PERFORMANCE AUDIT 24 JANUARY 2023

Design and implementation of the Transport Asset Holding Entity

NEW SOUTH WALES AUDITOR-GENERAL'S REPORT

audit office OF NEW SOUTH WALES

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In accordance with section 38E of the *Government Sector Audit Act 1983,* I present a report titled **'Design and implementation of the Transport Asset Holding Entity'.**

Margaret Crawford
Auditor-General for New South Wales
24 January 2023

auditoffice OF NEW SOUTH WALES

RECONCILIATION COMMITMENT STATEMENT

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.

Banner image: 'Yarning Circle' by Caitlin Liddle, Audit Office Indigenous Internship Program participant used with permission.

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Design and implementation of the Transport Asset Holding Entity

Section one

Design and implementation of the Transport Asset Holding Entity

Executive summary

The NSW Government established the Transport Asset Holding Entity (TAHE), a statutory State Owned Corporation (SOC), on 1 July 2020 to replace the former rail infrastructure owner – RailCorp. It is the State's custodian of rail network assets, including rail tracks and other infrastructure, rolling stock, land, train stations and facilities, retail space, and signal and power systems, within metropolitan and regional New South Wales. It is responsible for $2.8 billion of major capital projects in 2022–23.

TAHE was established under Part 2 of the *Transport Administration Act 1988* and is governed by a decision-making board. The Treasurer and the Minister for Finance and Employee Relations are the Shareholding Ministers of TAHE, and they annually agree performance expectations articulated in a Statement of Corporate Intent.

Whereas TAHE is the custodian of rail assets, Sydney Trains and NSW Trains operate public rail services. TAHE does not have responsibility for the operation of the heavy rail network or train services, nor does it have network control functions. TAHE, Sydney Trains and NSW Trains are in the Transport and Infrastructure cluster in the public sector (formerly the Transport cluster and renamed in April 2022), which also includes Sydney Metro and Transport for NSW (TfNSW).

TfNSW leads the Transport and Infrastructure cluster. Its role is to set the strategic direction for transport across the State. This involves the shaping of planning, policy, strategy, regulation, resource allocation and other service and non-service delivery functions for all modes of transport.

TAHE's Operating Licence is granted by the Portfolio Minister and authorises the entity to perform the functions required to acquire, develop, finance, divest and hold assets, pursuant to the *Transport Administration Act 1988*. The Portfolio Minister also issues a Statement of Expectations which outlines the government's expectation for the business for the next three to five years.

TAHE's original Portfolio Minister was the Minister for Transport who approved, on 30 June 2020, the issuing of an interim 12-month Operating Licence to enable TAHE to commence operating on 1 July 2020. The Portfolio Minister then granted TAHE's current Operating Licence in 2021. After TAHE requested a 12-month extension to its current Operating Licence, its next Operating Licence is due on 1 July 2024. The current Portfolio Minister is the Minister for Infrastructure, Cities and Active Transport.

About this audit

This audit assessed the effectiveness of NSW Government agencies' design and implementation of TAHE. In making this assessment, we considered whether:

- the process of designing and implementing TAHE was cohesive and transparent, and delivered an effective outcome
- agencies' roles and responsibilities were clear in the planning of TAHE
- agencies effectively identified and managed certain risks.

Conclusion

The design and implementation of TAHE was not effective. The process was not cohesive or transparent. It delivered an outcome that is unnecessarily complex in order to meet the NSW Government's short-term Budget objectives, while creating an obligation for future governments to sustain TAHE through continuing investment, and funding of the state owned rail operators. The ineffective process to design TAHE delivered a model that entails significant uncertainty as to whether the anticipated longer-term financial improvements to the Budget position can be achieved or sustained.

NSW Treasury and TfNSW had different objectives for TAHE

Up to June 2013, RailCorp had been the owner and operator of rail services and maintainer of the metropolitan rail network for almost a decade. It had been operating as a not-for-profit Public Non-Financial Corporation (PNFC).

In 2012, NSW Treasury (hereafter Treasury) decided there was a risk that the Australian Bureau of Statistics (ABS) would reclassify RailCorp to the General Government Sector (GGS), meaning depreciation expenses of approximately $870 million would be reflected in the GGS Budget. Treasury wanted to avoid this impact on the GGS Budget, and considered the establishment of a transport asset holding entity as a means to do so. Capital grants to RailCorp were being treated as an expense to the GGS Budget.

TfNSW also wanted an asset holding entity – but one that would be a non-trading ‘shell’ company with no staff that would hold and manage all public transport assets. TfNSW's concept envisaged the entity would have a structure that would enable future public transport reforms and strategic directions while ensuring vertical integration of operations between asset owners and the rail operators to maintain rail safety.

However, Treasury pursued its objective to improve the GGS Budget result, and sought to expand on TfNSW's 'shell' asset holding entity concept. Treasury wanted an entity that could generate a return on investment, as this meant that government investment in transport assets could be treated as equity investments, rather than a Budget expense, and in turn improve the GGS Budget position. As an example of the potential impact of creating this new entity, capital grants of $2.3 billion were paid to RailCorp in 2013–14. If Treasury's objective was met, grants of this significance would then be treated as an equity investment, rather than an expense in the GGS Budget.

In 2017, Treasury's preferred option was progressed through legislation, but both agencies' central objectives for the proposed asset holding entity would continue to prove difficult to reconcile. To achieve Treasury's objective to improve the Budget result, the entity would need to generate a return on investment (this is further discussed below). However, TfNSW expressed concerns that the prioritisation of rail safety, and the effective management of governance, regulation and operations would be more complex in an entity with commercial imperatives.

Asset holding entities are a common approach to the management of transport assets in Australia and internationally, and there are a range of approaches to how they are structured and used. Such structures should be driven by the goal of improved asset management. Ultimately, TfNSW's objectives could have been delivered through a simpler entity structure. However, reconciling TfNSW's objectives with Treasury's imperative to deliver and justify a Budget improvement in the short-term resulted in an overly lengthy process and an unnecessarily complex outcome that places an obligation on future governments to sustain. There is still significant uncertainty as to whether the short-term improvements to the Budget can continue to be realised in the longer-term.

The Budget benefits of TAHE were claimed before the entity was legislated, committing the agencies to deliver, regardless of the complexities that subsequently arose

The 2015–16 GGS Budget treated the government's investment in TAHE (still known at this time as RailCorp) as an equity contribution. This had the immediate impact of improving the Budget result by $1.8 billion per annum. However, the legislation to enable the establishment of TAHE had not yet been passed by Parliament, key elements of the operating model were still under development, and imminent changes in accounting standards had the potential to impact TAHE's financial model. The decision to book the benefits in the Budget early committed the involved agencies to implement a solution that justified the 2015–16 Budget impacts, irrespective of the challenges that arose.

TAHE's financial structure requires circular government investment to work

For the NSW Government to continue to treat its investment in TAHE as an equity contribution, rather than an expense to the Budget, there must be a reasonable expectation that TAHE will generate a sufficient rate of return as required by the Government Finance Statistics (GFS) framework. In doing so, it needs to recover a revaluation loss created by a $20.3 billion reduction in the value of its assets which was incurred in its first full year of operation. This loss occurred as a result of a revaluation of TAHE's assets when RailCorp (a not-for profit entity) became TAHE (a for-profit commercial entity) – and is discussed further in the 'Key findings' below.

TAHE generates a small portion of its income from transactions with the private sector but, as noted in our report 'State Finance 2021', TAHE receives the majority of its revenue (more than 80%) from access and licence fee agreements with Sydney Trains and NSW Trains. Both of these entities are funded by grants (a Budget expense) to TfNSW from the GGS Budget.

Based on Treasury’s correspondence with the ABS in 2015, TAHE was initially expected to pay a return on equity of 7% in 2016–17. The assumption of a 7% return persisted through to 2018, after the legislation enabling the establishment of TAHE was passed by Parliament. However, when the initial access and licence fees were agreed on 1 July 2020, this figure had been revised to an expected rate of return of 1.5% excluding the revaluation loss. This was below the long-term inflation target and did not include the recovery of the revaluation loss – risking the government's ability to treat its investment in TAHE as an equity contribution. Importantly, as TAHE is primarily reliant on fees paid by the state owned rail operators that, in turn, are funded by the GGS Budget (as an expense), the decision to change the returns model from 7% to 1.5% would in its own right have had a positive impact on the GGS Budget. However, the decision to use a 1.5% return would ultimately be problematic as it made it difficult to treat the government's contributions to TAHE as an equity investment, as discussed below.

On 14 December 2021, to avoid a qualified audit opinion, the NSW Government made the decision to increase TAHE's expected rate of return to 2.5%, equal to the Reserve Bank’s long-term inflation target.

In 2021-22, TAHE needed to start charging rail operators higher access and licence fees in order to generate a return of 2.5%, so as to support the government's treatment of its investment in TAHE as an equity contribution in the GGS Budget. This meant the government needed to provide additional grant (expense) funding to the state owned rail operators so they could pay the increased access and licence fees to TAHE. Based on current projections, TAHE is not expected to recover the revaluation loss until 2046.

There remains a risk that TAHE will not be able to generate a sufficient return on the NSW Government's investment without relying on increased funding to state owned rail operators so that they can in turn pay the higher access and licence fees. TAHE's ability to generate returns on government investment from other sources are uncertain and may not be achievable or sustainable. Current modelling highlights that TAHE remains largely reliant, through to 2046, on increasing fees (which are assumed to increase at 2.5% per annum from 2031 onwards when the current 10 year contracts with rail operators expire) paid by the state owned rail operators that remain principally reliant on GGS Budget grants.

The process of designing and implementing TAHE was not transparent to independent scrutiny

Our report 'State Finances 2021' commented that Treasury did not always provide this Office with information relating to TAHE on a timely basis. Similarly, during this performance audit, there were also multiple instances where auditees were unable to provide documentation regarding key activities in the process to deliver TAHE. Agencies also applied higher sensitivity classifications to large tranches of documents than was justified or required by policy. Of particular concern is the incorrect classification of documents as Cabinet sensitive information. The incorrect or over-classification of documentation as Cabinet sensitive delayed this Office's ability to provide scrutiny or independent assurance.

There was a lack of clarity around the roles and responsibilities of governance structures set up to oversee the design and implementation of TAHE

From 2014, multiple workstreams and advisory committees were established to progress the design and implementation of TAHE. For some of these committees and workstreams, there is limited information on what they were tasked to do and what they achieved. Most had ceased meeting by 2018, before significant work needed to deliver TAHE was completed.

The lack of clarity around the roles and responsibilities of these governance structures reduced opportunities for TfNSW and Treasury to reconcile their differing objectives for TAHE, and resolve key questions earlier in the process.

There was a heavy reliance on consulting firms throughout the process to establish TAHE, and the management of consultant engagements failed to ensure that agencies received independent advice to support objective decision-making

In 2020, Treasury and TfNSW failed to prevent, identify, or adequately manage a conflict of interest when they engaged the same 'Big 4' consulting firm to work on separate TAHE-related projects. Both agencies used the firm's work to further their respective views with regard to the financial implications of TAHE's operating model. At this time those views were still unreconciled.

Treasury engaged the firm to provide a fiscal risk management strategy and advice on the impact of changes to accounting standards. TfNSW engaged the same firm to develop operating and financial models for TAHE, which raised concerns regarding the viability of TAHE. Disputes arose around the findings of these reports. Treasury disagreed with some of the outcomes of the work commissioned by TfNSW, relating to accounting treatment and fiscal advice.

The management of this conflict (real or perceived) was left to the 'Big 4' consulting firm when it was more appropriate for it to be managed by Treasury and TfNSW. If these agencies had communicated more effectively, used available governance structures consistently, and shared information openly about their use of the firm and the nature of their respective engagements, these disputes might have been avoided. This issue, coupled with deficiencies in procurement by both agencies, reflected and further perpetuated the lack of cohesion in the design and implementation of TAHE.

