAHE's 30 June 2021 financial statements being qualified.

On 13 December 2021, the Board adopted a valuation of \$14.0 billion. This resulted in a correction of \$1.2 billion in the financial statements and TAHE revising its financial statements to reflect a valuation of \$14.0 billion, which was within the lower end of the acceptable range.

If TAHE had not adjusted its financial statements for the year ended 30 June 2021, the understatement of its asset values would also have resulted in the depreciation expense reported in its financial statements for subsequent years to be understated (and therefore lower).

On 18 December 2021, a Heads of Agreement was signed between TAHE, Transport for NSW, Sydney Trains and NSW Trains to reflect TAHE's intention to negotiate higher access and licence fees to deliver on its shareholding ministers' expectations to earn a return of 2.5 per cent on contributed equity, increased from a previous 1.5 per cent. The actual access and licence agreements have not yet been updated for the fees outlined in the Heads of Agreement. TAHE management has advised these will be updated and formalised as soon as possible.

As a result of signing the HoA on 18 December 2021, an additional \$5.2 billion in access and license fees was then included in the discounted cash flow valuation. The increased access and licence fees resulted in an increase in the value of the assets. The final adjustment reflected a change from the initial value adopted by TAHE of \$12.8 billion in its draft financial statements to \$17.15 billion in the signed financial statements and final write-down of \$20.3 billion.

An unqualified opinion, with an emphasis of matter, was issued on 24 December 2021

The Independent Auditor's Report, while unqualified, contained an emphasis of matter drawing attention to significant uncertainty noted in the TAHE financial statement disclosure Note 2.9 (ii) 'Property Plant and Equipment – Measurement' and Note 17.3 'Fair value measurements using significant unobservable inputs (level 3)' around significant uncertainty associated with the judgements, estimates and assumptions supporting the valuation of non-financial assets. While there is evidence to support those assumptions, there remains a process to be completed to reflect those assumptions in legally binding contracts. Further, the funding to enable TAHE's customers to pay the increases, has been at least partially reflected in the forward budget estimates to 2024–25, but is yet to be included in appropriations. Furthermore, increases in prices over the period 2025–31, while reflected in the HoA are outside the forward estimates period.

There remains significant uncertainty relating to the access and licence fees to be paid by rail operators

These uncertainties resulted in our Independent Auditor's Report including an Emphasis of Matter, particularly drawing attention to the following:

- TAHE's future estimated access and licence fees, which are critical to the ability to earn the
 expected 2.5 per cent rate of return are subject to re-negotiation and re-signed access
 agreements, based on proposed indicative future access and licence fees set out in the
 Heads of Agreement, which will form the basis of the re-negotiation.
- \$1.1 billion in additional funding for TAHE's key customers was provided in the 2021–22 'NSW Budget Half Yearly Review' consistent with the terms in the Heads of Agreement, but this funding only extends out to the end of the forward estimates period in 2024–25. There is an additional \$4.1 billion over the following six years outside of the forward estimates period (up to the end of the 10-year contract period), which has been broadly communicated to the Expenditure Review Committee, but is yet to be provided for in government budget figures.
- A significant portion of the fair value of TAHE's non-financial assets is reflected in the terminal value, which is outside of the 10-year contract period (terminating 30 June 2031). There is a risk that, in the years beyond the forward estimates period, TAHE will not be able to negotiate contract terms for access and licence fees at a level to support the terminal value. There is also a risk that funding for TAHE's key customers will not be sufficient to fund payment of access and licence fees at a level that is consistent with current projections. TAHE has included an asset specific risk premium in the discount rate to reflect this risk.

The uncertainty highlighted does not relate to the risk profile of TAHE when estimating the discount rate to apply to the valuation model compared to market benchmark companies. The uncertainty highlighted in the Independent Auditor's Report relates to the fact that the cash flows incorporated in the valuation model are subject to re-negotiation and re-signed access agreements, based on proposed indicative future access and licence fees set out in the Heads of Agreement.