More broadly, over the period 2014 – 2021, 16 separate consulting firms were employed to work on 36 contracts, valued at over $22.56 million, relating to TAHE ranging from accounting and legal advice, project management, and the provision of administrative support and secretariat services.

Consultants are legitimately used by agencies to provide advice on how to achieve the outcomes determined by government, including advising agencies on the risks and challenges in achieving those outcomes. Similarly, consultants can provide expert knowledge in the service of achieving those outcomes and managing the risks. However, the heavy reliance on consulting firms during the design and implementation of TAHE heightened the risk that agencies were not receiving value for money, were outsourcing tasks that should be performed by the public service, and did not mitigate the risk that the advice received was not objective and impartial. The risk that the role of consultants could have been blurred between providing independent advice to government on options and facilitating a pre-determined outcome was not effectively treated or mitigated. This risk was amplified because a small number of firms were used repeatedly to provide advice on one topic. The effective procurement and management of consultants is an obligation of government agencies.

1. Key findings

TfNSW conceived the idea of a single asset holding entity (AssetCo) to consolidate and hold all transport assets

TfNSW's original plan was to create a 'shell' company (AssetCo) that would hold and manage all public transport assets (other than roads). As part of this plan, transport assets from across the cluster would be brought together and the management of these assets would be streamlined and consolidated. Assets would then be leased or contracted to other government entities and private sector firms who would use them for transport operations.

TfNSW intended that this entity would be a not-for-profit enterprise with no staff. This was deemed to be the simplest and least risky legal structure, that would be relatively easy to implement, and that would efficiently and effectively deliver transport objectives. This structure would not have changed the Budget result, as cash funding would continue to be treated as a grant expense, but it would ensure vertical integration of operations, which TfNSW wanted, so that safety could be maintained.

Treasury sought to capitalise on TfNSW's model to create an entity that would improve the GGS Budget

All government entities are classified by the ABS into one of three specific institutional sectors. These are:

- General Government Sector (GGS)
- Public Financial Corporations (PFC)
- Public Non-Financial Corporations (PNFC).

When a GGS entity incurs expenses (other than through transactions with other GGS entities) the expense is recognised in the GGS Budget. In contrast, the funds provided to a PNFC or a PFC are treated as equity contributions,[1] provided that the entity provides a reasonable expectation of a sufficient rate of return on investment.

In 2012, Treasury officials believed there was a risk that the ABS would reclassify RailCorp from a PNFC entity to the GGS. If this occurred, RailCorp's depreciation expenses would be included in the GGS Budget as a significant cost. To avoid this outcome, Treasury wanted RailCorp to remain a PNFC.

Further, to improve the GGS Budget, Treasury wanted to transition RailCorp (a PNFC) to an asset holding entity that was a for-profit PNFC. This would have the effect of permitting government investment in RailCorp assets to be treated as equity investments, as opposed to Budget expenses, as long as the new entity could demonstrate a reasonable expectation of a sufficient rate of return on investment.

In response to the concerns about reclassification, both Treasury and TfNSW began investigating ways to avoid an adverse reclassification outcome, and the in-principle decision to create some form of asset holding entity was made by the government in 2014.

TfNSW and Treasury's conflicting objectives for TAHE had still not been resolved into an operating model by the time enabling legislation was drafted and introduced into Parliament

Treasury accepted the importance of better asset management and rail safety outcomes in the transport sector. However, it introduced an additional purpose for TAHE – that is, improving the GGS Budget. The differing priorities of TfNSW and Treasury continued throughout the lengthy design period of TAHE.

In 2014 and 2015, TfNSW stated explicitly that it preferred that TAHE (then called AssetCo) be a GGS entity. This structure would not meet the return criterion, that ultimately changed the accounting treatment of government investment in TAHE, and would have also seen depreciation expenses recognised in the GGS Budget.

In contrast, Treasury advocated strongly for an entity that would have generated a return on investment (thereby changing the accounting treatment of the contributions to RailCorp/TAHE from an expense to an equity investment) that had the effect of improving the GGS Budget, and preserving the PNFC structure to ensure that depreciation expenses remained outside the GGS Budget.

When the enabling legislation was being drafted in 2016–17, direction was provided by the Treasurer that the legislation should be focused on delivering the Budget result. Ultimately, the legislation was drafted to provide flexibility to accommodate the final TAHE operating model as it had not been decided at the time.

[1] More detail on the classification of government entities and accounting treatment is provided in Appendix two.

Benefits were claimed in the 2015–16 Budget on the basis of assumptions that were later found to be incorrect, and before the operating model was agreed or implemented

Following the NSW Government's 2014 in-principle decision to establish a commercial asset holding entity, the 2015–16 GGS Budget included investment in RailCorp assets as an equity contribution instead of a government expense. This treatment improved the 2015–16 GGS Budget by approximately $1.8 billion per annum. A further $4.8 billion in improvements to the GGS Budget were claimed in the three years that followed ($1.7 billion in 2016–17, $1.2 billion in 2017–18 and $1.9 billion in 2018–19). By establishing a commercial asset holding entity, RailCorp's depreciation expenses continued to remain outside the GGS Budget.

However, key elements of the asset holding entity's operating model were still under development, and significant issues were yet to be addressed.

Less than 12 months after the 2015–16 Budget, Treasury identified concerns regarding weaknesses in the assumptions underpinning the financial modelling used. Specifically, early modelling assumed that dividends could be paid to the government from RailCorp’s retained earnings until TAHE became profitable. Treasury subsequently realised this would not be possible if RailCorp ceased to exist as a legal entity and TAHE was formed as a new agency in its place. On 1 July 2020, RailCorp was renamed TAHE, thereby ensuring RailCorp's use of retained earnings to pay dividends to the government.

The initial required rate of return on the NSW Government's investment in TAHE was 7%, then it became 1.5% and subsequently 2.5%

There must be a reasonable expectation that TAHE will generate a sufficient rate of return for the government to treat the funding it provides to TAHE as an equity contribution in the GGS Budget.

Based on Treasury’s correspondence with the ABS in 2015, TAHE was expected to pay a return on equity of 7% in 2016–17. This assumed 7% return persisted through to 2018, after the legislation enabling the establishment of TAHE was passed by NSW Parliament. When the initial access and licence fees were agreed on 1 July 2020, this figure had been revised to an expected rate of return of 1.5%.

However, 1.5% was below the long-term inflation target and did not include the recovery of the revaluation loss – risking the government's ability to treat its investment in TAHE as an equity contribution. Our report 'State Finances 2021' noted that the access and licence fees in the agreements effective from 1 July 2021 would not generate a sufficient rate of return.

Nonetheless, as TAHE is primarily reliant on fees paid by the rail operators, who in turn are funded by the GGS Budget (as an expense), the decision to change the returns model from 7% to 1.5% would in its own right have a positive impact on the GGS Budget.

On 14 December 2021, to avoid a qualified audit opinion, the NSW Government made the decision to increase TAHE's expected rate of return to 2.5%, equal to the Reserve Bank’s long-term inflation target.

However, assuming that TAHE’s contracts with the state owned rail operators generate a return of 2.5% contributed equity each year, it would still take until 2046 for TAHE to recover the $20.3 billion revaluation loss.

TAHE generates a small portion of its income from transactions with the private sector but, as noted in our report 'State Finance 2021', TAHE receives the majority of its revenue (more than 80%) from access and licence fee agreements with Sydney Trains and NSW Trains. Both of these entities are funded by grants to Transport for NSW from the GGS Budget.

The NSW Government has already invested an additional $1.1 billion to fund TAHE's increased access and licence fees, and the ongoing requirement for TAHE to make a sufficient rate of return creates a continuing obligation for future governments

In 2021–22 it became apparent that TAHE would not generate a sufficient rate of return unless it charged higher access and licence fees to its customers – the state owned rail operators.

Accordingly, at that time, the NSW Government committed to providing an additional $1.1 billion over the period 2023–25, and a further $4.1 billion over the remaining contract period to 2031, to fund state owned rail operators to pay TAHE.

Going forward, the 2022–23 Budget has allocated $5.5 billion to fund the operators to support their payment of contracted access and licence fees up to 2026 (the end of the current forward estimates period). A further $10.2 billion will also be required from 1 July 2027 up to the end of the contract period in 2031.

As noted in our report 'State Finances 2022', the government may need to fund the operators a total of $66.5 billion up to 2046 to ensure the government continues to demonstrate its expected return on investment of 2.5%.

The ongoing requirement for TAHE to generate a sufficient rate of return on the equity invested in the assets over their useful life embeds the obligation for investment by future governments.

Treasury advised that the government expects to largely cease providing funding to TAHE for capital projects via equity investments from 2026. However, the modelling for this decision is based on the assumption that TAHE accumulates sufficient cash over time, from access and licence fees, to fund approved future capital expenditures. In order to make a return on its investment in TAHE, the NSW Government needs to continue to fund the state owned rail operators (Sydney Trains and NSW Trains) so that they can pay these access and licence fees.

There remains a risk that TAHE will not continue to generate a sufficient rate of return

In 2020–21, when RailCorp became TAHE, the value of assets held by TAHE decreased by $20.3 billion. The revision to the value, undertaken in accordance with AASB 13 *'Fair Value Measurement'*, reflected a change in the approach to valuation from an assessment based on replacement cost to an income-derived approach, which was appropriate when TAHE started to earn an income from access and licence fees. The write-down occurred because the access and licence fees incorporated into the income-derived valuation model were not sufficient to maintain the value previously determined under a replacement cost assessment.

For TAHE's rate of return to be sufficient, it needs to recover this revaluation loss and be in line with the raised Shareholder expectations of a return aligned to the long-term inflation target.

Treasury's current returns modelling shows the government expects to earn a 2.5% return and recover 2021's revaluation loss by 2046. However, there remains a risk that TAHE will not be able to generate a sufficient rate of return. Treasury's estimate for the returns relies on:

- TAHE being able to contract for access and licence fees in the future at a level that is consistent with current estimations, and that these fees grow by 2.5% each year
- TAHE's key customers (Sydney Trains and NSW Trains) being able to afford access and licence fees at the necessary level
- TAHE being able to grow its non-government revenues.

This in turn relies on an obligation for future governments to provide additional funding to state owned rail operators in order to preserve the treatment of the government's investment in TAHE as an equity contribution.

The ABS recently confirmed the PNFC sector classification of TAHE and the New South Wales state owned rail operators. Should this change at any time in the future, Treasury has advised the government that there would be a significant estimated deterioration in the GGS Budget result over the medium and longer-term.

There was a lack of clarity around the roles and responsibilities of governance structures used to design and implement TAHE, reducing opportunities to resolve issues early

In May 2014, when the NSW Government gave in-principle approval for a commercial asset holding corporation to be formed, TfNSW established seven workstreams and three committees, all chaired by personnel from TfNSW, to investigate possible structures. Treasury staff were involved in the finance workstreams.

The seven workstreams reported, via a project management group, to the Readiness Review Group which reported to an Expert Reference Group which reported, in turn, to the AssetCo Steering Committee. There are no detailed terms of reference or guidance for these committees and no guidance for the decisions that each could make. All three of these governance groups stopped meeting in September 2014.

In September 2015, a reduced set of three working groups (formerly called workstreams) started up and operated until the end of 2018. It appears that the TAHE Steering Committee was re-established in 2015, although this audit has not seen any evidence of the exact composition of the committee and there is also no evidence that this Committee met before January 2017. A new TAHE Advisory Board was established in 2015 and met until May 2019. After a hiatus of a year, the TAHE Advisory Board reconvened in May 2020 and then permanently ceased to meet after this one meeting. This audit has not seen any evidence of why this happened.

Safety was an important consideration throughout the process to design and implement TAHE

TfNSW was concerned that a commercial structure for an asset holding entity would create risks to safety. This added complexity to the design and implementation process, but resolving TfNSW's safety concerns was a priority throughout.

In 2015, Treasury and TfNSW jointly developed a high-level model for TAHE which attempted to minimise the degree to which the Board could deviate from government policy whilst still being sufficiently independent to meet the requirements of the ABS. Treasury contended that as TAHE is ultimately subject to direction by the Portfolio Minister this would mitigate this problem. Nonetheless, to minimise this risk, one of the Guiding Principles for the design of TAHE was that there would be no impact on safety risks.

A safety assurance framework could only be established once TAHE's operating model had been agreed. TAHE's Operating Licence and Statement of Corporate Intent both include safety as a requirement, in addition to achieving a reasonable expectation of a sufficient rate of return. TAHE's Operating Licence for 1 July 2021 to 30 June 2023 requires it to have regard to safety, integrity and the policies and objectives of the NSW Government in relation to integration of transport modes. Further, TAHE lists safety as one of its top three non-financial performance indicators.

In August 2021, the then Minister for Transport directed the Office of Transport Safety Investigations (OTSI) to review TAHE's safety governance arrangements. This review was designed to determine whether the arrangements put in place adequately managed the potential conflict between TAHE's need to generate a commercial return and safety. OTSI concluded that the arrangements should have the desired effect, but noted that the arrangements were not fully developed or implemented at the time of the review.

There was a heavy reliance on consulting firms throughout the process to establish TAHE, and management of consultancies was ineffective

Over the period 2014–2021, 16 separate consultancy firms were employed to work on 36 contracts covering aspects of the design and implementation of TAHE. These engagements ranged from providing expert advice through to project management, and providing administrative support and secretariat services for TAHE. The heavy reliance on consulting firms during the design and implementation of TAHE heightened the risk that agencies were not receiving value for money, were outsourcing tasks that should be performed by the public service, and did not mitigate the risk that the advice that was received was not objective and impartial. There were risks that the role of consultants could have been blurred between providing independent advice to government on options, and facilitating a pre-determined outcome. This risk was amplified because a small number of firms were used repeatedly to provide advice on one topic.

The estimated final cost of these engagements was $22.56 million compared to a total initial cost of $12.94 million. Thirty-six per cent of contracts (13 out of 36 contracts) had at least one variation and, of these, there were 11 instances where the value of the variation exceeded the threshold for a tender.

Whilst some contract variations were the result of unexpected and unpredictable events, the large number of variations and variations of large value raised the risk that the initial engagements were not effectively or accurately scoped. Further, the repeated incidence of agencies using large contract variations instead of returning to the market is contrary to the NSW Procurement Policy Framework. This is because it can reduce competition and limit access to new suppliers, products and services and raises the risk that the commissioning agencies (and therefore the community) are not getting value for money in these engagements.

There is also one instance of the same consultancy (KPMG) being separately employed by Treasury and TfNSW at the same time in 2020. KPMG's work for Treasury was focused on a fiscal risk management strategy and the impact of new accounting standards. The TfNSW engagement resulted in two reports on an operating and financial model for TAHE, which raised concerns about the financial implications of TAHE.

In evidence to the NSW Parliament, KPMG advised that in June 2020 it had established a Conflicts, Oversight and Governance Committee to manage the risk of a real or perceived conflict. In July 2020, TfNSW was informed by KPMG that there was no issue with the two engagements, and that KPMG would manage any future issues though the Conflicts, Oversight and Governance Committee. Despite the presence of the Conflicts, Oversight and Governance Committee, disputes arose when Treasury strongly disagreed with some of the outcomes of the work commissioned by TfNSW, related to accounting treatment and fiscal advice. Specifically, Treasury strongly disagreed with the accuracy of the findings, and the assumptions on which they were based.

The management of this conflict (real or perceived) was left to the consultant, when it should have been managed by Treasury and TfNSW. If these agencies had communicated more effectively, used available governance structures consistently, and shared information openly about their use of consultants and the nature of their engagements, these disputes might have been avoided. This issue, coupled with deficiencies in procurement by both agencies, reflected and further perpetuated the lack of cohesion in the design and implementation of TAHE.

TfNSW and Treasury's record keeping was poor and higher sensitivity classifications were applied to large tranches of documents than is justified or required by policy, limiting external scrutiny

Our report 'State Finances 2021' commented that governance arrangements to support independent external audit were inadequate and that key documents were either not provided, or not provided on a timely basis, to the Audit Office.

Again, for this performance audit, TfNSW and Treasury did not always provide this Office with information relating to TAHE on a timely basis. During this audit, there also were multiple instances where TfNSW and Treasury were unable to provide the requested documentation. For example, there were numerous references to an announcement or communication from the ABS in 2012 about the reclassification of RailCorp to a GGS entity. This event is significant in the genesis of TAHE. Treasury advised that it performed an extensive search, including retrieval of documents from State Archives, to uncover documents that may have been received from the ABS, but could not locate evidence that this announcement or communication ever occurred or, if it did, that the interpretation is correct.

Records for the procurement of consultant engagements were also lacking. This audit specifically requested documents such as conflict of interest declarations, initial proposals/business plans, and justifications for contract variations. TfNSW and Treasury have been able to provide few, if any, of these items.

There are further issues with the incorrect and over-classification of documents. The NSW Government Information Classification, Labelling and Handling Guidelines specify that security classifications are only to be used when there is a clear and justifiable need to do so but during the course of this audit, we encountered many documents that have been incorrectly classified, or classified 'in bulk', as Cabinet-in-Confidence without clear justification. The classification of materials as Cabinet-in-Confidence had the effect of limiting our ability to comment on or refer to the contents of those documents in this report. Moreover, even after the Department of Premier and Cabinet approved the release of documents held by Treasury that are not official Cabinet records, the ultimate release of these documents required the intervention of the Treasury Secretary, with Treasury staff remaining reluctant to handover requested documents even after agreeing to do so in-principle. More broadly, the inappropriate classification of documentation as Cabinet sensitive limits this Office's, and the NSW Parliament's, ability to provide scrutiny or independent assurance.

2. Recommendations

NSW Treasury should, as an ongoing practice:

1. support improved accountability and transparency for major new fiscal transformation initiatives (such as the establishment of TAHE) by providing timely information to the Treasurer, the Parliament, and where relevant, to the public on:
    - the estimated costs, benefits and Budget impacts of fiscal transformation initiatives
    - significant on-going risks including, but not limited to, impacts on other government projects and initiatives
    - the rationale and implications of changes in the scope of previously announced fiscal transformation initiatives and reforms
2. ensure that government entities do not reflect the financial impact of significant initiatives in the General Government Sector Budget if:
    - there is an as yet unmitigated risk or uncertainty that the Budget impact or improvement may not be fully realised
    - reflecting financial benefits early creates perverse incentives for implementing agencies to preserve the financial improvement to the GGS Budget despite other significant risks or challenges that may arise in implementation of the initiative.

By 1 July 2023, NSW Treasury and Transport for NSW should:

3. review their record keeping practices, systems and policies to ensure compliance with the *State Records Act 1998*, and the NSW Government Information Classification, Labelling and Handling Guidelines, with a particular focus on the correct labelling of Cabinet-in-Confidence documents.

By 1 July 2023, NSW Treasury, TAHE and Transport for NSW should:

4. review their respective internal procurement policies to ensure that the use of consultants fully complies with NSW Government policy requirements, including:
    - the use of contract variations and extensions is consistent with the NSW Procurement Policy Framework
    - instances where consultants are simultaneously working for other agencies are identified, assessed and actively managed to ensure there are not real or perceived conflicts of interest.

1. Introduction

1.1 Background

The institutional framework for public transport in New South Wales

The institutional framework for the governance and delivery of public transport services has been subject to many significant changes since 1980, when the State Rail Authority of New South Wales (SRA) was created.

The SRA was created to operate all passenger and freight rail services and to conduct research and development to meet future rail transport needs arising from population, industrial, economic, technological and social changes. The SRA was required to work with the Urban Transit Authority to provide efficient, adequate and economic urban passenger services.

In July 1996 the NSW Government split the SRA into four entities. These were:

- State Rail Authority – responsible for passenger services
- Rail Access Corporation (RAC) – responsible for the management of infrastructure
- Railway Services Authority (RSA) – responsible for maintenance
- Freight Rail Corporation (later known as FreightCorp) – responsible for the operation of freight rail services.

The RAC was a State Owned Corporation (SOC) that was set up to ‘hold, manage and establish sufficient, safe and reliable infrastructure facilities' and to facilitate access to the New South Wales rail network for public and private operators.

The Glenbrook rail accident in December 1999 and the Waterfall rail accident in January 2003 together resulted in the deaths of 14 people in total. The Special Commission of Inquiry (the Special Commission) into the Waterfall rail accident highlighted several issues with safety systems and made multiple recommendations for its improvement. The Special Commission also noted that splitting the SRA into four bodies had replaced a vertically integrated structure with a horizontal one. Further, by 1998, three of these four agencies were commercial entities and were expected to generate a profit. The Special Commission stated that there was ‘a tension between the commercial objectives of the infrastructure owner and the infrastructure maintainer to maximise their profits and increase the return to the government, and the need… to provide safe and reliable train services to the travelling public’.

Further, as the then Roads and Transport Minister stated after the 1999 Glenbrook accident, commercial goals were often pursued at the expense of maintenance and safety. In the aftermath of the Waterfall rail derailment concerns were again raised about the competing goals of profit and rail safety.

In January 2001, the RAC was merged with another SOC, Rail Services Australia (previously called the Rail Services Authority) which had the task of constructing and maintaining locomotives and rolling stock, as well as rail infrastructure including track, signals, overhead wiring structures, bridges, and platforms. The merger resulted in the creation of the Rail Infrastructure Corporation which had the primary objective of ensuring that the New South Wales 'rail network enabled safe and reliable passenger and freight services to be provided in an efficient, effective, and financially responsible manner'. The Rail Infrastructure Corporation was also a SOC. As part of its response to the Special Commission, the then NSW Government merged the State Rail Authority of NSW and the metropolitan arm of the Rail Infrastructure Corporation on 1 January 2004 to create the Rail Corporation of New South Wales (RailCorp) to provide single-point accountability for the metropolitan rail network.

RailCorp held all rail property assets, rolling stock and rail infrastructure in the Sydney metropolitan area and in some country locations across the State. It also operated passenger train services. With the aim of ensuring clearer accountability, RailCorp established a Strategic Asset Management Division responsible for the development of asset management policy, frameworks and procedures, as well as asset planning and asset performance management.

RailCorp delivered services as a SOC until 31 December 2008. On 1 January 2009, RailCorp was reconstituted as a statutory authority and continued to operate as a PNFC reporting directly to, and taking direction from, the Minister for Transport.

In November 2011, the NSW Government adopted a new approach to the provision of public transport services in New South Wales, with the aim of promoting coherence and integration across all transport modes against a set of common statutory objectives for public transport agencies. Transport for NSW (TfNSW) was established, pursuant to the *Transport Legislation Amendment Act 2011*, as an integrated transport authority intended to improve the planning and coordination of transport services for the state. TfNSW was responsible for coordination, planning, policy and funding allocations across the transport system. RailCorp became a controlled entity of TfNSW at this time.

At this point, it is worth noting that the *Rail Safety National Law* (RSNL) was passed by the South Australian Parliament on 1 May 2012. The RSNL replaced 46 pieces of State, Territory and Australian Government legislation with one national law that applies across New South Wales and all other States and Territories in Australia. The Office of the National Rail Safety Regulator (ONRSR) was created to independently administer the RSNL in every Australian State and Territory.

On 7 December 2012, two new entities were created to manage the operation of passenger train services: Sydney Trains (metropolitan services) and NSW Trains (intercity, regional and country services).

According to Treasury, the Australian Bureau of Statistics (ABS) advised in 2012 that it intended to reclassify all three New South Wales rail agencies (RailCorp, Sydney Trains and NSW Trains) as General Government Sector (GGS) entities. Further, in May 2012, the then Minister for Transport announced the ‘Fixing the Trains’ initiative and noted that ‘RailCorp is currently financially unsustainable'. The then Minister stated that RailCorp cost $10 million a day to run, and that its costs were rising three times as fast as passenger usage.