Recommendation

TAHE needs to:

- finalise revised commercial agreements to reflect access and license fees detailed in the 18 December 2021 Heads of Agreement
- prepare robust projections and business plans to support returns beyond FY2031.

Control of assets

On transition of the former RailCorp to TAHE on 1 July 2020, management determined TAHE maintains accounting control of the assets held by TAHE. The Framework for the Preparation and Presentation of Financial Statements, AASB 116 'Property, Plant and Equipment' and AASB 15 'Revenue from Contracts with Customers' states that to fulfil the criteria to recognise assets, an entity must demonstrate control over them. This refers to TAHE's ability to direct the use of, and obtain substantially all of the remaining benefits from the asset as well as the ability to prevent other entities from directing the use of, and obtaining the benefits from an asset.

For the current year, the legal form of the arrangements established in its first year of operation imply TAHE has control over the assets. Collectively, in form, the legal arrangements supported TAHE's assertion over its control over the assets as at 30 June 2021. However, risks remain as TAHE is in its early stages, and the actual substance of operations will need to be observed and considered. This was included as a high risk management letter finding.

Under the *Transport Administration Act (TAA) 1988*, the functions of TAHE may only be exercised under one or more operating licences issued by the Portfolio Minister. The current Operating Licence confers terms and conditions for TAHE to carry out its functions, and imposes certain constraints. Such operating licences are short term in nature, and the TAA allows the Portfolio Minister to grant one or more operating licences to TAHE and may amend, substitute, or impose or revoke conditions of the operating licence. Furthermore, the Statement of Expectations issued by the Portfolio Minister outlines the minister's expectations of TAHE in ensuring the government's priorities for the transport sector are met.

Given the restrictions that can be placed on the entity through the Operating Licence, and the ability to make further changes to the Operating Licence and Statement of Expectations set by the Portfolio Minister, there is a risk there could be limitations placed on the Board of Directors to operate with sufficient independence in its decision-making with respect to the operations of TAHE. Over time, this may further impact the degree of control required by TAHE to satisfy the recognition criteria over its assets. It may also fundamentally change the presentation of TAHE's financial statements.

For further details on TAHE's control of assets, refer to the Report on State Finances 2021.

We accepted TAHE's position on control for the current year. It will remain an area of audit focus in future years as the substance of the arrangements put into place need to be confirmed by observation

Future limitations to the degree of control TAHE, and its Board, can exercise over its functions may impact the degree of control TAHE has over its assets going forward. As part of the 2021–22 audit, we will monitor and assess whether, in substance, these assets continue to be controlled by TAHE and whether, in substance, TAHE can operate as an independent SOC. We require management continue to demonstrate that TAHE continues to maintain control over its assets and has the ability to operate as an independent SOC.

Recommendation

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.

Other matters

Income Tax

On 3 March 2021, NSW Treasury approved TAHE will be subject to the Tax Equivalent Regime (TER) instead of National Tax Equivalent Regime (NTER) on a temporary basis as TAHE continues to develop its commercial strategy. The approval outlined it is expected TAHE will consult with NSW Treasury before transitioning from the TER to NTER for consistency with the other NSW SOCs. The TER is effective from 1 July 2020 and the income tax is calculated based on accounting profit in accordance with TPP 21-05 'Tax Equivalent Regime'.

NTER is monitored by the Australian Taxation Office (ATO) and income tax is determined based on the requirements under *Income Tax Assessment Act 1997* (Cth) and the *Income Tax Assessment Act 1936* (Cth) whereas TER is administered by Revenue NSW and income tax is determined using a simplified accounting profit model.

During 2020–21 financial year, TAHE had recognised an accounting deficit and as a result there was no income tax expense recognised.

State Taxes (including land tax)

On establishment on 1 July 2020, TAHE was exempted from State taxes for a period of 12 months (other than for land tax subject to a lease or licence by TAHE to another person other than a public transport agency). This exemption was provided under section 227 of the *Transport Administration Act 1988* as part of the transitional provisions for TAHE.

On 28 June 2021, the Treasurer approved a proposed regulation amendment to exempt TAHE from State taxes for a further 24 months. This was on the premise TAHE has significant land holdings and land tax is levied by Revenue NSW on the Valuer General values. The Valuer General's records do not contain sufficient reference details to land holdings and valuation data. Management have explained extensive work will need to be undertaken by TAHE and Revenue NSW to enable Revenue NSW to levy land tax. The Transport Administration (General) Amendment (State Tax Exemption) Regulation 2021 commenced on 16 July 2021 that extended the exemption for another 24 months.

TAHE recorded a land tax provision of \$16.1 million in 2020–21 in relation to licence/leases with persons other than a public transport agency.

Operating Model, policies and agreements

On 1 July 2020 when TAHE commenced, the operating model for TAHE was still under discussion. An operating model was endorsed by the Expenditure Review Committee on 18 March 2021.

During the 2020–21 financial year, TAHE:

- approved the Statement of Corporate Intent for 2020–21 financial year and 2022 to 2024 financial years
- entered into access agreements and licence agreements with Sydney Trains and NSW
 Trains for the use and access to TAHE's assets. These arrangements are effective from
 1 July 2021. The licence and access fees were determined based on the expected returns
 on the assets constructed since 2015–16 from the equity injections received from NSW
 Treasury
- established a mid-term commercial strategy for 2022 to 2025 financial years
- established financial delegations
- appointed Sydney Trains and Transport for NSW as its agent to perform certain functions on behalf of TAHE as part of the implementation deed for 2020–21 and subsequent agreements effective from 1 July 2021
- entered into corporate services arrangements with Sydney Trains and Transport for NSW
- established an Asset, Safety and Environment Committee to help maintain an assurance framework that provides oversight and assurance over the asset and safety requirements across its assets, undertakings and third party operations
- progressively establishing policies and procedures such as fraud and corruption policies.

As advised by management, TAHE will continue to implement the operating model during 2021–22 financial year, including:

- establishing policies and procedures such as risk management policies and compliance policies
- employ staff for key roles established within TAHE
- renegotiate access agreements with private operators
- implement the mid-term commercial strategies.

In accordance with the TAHE Implementation Deed, the Transport for NSW policies and procedures were applicable for 2020–21 only. The implementation deed expired on 30 June 2021. While TAHE is progressively implementing policies and procedures during 2021–22, there are gaps in the period where there is no applicable policy in place as Transport for NSW policies would no longer be applicable. Several policies and procedures were only finalised in August 2021 and many other policies are currently in draft more than 12 months since TAHE commenced operations. We have raised a management letter issue for TAHE management to finalise the relevant policies and procedures as soon as possible.

As discussed above, the Heads of Agreement was signed on 18 December 2021 with updated fees. The actual access and licence agreements have not been updated for these fees. TAHE management have advised these will be updated and formalised as soon as possible. TAHE management will also need to update its Statement of Corporate Intent and 10-year Business Plan to reflect these updated fees.

We will review the new arrangements, policies and procedures implemented as part of the 2021–22 audit.

Governance and quality of information to support accounting transactions

Transport for NSW needs to improve its provision of documents relating to TAHE. Key documents were either not provided to the Audit Office, or were not provided on a timely basis, or their existence was not made known to the Audit Office

A key reason for the delay in signing the audit opinion for the Total State Sector Accounts and TAHE related to the fact that not all information relating to TAHE was shared with the Audit Office or information was not shared on a timely basis. This unnecessarily prolonged the audit process.