As part of the ‘Fixing the Trains’ initiative, on 17 May 2013, Sydney Trains and NSW Trains (which were public subsidiary corporations of RailCorp) both became statutory bodies for the purposes of the *Public Finance and Audit Act 1983*, pursuant to the Public Finance and Audit Amendment (Sydney Trains and NSW Trains) Proclamation 2013. Both of these agencies became operational on 1 July 2013 whilst RailCorp remained the owner of the rail network and the rail property assets in the metropolitan area.

In summary, from 1 January 2004 to 30 June 2013, RailCorp operated rail services, and owned and maintained the metropolitan rail network.

The NSW Government flags its intention to establish a rail asset manager as a commercial entity

The NSW Government flagged its intention to create a separate asset manager as a commercial entity in its 2013–14 Half-Yearly Budget Review. The government indicated that the process of reforming the delivery of transport services was continuing and the next phase would be the transformation of RailCorp into a commercial entity, which would manage access to rail assets through transparent and commercially based agreements with all operators. At that time, funding for new rail infrastructure was provided as a recurrent Budget grant which appeared as an expense in the NSW Budget. Transforming RailCorp into a commercial entity would have the effect of replacing the capital grants with equity investments, which are not Budget expenses.

The 2013–14 Half-Yearly Budget Review noted this would have a ‘significant’ impact on the NSW Budget by reducing the overall State expenditure. It further noted that this arrangement would not change the net lending position of the GGS or result in any reduction in the total level of capital investment in the rail sector or the net level of government support provided to the state owned rail operators.

The structure of this new commercial entity, then called AssetCo, was developed by Treasury and TfNSW, and approved in-principle by the NSW Government in 2014. In 2015, the ABS classified the entity, now called TAHE, as a PNFC entity. As part of its submission to the ABS about the classification of TAHE, Treasury included a transition plan (also referred to as 'the milestones'), to be completed between 30 June 2015 and 1 July 2019.

RailCorp’s 2014–15 Annual Report noted that RailCorp funding would be provided by equity investments from 2015–16 and that TAHE, when established, would procure and sell assets and manage assets on a portfolio basis.

The 2015–16 Budget Statement included a forecast of a $2.5 billion surplus in 2015–16 and further surpluses over the period of the forward estimates. The 2015–16 Budget Statement also stated the government's intention that TAHE would be created on 1 July 2015. TAHE would streamline the delivery of public transport asset management and have a positive impact on the Budget. However, TAHE did not start operating during 2015 and RailCorp continued to operate as the owner of rail property assets and the network.

The *Transport Administration Act 1988* (TAA) was amended in 2017 (and assented to on 11 April 2017) to enable the establishment of TAHE as a dedicated transport asset manager. At the time, it was anticipated that RailCorp would transition to TAHE from 1 July 2019. However, RailCorp continued to operate until 30 June 2020, and TAHE started operating as a SOC on 1 July 2020.

Objectives and functions of TAHE

In April 2017, during the second reading of the Transport Administration Amendment (Transport Entities) Bill 2017, the then Treasurer said that TAHE would consolidate transport asset ownership by ‘optimising the existing transport asset base, to enable a more effective, efficient and commercial approach to the management of transport assets, particularly property’. The Treasurer noted that the creation of ‘a dedicated asset holding entity, operating on commercial principles set out by the SOC Act, will provide an efficient base from which we can optimise transport service outcomes for the New South Wales community’.

The Treasurer also noted that the responsibility for safety with respect to operational assets would remain with Sydney Trains and NSW Trains, thus providing the ‘safety benefits of vertical integration’. The Transport Secretary will be appointed to the Board of TAHE to provide a coordinated approach to safety across the sector and, in exceptional circumstances, the Portfolio Minister will be able to issue a binding direction to the Board of TAHE to take actions in the public interest. Finally, TAHE will need to comply with the terms of its Operating Licence, which will specify how it deals with issues including:

- safety
- the integration of transport modes
- compliance with network and asset standard requirements issued by Transport for NSW.

TAHE has the role of focussing on the strategic, commercial and financial management of the New South Wales rail asset portfolio, which was valued at approximately $21 billion in TAHE's Annual Report for 2020–21.

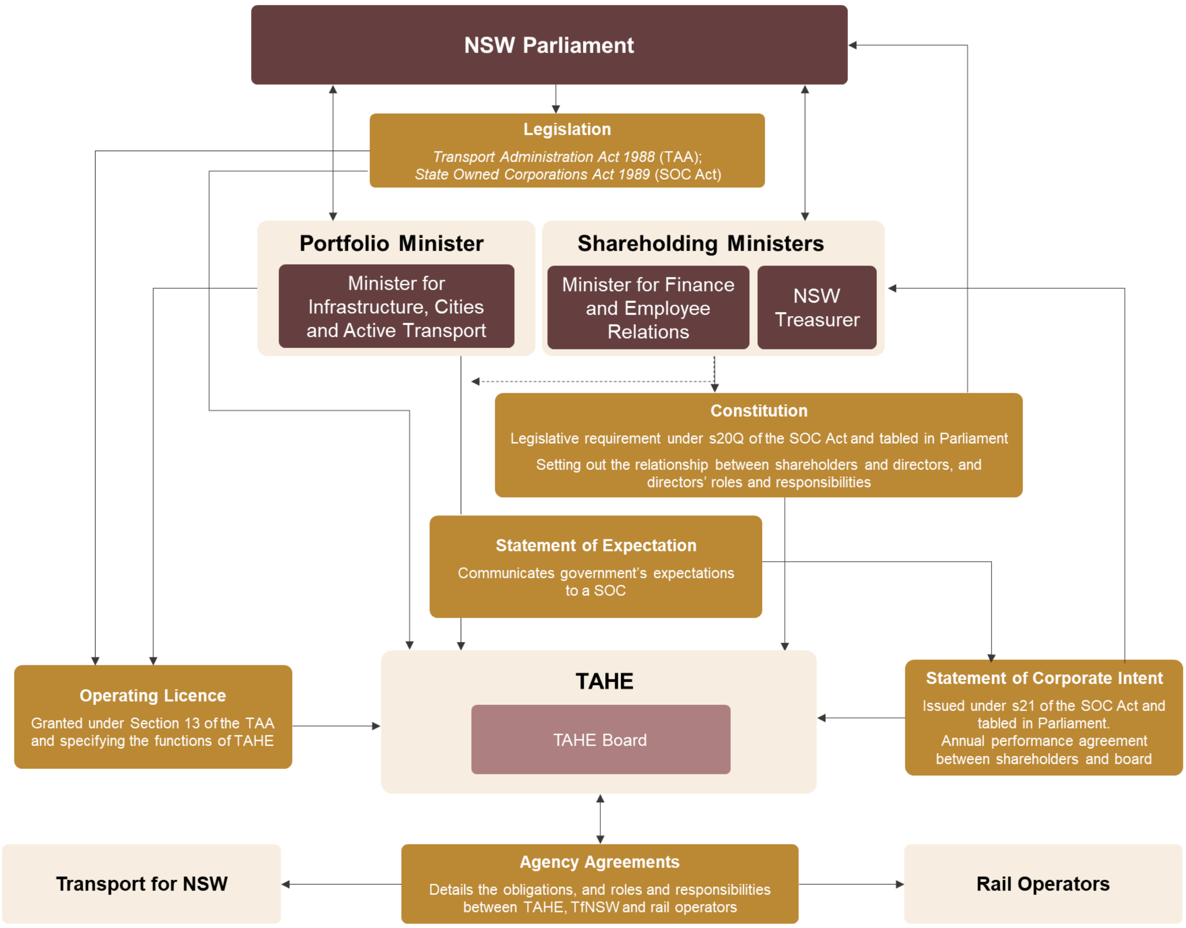
Under Section 10 of the TAA , the principal objectives of TAHE (each of equal importance) are:

- to undertake its activities in a safe and reliable manner
- to be a successful business and, to this end:
  - to operate at least as efficiently as any comparable business
  - to maximise the net worth of the State's investment in TAHE.
- to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates
- where its activities affect the environment, to conduct its operations in compliance with the principles of ecologically sustainable development contained in Section 6(2) of the *Protection of the Environment Administration Act 1991*
- to exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates.

Under Section 11 of the Act, the functions of TAHE include holding, managing, operating and maintaining transport assets (land and property, rolling stock and rail infrastructure). These assets are made available to Sydney Trains and NSW Trains for their operations and TAHE's operation and maintenance functions are restricted by its Operating Licence which is provided by the Portfolio Minister. TAHE is also responsible for promoting and facilitating access to the New South Wales rail network in accordance with the NSW Rail Access Undertaking (the Undertaking).

Exhibit 1 shows the governance arrangements for TAHE.

Exhibit 1: TAHE's governance arrangements

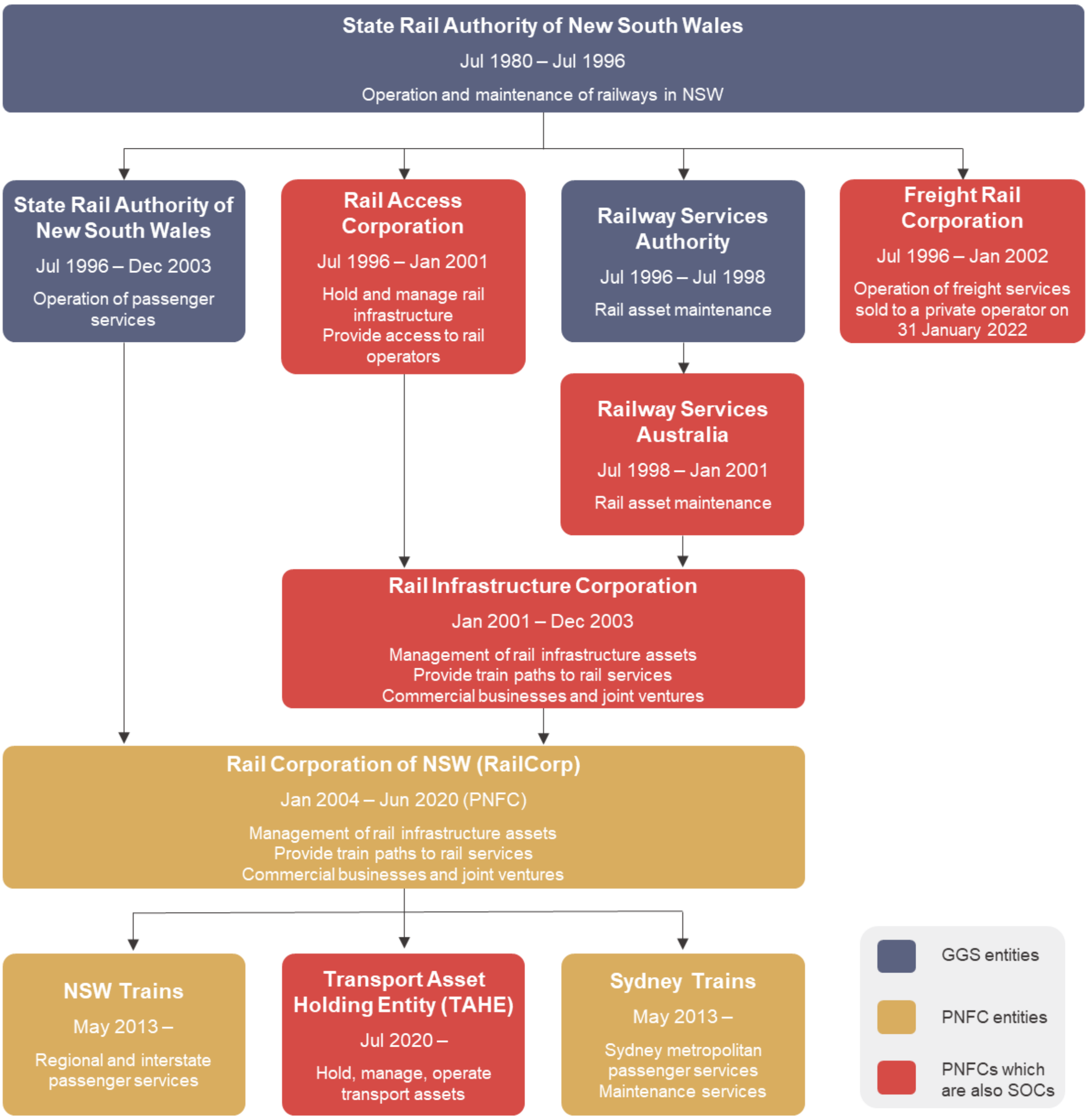


* TAHE's current Operating Licence was issued by the former Portfolio Minister, the Minister for Transport. In July 2024, the Portfolio Minister is expected to issue its replacement.