Between 2017 and 2021, the Audit Office regularly liaised with Transport for NSW on TAHE transition plans. However, during this period, limited documents had been shared with the Audit Office on the basis these documents were either in draft or Cabinet sensitive documents that were yet to be endorsed by Cabinet. Requests for relevant information about TAHE to support the 2020–21 financial year audit date back to at least July 2020. A letter from the Audit Office to the Secretary of NSW Treasury, Secretary of Transport and the Acting CEO of TAHE in June 2021 outlined requested documents not received and flagged that not receiving those documents by 30 June 2021 would put the reporting timetables at risk. This letter was followed up with a further letter from the Auditor-General to the Secretary of NSW Treasury in September 2021, stating that all key information had still not been received. The requested information was received progressively up to 5 October 2021.

Not sharing key information with the independent external audit on a timely basis delays discussions and resolution of issues. Had all information been shared with our Office earlier, discussions on the GGS's intent to earn a sufficient rate of return would have been held and resolved earlier. For further details, refer to the Report on State Finances 2021.

Transport for NSW needs to significantly improve its processes to ensure all relevant information is identified and shared with the Audit Office on a timely basis. This will ensure the audit team has access to complete and accurate information when considering material transactions and balances of the cluster.

Recommendation

Transport for NSW 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 cluster.

Upcoming performance audit on TAHE

A performance audit on the establishment of TAHE is currently in progress. We plan to table this report in 2022.

Land acquisitions

Processes for managing conflicts of interests in relation to land acquisitions can be improved

The cluster conducted land acquisitions totalling \$2.2 billion for the year ended 30 June 2021 (\$447 million). These are generally acquired as part of infrastructure projects. The increase in land acquisitions from prior year can be largely attributed to acquisitions for the Sydney Metro West and Sydney Metro Western Sydney Airport line projects.

Land acquisitions are governed by the *Land Acquisition (Just Terms Compensation) Act 1991* (the Act) and can be acquired by way of an agreement or through a compulsory acquisition process. The Act guarantees that when land is acquired by an authority of the State, the amount of compensation will not be less than the market value of the land (unaffected by the proposal) at the date of acquisition and encourages the acquisition of land by agreement instead of compulsory process.

As part of the financial audit, we obtained an understanding of key controls and processes relating to the acquisition of land, relevant to the audit of the financial statements. We found that conflicts of interests were not always declared by all officers involved in the land acquisition process. Furthermore, processes for declaring conflicts of interests are not consistently applied across cluster agencies.

Absence of rigorous and consistent management of conflicts of interests, and non-compliance with established policies increases the risk that agencies may be exposed to reputational damage or financial losses in relation to land acquisitions.

We conducted a performance audit over the Acquisition of 4–6 Grand Avenue, Camellia in 2021 which examined:

- whether Transport for NSW conducted an effective process to purchase 4–6 Grand Avenue,
 Camellia
- whether Transport for NSW has effective processes and procedures to identify and acquire property required to deliver the NSW Government's major infrastructure projects.

The report made several recommendations over Transport for NSW's internal policies and procedures to guide the land acquisition process.

Recommendation

Transport agencies should implement a process to ensure conflicts of interest declarations are completed for all members of the land acquisition process, and consistently applied across the cluster.

Completeness and accuracy of contract registers

There continues to be no centralised processes to record all significant contracts and agreements in a register across the cluster

Across the cluster, contracts and agreements continue to be maintained by the transport agencies using disparate registers due to procurement being decentralised in each agency.

In 2018–19 and 2019–20, we reported that not all contracts and agreements entered into by transport agencies were captured in the contract registers. Our audit in 2020–21 identified that this continues to be the practice. Furthermore, we also identified in some cases key details of contracts and agreements on the registers were missing.

There are significant contracts and agreements in the cluster given the large number of infrastructure projects. More specifically, Transport agencies have many agreements with private sector companies and other government agencies for project construction and integrated developments which may involve multiple parties. Absence of a complete and accurate register increases the risk that agencies may not be aware of all contractual and other obligations. There is a risk financial statements may be misstated if the financial impacts of certain contracts and agreements are not considered.