Source: Audit Office of New South Wales research based on material provided by TfNSW and Treasury.

Exhibit 2 shows the evolving structure of rail operations in New South Wales from 1980 to date and the classification of each of the entities. The rest of this report focuses on the design and implementation of TAHE, which is a SOC with a PNFC classification.

Exhibit 2: Structure of rail operations in NSW from 1980 to date



Source: Audit Office of New South Wales research based on information in the State Records archive.

1.2 External scrutiny of the establishment of TAHE

The NSW Parliament's Public Accountability Committee (the Committee) initiated an inquiry into TAHE on 23 June 2021 and it reported on 8 April 2022. The findings of this inquiry represented the opinions of the majority, but not all, of the Committee's members and included that:

- TAHE was established with the primary aim of improving the State's fiscal position in the Budget papers, rather than for other purported efficiency and safety benefits
- the NSW Government implemented its policy decision of creating TAHE without due consideration of the real financial impact on the Budget result and the applicable accounting standards and rules that would apply to the entity
- it is inappropriate for TAHE to have property development as its primary business focus, given it holds some of the State's most critical transport infrastructure and should be focused on the rail system
- the NSW Government failed to give proper consideration to safety, accountability and risk mitigation matters before implementing its policy decision of creating TAHE.

The report recommended that 'the NSW Government unwind the Transport Asset Holding Entity, due to the further negative financial impacts it will cause to the General Government Sector Budget and its inability to credibly make a commercial return'. Further recommendations also included that, in the engagement of consultants, the NSW Government implement:

- controls to ensure consultants are chosen to provide genuine independent advice rather than to deliver desired outcomes
- measures to ensure agencies share information with each other, to avoid the same consultancy firm being used to provide advice in instances where agencies may have disparate interests in the same policy area
- measures to prevent conflicts of interest when engaging consultants from more than one agency.

Government members of the Public Accountability Committee rejected the report as failing to take into consideration in its conclusions all of the evidence that was presented to the Committee. Amongst other things, the government members noted that:

- legislation clearly outlines TAHE's primary aims (of equal importance) and functions
- TAHE is not dissimilar to other heavy rail entities established and operating in other state and federal jurisdictions, such as Queensland Rail, VicTrack and ALTRA
- introducing commerciality results in greater transparency and accountability for taxpayers
- commerciality means having a structure in place that properly accounts for the costs of recurrent services and capital expenditure and provides an identifiable return to the taxpayers on their significant investment.

The NSW Government's response to the Committee's report was released on 7 October 2022. The response rejected the call to unwind TAHE, for the reasons discussed above, but accepted in-principle the recommendation concerning the engagement of consultants. The response also noted that in July 2022, the Auditor-General commenced a performance audit on the use of consultants in the NSW Government and the role of NSW Procurement in providing guidance and advice. The NSW Government stated that it intends to wait for that performance audit report to be tabled and will be guided by its recommendations on the use of consultants. The Auditor-General is intending to table the performance audit report on the use of consultants in early March 2023.

On 6 May 2022, the Audit Office of New South Wales published its financial audit report on the Transport cluster for the financial year ended 30 June 2021. The report, 'Transport 2021', found there was considerable uncertainty around the value of:

- future access and licence fees
- additional funding provided outside the forward estimates period
- the fair value of TAHE's non-financial assets.

In addition, the transition from RailCorp to TAHE altered the valuation of TAHE's assets arising from a change in valuation methodology from replacement cost to an income approach. This change was undertaken in accordance with AASB 13 *'Fair Value Measurement'* and resulted in a $20.3 billion decrease to the fair value of TAHE's assets. The write-down occurred because the access and licence fees incorporated into the income-derived valuation model were not sufficient to maintain the value previously determined under a replacement value assessment. The financial audit raised questions about TAHE's ability to generate a reasonable expectation of a sufficient rate of return on the government's investment. In the same year, the report 'State Finances 2021' also raised concerns about TAHE.

Specifically, the report found there remains a risk that:

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

The report 'State Finances 2021' also raised concerns about the undue reliance on consultants.

On 30 June 2022, an 'Independent assessment of Treasury's processes in relation to the preparation of the 2021 State Financial Statements' (the Sedgwick report) was released by the NSW Government. This report, authored by Stephen Sedgwick AO, was intended to find ways to improve Treasury's systems, processes and culture in its interactions with the Audit Office of New South Wales. The findings of this report included that:

- the transition to fully establish TAHE took too long
- Treasury had committed to a particular treatment of TAHE in the 2015–16 Budget before developing a sufficiently detailed business model
- consultants were involved with the policy development and implementation of TAHE from the beginning, and it is unclear whether Treasury was sufficiently aware of the risks between the roles played by consultants as external advisors and as part of Treasury's team.

The findings in this performance audit report are drawn from analysis of documentation provided by Treasury, TfNSW and TAHE, Cabinet documents and decisions. This audit also had regard to the findings and recommendations in other reports of inquiries into TAHE, but the conclusions drawn in this report are those of the Audit Office of New South Wales and are based on its own analysis.

The Audit Office of New South Wales also has a performance audit currently in progress on the use of consultants which has both Treasury and TfNSW as auditees (in addition to another eight auditees). The findings of that audit may add further information to the analysis of the use of consultants that is the subject of this report.

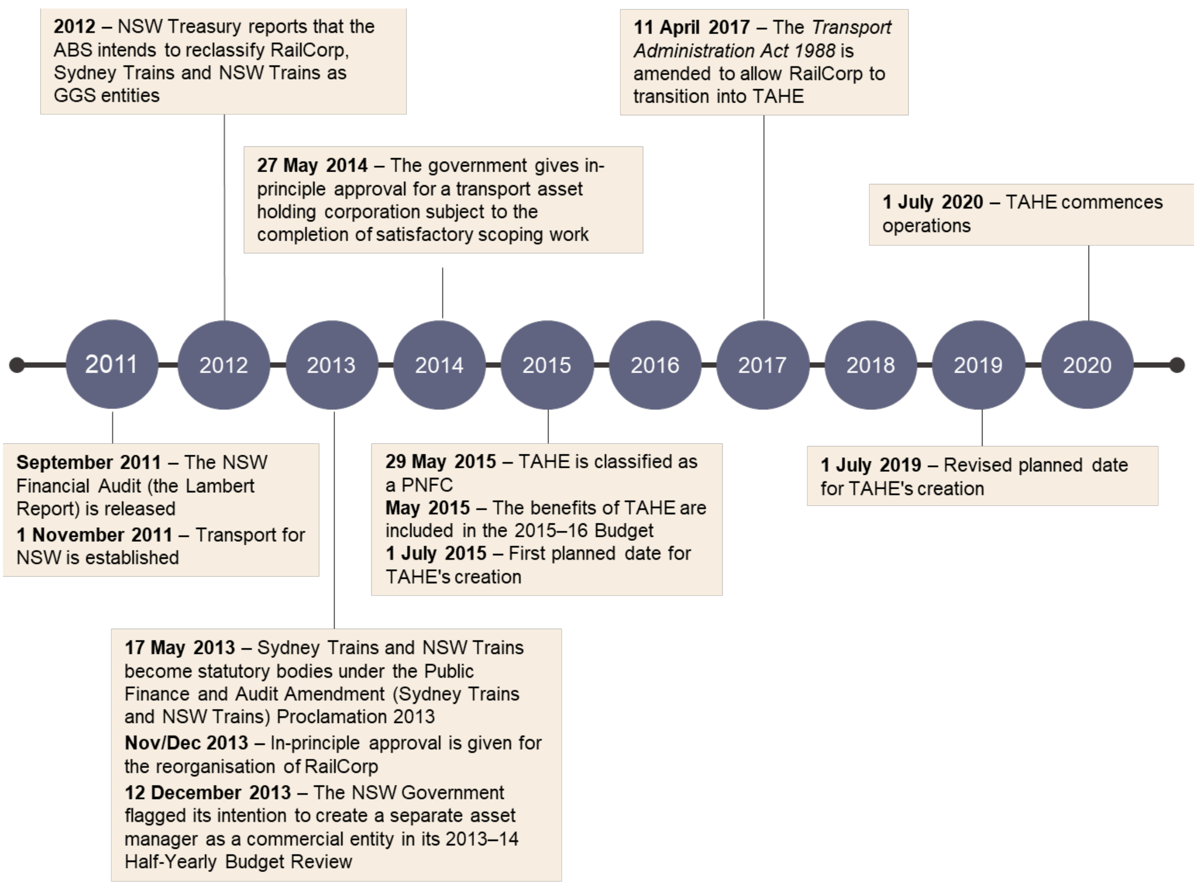
2. Design of TAHE

2.1 Intent of TAHE

The concept of an asset holding entity was first proposed in 2013 and TAHE began operating on 1 July 2020 – five years later than initially planned by the government. TAHE had several intended start dates in the years since it was conceived. The 2015–16 Budget Statement stated that a dedicated asset manager, the TAHE, would be created from 1 July 2015. TAHE's second planned commencement date was 1 July 2019 when it was intended that it start operating as a State Owned Corporation but this was delayed due to the NSW State Election and the need to further refine TAHE's operating model. Finally, TAHE commenced operations on 1 July 2020.

Exhibit 3 gives an overview of the timeline of this process. It was always intended by government officials that there would be a staged approach to the realisation of TAHE. Chapters Two and Three of this report focus on the design and implementation phases separately. It is noted that, in practice, these phases are often not linear and that some elements of the implementation of TAHE continued after it commenced operations on 1 July 2020.

Exhibit 3: Timeline of design and implementing TAHE



Source: Audit Office of New South Wales research based on documentation provided by TfNSW and Treasury.

TfNSW conceived the idea of a single asset holding entity (AssetCo) to consolidate all transport assets

In July 2014 correspondence from TfNSW to Treasury, TfNSW stated that it conceived of the creation of a public transport asset holding entity some time prior to sending this correspondence with the primary intent of streamlining and consolidating public transport asset holding entities. TfNSW's plan was to create a 'shell' AssetCo (a non-profit, non-trading entity with no staff), which held all public transport assets, and would continue to be controlled by TfNSW.

It is unclear when TfNSW's idea was specifically devised but the details in the correspondence indicate it was after the creation of TfNSW in November 2011 and before the announcement of the rail asset manager in the 2013–14 Half-Yearly Budget Review.

Government entities are classified into specific institutional sectors

All government entities are classified by the ABS into one of three specific institutional sectors. These are:

- General Government Sector (GGS)
- Public Financial Corporations (PFC)
- Public Non-Financial Corporations (PNFC).

When a GGS entity incurs expenses (other than through transactions with other GGS entities) the expense is recognised in the GGS Budget. In contrast, the funds provided to a PNFC or a PFC are treated as equity contributions,[2] provided that the entity provides a reasonable expectation of a sufficient rate of return on investment.

TfNSW aimed to ensure it retained integrated control of the assets to support the transport system and ensure safety

TfNSW intended that this entity would be a not-for-profit 'shell' company as this would:

- be the simplest and least risky legal structure
- be relatively easy to implement
- efficiently and effectively deliver transport objectives.

It was intended that the assets would be managed, maintained and operated through service contracts with both public and private operators. A key focus was to minimise the level of complexity. In addition, the creation of this entity was intended to facilitate future public transport reforms and support TfNSW's strategic direction. This structure would also ensure vertical integration of operations, so that safety could be maintained. TfNSW considered a for-profit alternative but ruled it out as too complicated and risky.