Several accounting standards including AASB 16 'Leases', AASB 15 'Revenue from Contracts with Customers', AASB 1058 'Income of Not for Profit Entities' and AASB 1059 'Service Concession Arrangements: Grantors' require agencies to reflect the rights and obligations of contracts within its financial statements. Agencies must perform detailed assessments of their contracts and agreements to comply with the new accounting standards. A lack of a complete register of all contracts and agreements increases the risk that agencies may not be able to fully comply with the new accounting standards.

Recommendation (repeat)

Transport agencies should continue to implement a process to centrally capture all contracts and agreements entered. This will ensure:

- agencies are fully aware of contractual and other obligations
- appropriate assessment of financial reporting implications
- ongoing assessments of accounting standards, in particular AASB 16 'Leases', AASB 15 'Revenue from Contract with Customers', AASB 1058 'Income of Not-for-Profit Entities' and new accounting standard AASB 1059 'Service Concession Arrangements: Grantors' are accurate and complete.

Section two

Appendices

Appendix one – Misstatements in financial statements submitted for audit

2020–21 2019–20

		2020-21		2013-20			
	Uncorrected	Corrected	Total	Uncorrected	Corrected	Total	
Department of							
Transport		2	2				
Transport for NSW	1	6	7	2	7	9	
NSW Trains							
Port Authority of New South Wales		1	1				
State Transit Authority of		4					
New South Wales		1	1				
Sydney Ferries							
Sydney Metro	1	6	7		6	6	
Sydney Trains							
Transport Asset Holding Entity of New South Wales*		7	7		-		
Transport Service of New South Wales		1	1				
Former Roads and Maritime Services**				3	9	12	
Total	2	24	26	5	22	27	

^{*} On 1 July 2020, the former Rail Corporation New South Wales was renamed Transport Asset Holding Entity of New South Wales (TAHE) and converted to a for-profit statutory State-Owned Corporation pursuant to the *Transport Administration Act 1988* and *State Owned Corporations Act*

Note: Chief Investigator of the Office of Transport Safety Investigations and Residual Transport Corporation of New South Wales have assessed and determined they met the reporting exemption criteria under the GSF Regulation, and therefore were not required to prepare annual financial statements. Source: Engagement Closing Reports issued to cluster agencies.

^{**} The former Roads and Maritime Services (RMS) was dissolved on 1 December 2019 through the *Transport Administration Amendment (RMS Dissolution) Act 2019*. RMS' assets, rights, liabilities and functions were transferred to Transport for NSW. 2020 misstatements for the former Roads and Maritime Services relate to the completion audit conducted for the period 1 July 2019 to 30 November 2019, prior to its dissolution.

Appendix two – Early close procedures

No.	Procedure	Description
1	Proforma financial statements	Complete proforma financial statements and ensure management has endorsed the statements and reviewed the supporting working papers. Reconcile the March 2021 month-end prime submission to the proforma financial statements and provide explanations for variances exceeding \$5 million.
2	Fair value assessment of property, plant and equipment	Perform and document an annual assessment of the fair value of property, plant and equipment (PPE), their useful lives and residual values, and the reasons why the carrying value was not materially different to the fair value. This assessment is performed between comprehensive revaluations.
3	Revaluation of property, plant and equipment	Complete the comprehensive revaluation of property, plant and equipment (PPE) by early close.
4	Inter and intra (cluster) agency transactions and balances	Agree and confirm all inter and intra (cluster) agency balances and transactions with the counterparty agency.
5	Significant management judgements and assumptions	Document all significant management judgements and assumptions made when estimating transactions and balances.
6	Reconciliation of key account balances	Reconcile all key account balances (including annual leave provisions) and clear reconciling items.
7	Changes in accounting policy	Review and agree changes in accounting policy with the Principal Cluster Agency.
8	Finalise right-of-use assets and lease liability balances	Ensure that all lease arrangements are accurate and complete.
9	Finalise assessment of all revenue contracts	Ensure revenue is accurate and complete and has been correctly accounted for under AASB 15 'Revenue from Contracts with Customers' or AASB 1058 'Income of Not-for-Profit Entities'.
10	Correction of material prior period errors	Confirm there are no changes to the 2019–20 closing balances except for adjustments for AASB 1059 'Service Concession Arrangements: Grantor' and TPP06-08 'Accounting for Privately Financed Projects'. Proposed changes are accompanied by journals, explanations and proposed disclosures.
11	Monthly management reports	Perform variance analysis with meaningful explanations for actuals versus budget, and year-to-date actuals for the previous year.
12	Changes to legislation	Identify and document changes to legislation affecting agency structures and/or financial reporting requirements.
13	Delegations	Ensure all material transactions are supported by appropriate delegations.