However, during consultation with the central agencies before submitting the TfNSW plan for government consideration, the direction was significantly changed by Treasury.

Treasury sought to capitalise on the model to create an entity that would improve the GGS Budget

Treasury accepted the importance of better asset management and rail safety outcomes. However, it introduced a competing priority – that is, improvement of the NSW Budget.

In 2012, Treasury officials believed the ABS had concerns about whether RailCorp met the criteria for a PNFC and that there was a risk that RailCorp would be reclassified by the ABS to the GGS as a result. The concerns related to RailCorp's revenue generation and the government subsidies it received, and how much its key customers were paying for rail access.

[2] More detail on the classification of government entities and accounting treatment is provided in Appendix two.

Had this reclassification occurred, it would have had a negative impact on the GGS Budget as it would have resulted in RailCorp's depreciation expenses being allocated to that sector's Budget. Treasury, wanting to avoid a negative impact to the GGS Budget, sought to avoid reclassification by the ABS. In response to Treasury's concerns, both Treasury and TfNSW began investigating ways to avoid an adverse reclassification outcome, and the decision to create a commercial asset holding entity was made by the government in 2014.

In briefing the incoming Secretary of NSW Treasury in January 2022, Treasury advised that the impetus to create TAHE was the government's commitment to invest substantial funds in a significant uplift in transport network capacity. It also advised that:

- in 2012, the NSW Government released a State Infrastructure Strategy and a Long-Term Transport Master Plan which proposed better use of existing assets as well as flagging substantial new asset delivery
- TAHE reforms reflect policies that have been progressively adopted since National Competition Policy
- the policy reflects a view that improved market design can achieve many of the benefits of competition while maintaining state ownership of natural monopolies.

A separate (undated) briefing stated that the current government could not deliver its infrastructure plans under the previous grant-funded model as funding was linked directly to the Budget result and other government priorities. The TAHE reform was intended to provide Transport with more consistent funding through rail access pricing.

Further, if TAHE generated a reasonable expectation of a sufficient rate of return on investment, then the funds TAHE received from the government would be recognised in the GGS Budget as equity investments and not as a grant expense. The accounting change from grant funding to equity investments would have the effect of improving the GGS Budget.

Fiscal risks related to the structure and classification of the asset holding entity became a central focus for Treasury

With the restructuring of rail entities in 2012–13, the government decided to separate the operational functions of RailCorp from the ownership of assets. This was done to allow specialist rail operators to be formed which would focus on the needs of passengers.

The State Fiscal Strategy was anchored in the NSW Financial Audit 2011 (the Lambert report), which was commissioned by, and delivered to, the then incoming Coalition government. This report identified a 'marked deterioration' in the State’s financial position since 2005-06 as a result of growth in recurrent expenditure, which was faster than revenue growth. The report showed that transport accounted for 50% of all general government capital expenditure in 2011 and that most of this expenditure was directed to RailCorp. The report also noted that fare revenue provided only about 20% of RailCorp’s total funding.

Lambert recommended that ‘RailCorp, the State Transit Authority and the Roads and Traffic Authority be corporatised with high quality, commercial boards established under a commercial charter, with arms-length service delivery agreements with the Department of Transport, based on phasing out inefficiency costs in the provision of services'. Lambert noted that ‘structural reform of the rail sector would be complex and carry significant transactional costs and long lead times to implementation’.

In briefing the new Treasurer in 2017, Treasury stated that, in 2012, the ABS announced that it was intending to reclassify the rail entities in New South Wales (RailCorp and its subsidiaries Sydney Trains and NSW Trains) as GGS entities, which would result in RailCorp's depreciation expenses being allocated to the GGS Budget. Treasury is responsible for managing the relationship with the ABS for all NSW Government entities.

This performance audit requested from Treasury, but did not receive, evidence of this ABS announcement. We have been unable to confirm its content. Treasury advised that it performed an extensive search, including retrieval of documents from State Archives, to uncover documents that may have been received from the ABS, but was unable to provide any further information about this announcement or communication.

On 23 February 2015, upon review of the financial statements of RailCorp, Sydney Trains and NSW Trains, the ABS wrote to Treasury and advised that it would have reclassified all three entities from the PNFC sector to the GGS, but for the changes that were being planned for the structure and operations of RailCorp at that time. The reasons given by the ABS for this possible reclassification were:

- revenue from operations only covered 29% of total operating expenses
- the high amount of government subsidies
- the difficulty in determining the correct fees paid by NSW Trains and Sydney Trains to access the rail network.

Conflicting objectives created tension between the agencies and led to a lack of cohesion in the design and implementation of TAHE

Whilst Transport for NSW wanted TAHE to be a GGS entity, Treasury wanted a PNFC classification for TAHE, as this was necessary for TAHE to be a for-profit entity. TAHE needed to make a return on investment in order for government contributions to TAHE to be treated as equity investments (which are not classed as an expense to the Budget) rather than capital grants (which are a Budget expense).

From 2013 onwards, the desire to improve the NSW Budget in this way was repeatedly put forward in briefings to the NSW Government as the reason for creating a commercial asset holding entity for transport. It should be noted, however, that this would not result in any change to the Total State Sector expenditure because PNFCs are part of the Total State Sector. Further, there is no change in the total government spend on TAHE. The change is an accounting presentation that positively impacts the GGS Budget result.

In May 2014, the NSW Government gave in-principle approval for the creation of an asset holding corporation.

In November 2014, TfNSW stated explicitly that it preferred that RailCorp become a GGS entity. It raised concerns about the impact of a commercial structure on the governance, regulation and operations of TAHE and advised that there could be risks to safety arising from the competing needs to generate a profit and maintaining rail safety.

However, in February 2015, the NSW Government gave final approval for a new entity with the intention that it would be classified by the ABS as a PNFC, noting the potential operational, regulatory and safety risks raised by TfNSW. In the same year, the Budget benefits of this decision were included in the 2015–16 NSW Budget.

Guiding Principles were approved by the TAHE Steering Committee (chaired by TfNSW) and endorsed by the TAHE Advisory Board (chaired by TfNSW with representation from DPC and Treasury) in 2017. The Guiding Principles, as reported in the Gold Milestone[3] report (prepared by Ernst and Young for TfNSW) in December 2017 were:

- Improve commerciality
  - maximise the return to shareholders by pursuing commercial opportunities
- No impact to safety risk
  - not act in a way that impacts the ability of the NSW transport cluster to ensure the safety of the system
  - no impact on the ability to operate a vertically integrated metropolitan rail system
- Align to government objectives/strategy
  - actively align to whole-of-government objectives specifically including the long-term objectives of TfNSW
- Ensure operational continuity
  - TAHE should seek to optimise service delivery outcomes of the operators and limit impact upon operational continuity/performance (both short and long-term)

[3] This should not be confused with the report titled 'Accounting Tax and Financial Gold report' (the Gold report) which was produced by KPMG for TfNSW in 2018.

- Meet the requirements of a commercial, independent entity
  - meet the requirements of an independent asset owning entity, discharging delivery through commercial agreements whilst ensuring asset remain on balance sheet
- Clarify accountabilities and responsibilities
  - clearly articulate the accountability and responsibilities of TAHE and other parties involved in the delivery of transport services and infrastructure, and ensure the design is 'light touch' and does not duplicate organisational functions and introduce additional levels of bureaucracy.

The Gold Milestone report of December 2017 focused on TAHE's 'functional model design' and was intended as a key reference for the Steering Committee and Advisory Board and other stakeholders. The Guiding Principles laid out in this report were used by relevant agencies in the process of designing TAHE. However, Treasury and TfNSW did not resolve their differing objectives. As a result, the design of TAHE was not cohesive as the agencies involved had different motivations and divergent views on the path to establish TAHE, and the weight given to different risks and issues.

There is minimal publicly available information about the purpose, risks and complexities in the design and implementation of TAHE

The establishment of TAHE is a significant fiscal and structural reform to the transport sector in New South Wales. However, aside from references made in half yearly or annual Budget papers, in RailCorp's 2014–15 Annual Report, and then later in second reading speeches in NSW Parliament, there is little publicly available information about the reasons for, and risks concerning, the establishment of TAHE. The information that has been made publicly available has at times been inconsistent. There have also been inconsistencies in the advice to government, from NSW Government agencies, about the purpose of TAHE.

Transport for NSW envisaged that the single public transport asset holding entity would provide a platform and structure underpinning effective implementation of public transport reforms and direction. However, the purpose of TAHE, as described in government documents, changed over time. Although it is consistently described as a commercial entity from 2015 onwards, the details have been inconsistent.

In the 2013–14 Half-Yearly Budget Review the proposed new structure for RailCorp was described as 'a stand-alone business, managing access to those assets through transparent and commercially based agreements with all operators'. However, the 2014–15 Budget described the new entity as a 'new stand-alone business to manage and construct the public transport capital infrastructure' which is somewhat different to the previous description.

In the 2015–16 Budget Statement, TAHE (as it is now called) is referred to as a dedicated asset manager which would eventually hold all of the public transport assets for the State. Further, TAHE would make active decisions about the use of transport assets, procure and sell assets, and lease assets to operators under negotiated leases and other contracts.

In contrast, in 2017, when Sydney Metro was established as a separate entity, NSW Government Ministers were advised that TAHE would be a passive asset holder, and that it did not have the ability to manage and deliver projects. The expected benefits of TAHE were also described as uncertain, but that they would be lower than those generated by Sydney Metro. These concerns about the performance of TAHE are inconsistent with earlier descriptions and information provided to NSW Government Ministers about this entity. These differing descriptions of TAHE, used over several years, suggests a lack of clarity around its form and purpose in the design phase.

Legislative amendments to enable TAHE were geared to achieving a positive impact on the General Government Sector Budget

In early December 2015, TfNSW provided a preliminary version of drafting instructions to Parliamentary Counsel for amendments to the *Transport Administration Act 1988* (TAA) to establish TAHE. On 17 August 2016, TfNSW reported that it had been advised that changes to the legislation should be limited to those required to effect the Budget outcomes. This echoes a direction given by the Treasurer to Treasury that the focus of the revised legislation should be on delivering the Budget result and should not be influenced by commercial objectives.

When the TAA was amended in 2017 to enable the conversion of RailCorp to TAHE, the revised planned commencement date for TAHE was 1 July 2019, but this was delayed to 1 July 2020. The expected TAHE commencement date of 1 July 2019 coincided with the date of implementation (for the New South Wales public sector) of new accounting standards in relation to leases. Then, on 1 July 2020, a new accounting standard on Service Concessions was introduced. In determining possible responses to these new standards, a range of options were considered by Treasury before it was determined that the best way to proceed was with TAHE as a SOC.

2.2 Financial considerations in planning TAHE

Treasury modelling indicated that a commercial entity would benefit the Budget more than other options

In 2014, Treasury modelling suggested that a commercial (PTE) entity would generate a cumulative positive impact on the Budget of $20.26 billion (unaudited figures) over the period from the 2015–16 financial year to the 2023–24 financial year. In comparison, a GGS structure would generate a cumulative positive Budget impact of $3.39 billion (unaudited figures) over the same period. Exhibit 4 shows the estimated Budget impact on a year-by-year basis.

Exhibit 4: 2014 Treasury modelling of potential Budget result impacts of TAHE from 2015–16 to 2023–24 ($ billion)

	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24	Total
GGS	0.52	0.74	0.88	(0.54)	1.07	(0.34)	(0.36)	0.75	0.67	**3.39**
PTE	2.25	2.14	2.36	1.39	3.1	1.76	1.62	2.82	2.82	**20.26**

Note: These calculations are based on an assumption of a 7.5% increase in both farebox and external revenues per year, and 4.3% depreciation per year throughout the period.

Source: Treasury 2014 (unaudited figures).

In the 2015–16 Budget, the impact of TAHE on the Budget result was reported to be an improvement of $1.8 billion in 2015–16. The 2015–16 Budget Statement included a forecast of a $2.5 billion surplus in 2015–16 and further surpluses over the period of the forward estimates. More recently, our report 'Transport 2020' noted that the accounting change improves the GGS Budget result each year, typically by as much as $1.2 billion to $1.9 billion.

Reflecting these expectations, in the financial year 2015–16, RailCorp received a total of $1.93 billion from the NSW Government of which $1.85 billion was an equity investment and $83.3 million was capital grants. In previous years it had received only capital grants. Exhibit 5 shows the change in funding sources for RailCorp from 2013–14, through to the change in funding in 2015–16, and onto 2019–20.

Exhibit 5: Accounting change: Funding sources for RailCorp from 2013–14 to 2019–20 ($ million)

Funding source	Financial year						
	2013–14	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20
Capital grants	2,283.1	2,188.1	83.3	70.7	92.2	73.9	4.6
Third-party contributions	--	7.9	--	--	--	--	--
Equity	--	--	1,847	1,669.2	1,206.7	1,904.6	1,918.0
Total	**2,283.1**	**2,196**	**1,930.3**	**1,739.9**	**1,298.9**	**1,978.5**	**1,922.6**

Source: Audit Office of New South Wales research based on RailCorp annual reports.

In addition to the funds provided by the NSW Government, there is also income from the fares paid by passengers. Transport farebox recovery is typically around 20% to 30% of the cost of services. In the State Infrastructure Strategy 2022, Infrastructure NSW stated that 'public transport pricing reform should aim to better reflect the real cost of trips on the network, integrate with pricing reform in the road system and reflect the investments government is making to the network and the overall benefits users and society receive from the accessibility the public transport network provides'. However, at the current time, farebox recovery is insufficient to fund public transport and support from the government is essential.

The benefits of TAHE were included in the NSW Budget four years before the entity commenced operating

The benefits of TAHE were included, or 'booked', in the 2015–16 NSW Budget in anticipation of the establishment of TAHE. At that time, a commercial structure had been approved but key elements of the operating model were still under development (and required further detailed deliberations), and importantly, the legislation had not yet been amended to allow TAHE to exist as a commercial entity.

However, TAHE did not start operating during 2015 and RailCorp continued to operate as the owner of rail property assets and the network. The TAA was amended in 2017 (and assented to on 11 April 2017) to enable the establishment of TAHE as a dedicated transport asset manager, operating on the commercial principles set out by the SOC Act. At the time, it was anticipated that RailCorp would transition to TAHE from 1 July 2019. However, RailCorp continued to operate until 30 June 2020, and TAHE started operating as a SOC on 1 July 2020.

It was always envisaged by senior officials that there would be a staged approach to TAHE's establishment. However, in the years that followed the 2015–16 NSW Budget, the risks that TAHE would not generate the required returns were raised several times in briefings to the government. Further, once the benefits of TAHE were locked into the GGS Budget, all the involved agencies were incentivised to implement a solution that maintained the 2015–16 Budget result, irrespective of the subsequent challenges that arose.

Treasury did not establish any guidelines on the rate of return for State Owned Corporations, including TAHE, until September 2022

The objectives of the *Government Sector Finance Act 2018* (GSF Act) include promoting sound financial management in the government sector, facilitating cooperation and collaboration within and between agencies, and facilitating keeping and sharing of performance information for the purposes of decisions about resource allocation. However, at that time, there was no set rate of return that for-profit entities had to generate to meet the requirements of the GSF Act.

In July 2018, the Australian Government's Department of Finance issued general advice for the Commonwealth Sector that for an investment to be regarded as equity, it should expect to earn a rate of return at least equal to the long-term inflation rate, and have a reasonable expectation that the investment will be recovered.

Further, there was no guidance on a sufficient rate of return for SOCs in New South Wales. On 6 September 2022, Treasury released a policy on returns on equity investments for SOCs (TPG22-28) which rectified this omission, following a recommendation from the Audit Office of New South Wales in the report 'State Finance 2021'.

The initial required rate of return on the NSW Government's investment in TAHE was 7%, then it became 1.5%

Based on Treasury's correspondence with the ABS in May 2015, TAHE was expected to pay a return on equity of 7% in 2016–17. However, a reasonable expectation of a sufficient rate of return for any future equity transfers was not identified. In addition, TAHE was expected to cover 60% of its production costs by sales.

The assumed 7% return persisted through to 2018, after the legislation enabling the establishment of TAHE was passed by NSW Parliament. When initial access and licence fees were agreed on 1 July 2020, this figure had been revised to an expected rate of return of 1.5%, which the government considered to be a sufficient rate based on factors such as the current and future expected bond rates, inflation and the rates of return achieved by similar SOCs.

TAHE could not generate a sufficient rate of return by charging access and licence fees at the rate in the 2021 access agreements

TAHE generates a small portion of its income from transactions with the private sector but, as noted in our report 'State Finances 2021', TAHE receives the majority of its revenue (more than 80%) from access and licence fee agreements with the state owned rail operators, Sydney Trains and NSW Trains. Both of these entities are funded by grants to TfNSW from the GGS Budget. As a result, the decision to change the returns model from 7% to 1.5% would in its own right have a positive impact on the GGS Budget.

However, 'State Finances 2021' noted that the existing access and licence fees did not support a reasonable expectation that a sufficient rate of return would be earned on the equity investments to TAHE. Further, these arrangements reflected an expected rate of return of only 1.5% per annum and did not include recovery of the revaluation loss of $20.3 billion incurred in 2020–21.

The first modelling Treasury shared with the Audit Office did not include a rate of return that recovered the revaluation loss

When TAHE started operating in July 2020, its assets were revalued resulting in a revaluation loss of $20.3 billion (as discussed above). This write-down occurred because the access and licence fees incorporated into the income-derived valuation model were not sufficient to maintain the value previously determined under a replacement cost assessment.

The first time the Audit Office of New South Wales received any modelling regarding TAHE was during our 2021 financial audit. At that time, the modelling focused on the 1.5% expected rate of return and did not factor in recovering the revaluation losses. Further, the expected rate of return of 1.5% on government equity contributions was below the long-term inflation target. TAHE's expected rate of return was subsequently increased from 1.5% to 2.5% to avoid a qualified audit opinion.

Continuing with the 1.5% rate of return would have risked the government's ability to treat its investment in TAHE as an equity contribution – a concern raised by the Audit Office in 2021. To avoid a qualified audit opinion, on 14 December 2021, the NSW Government made the decision to increase TAHE's expected rate of return to 2.5%. This was equal to the Reserve Bank's long-term inflation target, and in line with the general advice provided by the Australian Government's Department of Finance to the Commonwealth Sector in 2018 (which has since been updated).

However, assuming that TAHE's contracts with the state owned rail operators generate a return of 2.5% of contributed equity each year, it would take until 2046 for TAHE to recover the $20.3 billion revaluation loss.

In 2021–22, additional government funding was required for TAHE to make a sufficient rate of return

At the current time, TAHE's sources of revenue include the government and third-party rail operators, and land and property leasing, asset management and recycling. Other commercialisation opportunities may become available in the future. At the time of writing this report, it is too early to confirm the likely financial impact of the opportunities the TAHE Board is considering.

The original access agreements between TAHE, TfNSW, Sydney Trains and NSW Trains were based on an expected rate of return of 1.5%. However, on 18 December 2021, TfNSW, TAHE, Sydney Trains and NSW Trains agreed to revise annual operating agreements to meet the expected return of 2.5% of contributed equity.

In order to pay the increased access and licence fees, the NSW Government allocated an additional $1.1 billion over the period 2023–25 to fund increased access and licence fees from the state owned operators (Sydney Trains and NSW Trains) which was used, in turn, to pay TAHE.

This agreement also included proposed increases to access and licence fees over the 10 year period from 2022–2031 of $5.2 billion, with most of this increase occurring outside the forward estimates period and which are not yet sufficient to recover the revaluation loss incurred in 2020–21.

Going forward, the 2022–23 Budget allocated $5.5 billion to fund TAHE's key customers, Sydney Trains and NSW Trains to support their payment of the increased access and licence fees. This funding only extends out to the end of the forward estimates period in 2025–26.[4]

It is likely that increases in access and licence fees will need to be funded through additional transfers from the GGS to the state owned rail operators. The effects of this additional funding, and its impact on the GGS Budget, will predominantly be borne by future state governments.

Since 2016 the NSW Government has contributed $13.4 billion in equity investments and received $71.2 million in dividends

Since 2015–16, the NSW Government has provided a total of $13.4 billion in equity investments to RailCorp and TAHE. This includes $8.55 billion to RailCorp (see Exhibit 5), a further $2.41 billion in equity into TAHE in 2020–21, and equity injections of $2.3 billion in the current year.

NSW Treasury advises that revenue from access and licence fees is also used to fund ongoing capital maintenance of the existing asset base, as well as future investment in the asset base, and is not just used to pay dividends. However, to date, TAHE has not generated a return on investment, although it did declare a dividend of $71.2 million in 2021–22. Since TAHE did not actually make a profit in 2021–22 and its retained earnings were negative as well, this dividend is effectively a return of the government's previous investment in TAHE, and not a return on investment.

Treasury's current returns modelling shows the government expects to earn this return and recover last year's revaluation loss by 2046. It is only from 2030 that the modelling demonstrates returns in excess of the long-term inflation target, which is the point at which the $20.3 billion begins to be recovered.

RailCorp was renamed TAHE so that TAHE could access RailCorp's retained earnings

Less than 12 months after the 2015–16 Budget was handed down concerns were raised by Treasury officials that a number of weaknesses had been identified with the assumptions underlying the financial modelling for TAHE for the 2015–16 Budget. Specifically, early modelling led by Treasury assumed that dividends could be paid to the government from RailCorp's retained earnings until TAHE became profitable. However, Treasury subsequently realised this would not be possible if RailCorp ceased to exist as a legal entity and TAHE was formed as a new agency in its place.

[4] More detail on the NSW Government's investment in TAHE can be found in the Audit Office of New South Wales' report 'State Finances 2022'.

For this reason, RailCorp had to be renamed as TAHE so that the legal entity (RailCorp) would continue to exist, and its retained earnings would be available for dividend payments by TAHE. This necessitated changes to the TAA so that RailCorp could be renamed as TAHE with no break in continuity.

In the Agency Information Guide viewed by this audit, TAHE highlighted that, 'on 1 July 2020, the corporate name of RailCorp was changed to TAHE, however the entity for all purposes continued in existence under its new name so that its identity was not affected. TAHE remains the holder of an asset portfolio of property, stations, rolling stock and rail infrastructure'.

The introduction of new accounting standards from 1 July 2020 initially created confusion about their implications for TAHE

The accounting standard, AASB 1059 'Service Concession Arrangements: Grantor', came into effect on 1 July 2020. This standard requires the government to recognise a state asset which is managed by an operator, where the operator provides a 'public service' which is controlled or regulated by the government. Treasury briefed the government in January 2020 that, while assessing implementation of AASB 1059, issues emerged concerning the TAHE transaction, with the estimated potential impact of about a $1.4 billion per annum reduction in the Budget result due to depreciation expense coming back into the GGS with some offsetting revenue.

Treasury and Price Waterhouse Coopers (PwC) advice indicated that the TAHE arrangement was no longer viable because:

- the new Service Concession (or the Leasing Standard) would result in TAHE assets being controlled by TfNSW resulting in a significant increase in GGS depreciation and/or interest expenses
- TAHE might be reclassified to the GGS, with a significant increase in GGS depreciation and debt.

For AASB 1059 to apply the operator of the assets also needs to control the assets. Initially Treasury was concerned that TfNSW would have effective control of the assets rather than TAHE. However, as the proposed operating model for TAHE continued to develop during preparations for its establishment, further analysis by KPMG demonstrated that the assets would not be controlled for accounting purposes by TfNSW. Steps in the development of the operating model included:

- completion of the Implementation Deed for TAHE on 30 June 2020
- establishment of TAHE on 1 July 2020 pursuant to the *Transport Administration Act 1988* and the repeal of TfNSW's ability to direct TAHE
- establishment of an interim Operating Licence on 1 July 2020
- execution of Track Access Agreements and a ten-year Licence, Agency and Maintenance Deed with TfNSW, Sydney Trains and NSW Trains effective from 1 July 2021.