No.	Procedure	Description
14	Prior year Management Letter and Engagement Closing Report issues	Agreed action plans are in place to address prior year Management Letter and Engagement Closing Report issues. Explanations are provided for any unresolved issues(s).
15	Complete Commonwealth Funding Agreement – Revenue Assessment Form for Commonwealth Funding Agreements	Complete and return the 'Commonwealth Funding Agreement – Revenue Assessment Form for Commonwealth Funding Agreements' for all new and amended Commonwealth Funding Agreements entered or amended during the 2020–21 financial year.
16	New and updated accounting standards	Supporting workpapers evidencing how management has considered the requirements of new and updated accounting standards.

Appendix three - Financial data

	Total assets		Total liabilities		Total revenue*		Total expense**	
-	2021 \$m	2020 \$m	2021 \$m	2020 \$m	2021 \$m	2020 \$m	2021 \$m	2020 \$m
Principal entities								
Department of Transport (Parent Entity)					1	1	1	1
Transport for NSW	146,847	138,407	26,141	23,577	24,485	19,612	20,087	17,139
Other cluster agencies lis	sted in App	pendix A d	of Treasury	Direction	TD21-02			
NSW Trains	198	121	359	361	910	833	854	880
State Transit Authority of New South Wales	100	89	272	294	468	450	434	451
Sydney Ferries	152	157	9	8	8	12	13	14
Sydney Metro	24,059	18,391	4,027	2,566	4,709	3,370	789	743
Sydney Trains	3,150	3,149	3,627	3,687	3,776	3,516	3,802	3,779
Transport Asset Holding Entity of New South Wales***	22,133	41,069	3,563	3,365	349	302	17,880	1,809
Other cluster agencies								
Port Authority of New South Wales	660	610	284	286	182	178	155	167
Transport Service of New South Wales	572	544	572	544	2,244	2,109	2,256	2,109
Former Roads and Maritime Services****		108,939		2,620		3,916		1,775

^{*} Total revenue includes other gains, gains on disposal, government and other contributions and reversal of impairment losses which are shown separately on the financial statements.

Note: Chief Investigator of the Office of Transport Safety Investigations and Residual Transport Corporation of New South Wales have assessed and determined they met the reporting exemption criteria under the GSF Regulation, and therefore were not required to prepare annual financial statements. Source: Agencies audited 2020–21 financial statements.

Total expense includes other losses, income tax equivalent expense and impairment losses on financial assets which are shown separately on the

^{***} On 1 July 2020, the former RailCorp was renamed Transport Asset Holding Entity of New South Wales (TAHE) and converted to a for-profit statutory State-Owned Corporation pursuant to the *Transport Administration Act 1988* and *State Owned Corporations Act 1989*.

^{****} The former Roads and Maritime Services (RMS) was dissolved on 1 December 2019 through the *Transport Administration Amendment (RMS Dissolution) Act 2019*. RMS' assets, rights, liabilities and functions were transferred to Transport for NSW. 2020 financial data for the former RMS represents total assets and total liabilities at 30 November 2019 and total revenue and total expenses for the period 1 July 2019 to 30 November 2019, prior to its dissolution.

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Our insights inform and challenge government to improve outcomes for citizens.

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To help Parliament hold government accountable for its use of public resources.

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Pride in purpose
Curious and open-minded
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Courage (even when it's uncomfortable)



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