Once these changes were factored into the analysis, it became clear to Treasury that AASB 1059 did not apply with respect to these rail assets.

2.3 Governance during the planning of TAHE

There were unexplained changes in initial governance arrangements and some roles and responsibilities were ambiguous

In May 2014, the NSW Government gave in-principle approval for a commercial asset holding corporation to be created subject to satisfactory scoping work being completed.

This resulted in the establishment of seven workstreams and three committees in the public service, all chaired by personnel from TfNSW (which included the Asset Standards Authority), to investigate possible structures for this entity. Treasury staff were involved in the finance workstreams and did not have a role in any of the other workstreams.

The seven workstreams reported, via a project management group, to the Readiness Review Group. The Readiness Review Group was established with the objective of ensuring that the transport asset holding entity had the structure that would best allow TfNSW to achieve its strategic goals.

The Readiness Review Group met every two weeks to discuss the work of the workstreams and to refer work on to the Steering Committee and the Expert Reference Group. The Readiness Review Group was chaired by the Executive General Manager for Service Procurement and Performance in TfNSW, and the group included representatives from TfNSW, Sydney Trains and RailCorp. Treasury staff members were not included in the Readiness Review Group, but they attended meetings to report on the progress of the workstream of which they were members. The Readiness Review Group stopped meeting in September 2014 and never met again.

The Expert Reference Group had the same strategic objective as the Readiness Review Group and reviewed materials that were referred to it. The Expert Reference Group was chaired by the Group Corporate Counsel of TfNSW and had members from TfNSW and Treasury. It is unclear whether the Readiness Review Group and Expert Reference Group had any decision-making powers. There are no detailed terms of reference or guidance for the decisions that could be made by the Expert Reference Group.

The AssetCo Steering Committee was formed in 2014 (chaired by the Secretary of TfNSW and with members drawn from TfNSW, Sydney Trains and Treasury) and was responsible for strategic oversight, guidance, decision-making and resolving stakeholder issues. It reviewed materials that were sent from the Readiness Review Group and Expert Reference Group, and made key decisions and approved milestones. The audit requested but did not receive detailed terms of reference or guidance on what key decisions, documents, and milestones the committee could approve, and where these recommendations would come from.

All three of these governance groups stopped meeting in September 2014 and the Readiness Review Group and Expert Reference Group were never reconvened. The reasons for this hiatus were not documented.

In September 2015, a reduced set of three working groups (formerly called workstreams) started up and operated until the end of 2018. These working groups included members from both Treasury and TfNSW, but this audit does not have any evidence of who chaired these working groups or which agencies were represented.

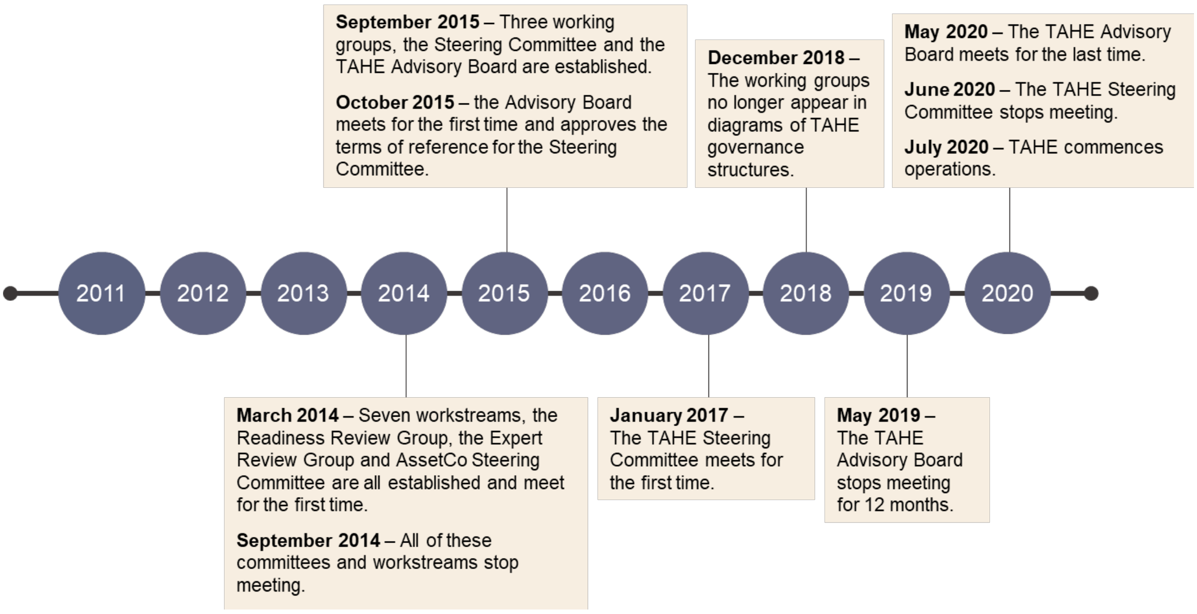
A second Steering Committee was established in 2015 and included representatives from both Treasury and TfNSW, although the chair and exact composition of the committee is unknown. There is no evidence that this committee met before January 2017. In 2018, the Steering Committee was expanded to include more members from TfNSW, as well as Sydney Trains, Roads and Maritime Services, the Department of Premier and Cabinet (DPC), and Treasury. At this point in time the chair of this committee was the Executive Director for Strategic Projects in TfNSW.

A new TAHE Advisory Board was established in 2015. It was chaired by the Secretary of TfNSW and met until May 2019 and then stopped meeting for a year. The TAHE Advisory Board reconvened in May 2020 and then permanently ceased to meet after this one instance. TAHE's Advisory Board included members from TfNSW, RailCorp, Treasury and DPC and its objectives were:

- overseeing the establishment of the TAHE as a commercial public trading enterprise
- overseeing the separation of Sydney Trains and NSW Trains from RailCorp into stand-alone organisations
- monitoring implementation against the agreed milestones and for asset transfers
- ensuring that all appropriate safety considerations were undertaken.

Exhibit 6 illustrates the timelines for the different governance groups from January 2014 until 1 July 2020, based on the evidence provided to this audit by TfNSW and Treasury.

Exhibit 6: Timelines for governance groups



Source: Audit Office of New South Wales research based on documentation provided by TfNSW and Treasury.

2.4 Financial outcomes

The process has delivered an outcome that achieves the NSW Government's objectives in the short-term. On 29 May 2015, the ABS wrote to Treasury that it had made a determination that TAHE would be classified as a PNFC. In making this determination the ABS considered the evidence presented by Treasury and concluded that TAHE would:

- be an institutional unit designed to manage transport assets
- generate a commercial return for the government and charge economically significant prices for access to transport assets
- provide dividends to its shareholders from after tax profits, comparable to an equivalent private sector business
- have limited competition.

If there were a significant change in the activities of TAHE in the future, there is the possibility that the ABS could reclassify TAHE to the GGS.

As part of its submission to the ABS, Treasury included a transition plan (also referred to as the milestones) to be met between 30 June 2015 and 1 July 2019. In March 2018, Treasury approached the ABS to agree to a revised set of deadlines. Exhibit 7 details the milestones in the transition plan, their due dates (original and revised), and indicates whether or not TAHE has achieved each one.

Exhibit 7: Milestones in Treasury's transition plan for the creation of TAHE

Milestone	Original due date	Revised due date	Achieved
Establish a TAHE Advisory Board with representatives from Treasury, TfNSW, RailCorp and DPC.	30 June 2015		✔
Establish implementation budget and undertake a RFP and appoint accounting, transactional, safety management and legal advisors.	30 June 2015		✔
Separate, by legislation, from RailCorp and establish Sydney Trains and NSW Trains as stand-alone statutory entities able to commence operations on this date.	01 July 2016	01 July 2017	✔
Enable, by legislation, RailCorp to own non-rail assets and create an independent board.	01 July 2016	01 July 2017	✔
Develop complete register of tranche one (country and passenger heavy rail/RailCorp/TfNSW) assets to be contained within TAHE.	01 July 2016	01 July 2017	✔
Appoint Acting CEO and key senior executives required for the transition of TAHE.	01 July 2016	01 July 2017	✔
Put in place interim commercial access arrangements between RailCorp and all operators.	01 July 2016	01 July 2017	✔
Develop the governance, asset management, safety management and accreditation, asset valuation and revenue frameworks required to establish the commercially classified Public Transport Asset Holding Corporation (PTAHC)* tranche one (country and passenger heavy rail/RailCorp/TfNSW) assets.	01 July 2017	01 July 2018	✔
Transfer all other public transport assets other than buses - PTAHC tranche two (such as light rail, ticketing, ferries, ferry wharves, etc) and be fully operational from this date, with an independent board appointed.	01 July 2018	01 July 2019	!
Transfer remaining public transport assets (PTAHC tranche three) and be fully operational from this date.	01 July 2019	01 July 2019	!

Key ✔ **Milestone met** ! **Milestone not met**

* The PTAHC referred to here is TAHE.

Source: Audit Office of New South Wales research based on Treasury documents from 2018.

The government created TAHE with the intention of it managing public transport assets, including buses and ferries (and excluding roads). Under the TAA, this is only to the extent that assets are owned by or vested in TAHE. The audit has seen no evidence to suggest that the original intention does not still hold for the future. Further, the final two milestones for TAHE, in Exhibit 7, are both about the transfer of ownership of public transport assets other than heavy rail. These milestones have not yet been completed and the implications of this for TAHE are unknown at this time.

There is significant uncertainty as to whether the anticipated longer-term financial benefits to the Budget position can be achieved or sustained

The ongoing requirement for TAHE to make a sufficient rate of return on the equity invested in the assets over their useful life creates an obligation for future state governments. Treasury advises that the government expects to largely cease providing funding for capital projects via equity investments from 2026. However, the modelling for this decision is based on the assumption that TAHE accumulates sufficient cash over time, from access and licence fees, to fund approved future capital expenditures. As a result, in order to make a return on its investment in TAHE, the NSW Government needs to continue to fund the state owned rail operators (Sydney Trains and NSW Trains) so that they can pay these access and licence fees to TAHE.

There remains a long-term risk that TAHE will not be able to generate a sufficient rate of return. Treasury has estimated the return to the GGS from the investment in TAHE to be $37.9 billion (includes dividends, tax and undistributed profits) over the period from 1 July 2022 to 30 June 2046. The majority of these returns ($31.5 billion) are estimated to be generated between 2032 and 2046.

This estimate relies on:

- TAHE being able to contract for access and licence fees in the future at a level that is consistent with current estimations
- TAHE's key customers (Sydney Trains and NSW Trains) being able to afford access and licence fees at the necessary level
- TAHE being able to grow its non-government revenues.

However, current modelling also foreshadows a requirement for future NSW governments to fund the state owned rail operators to maintain TAHE's achievement of a sufficient rate of return and the subsequent preservation of the treatment of government's investment in TAHE as an equity contribution. As noted in our report 'State Finances 2022', the government may need to fund the operators a total of $66.5 billion up to 2046 to ensure the government continues to demonstrate its expected return on investment of 2.5%.

If this does not continue, and if TAHE can no longer provide a reasonable expectation of a sufficient rate of return, then the government's investment in TAHE will need to be treated as expenditure. This would result in significant deterioration in the GGS Budget result.

In order to pay access and licence fees to TAHE, Sydney Trains and NSW Trains need additional funding from the government. These agencies then pass that money onto TAHE in the form of access and licence fees and, in turn, TAHE uses some of that money to pay dividends to the government, thereby resulting in an outcome that has been described in advice to decision-makers as a ‘money-go-round’.

2.5 Maintaining rail safety

TAHE has developed and implemented an Asset, Safety and Environment Assurance Framework

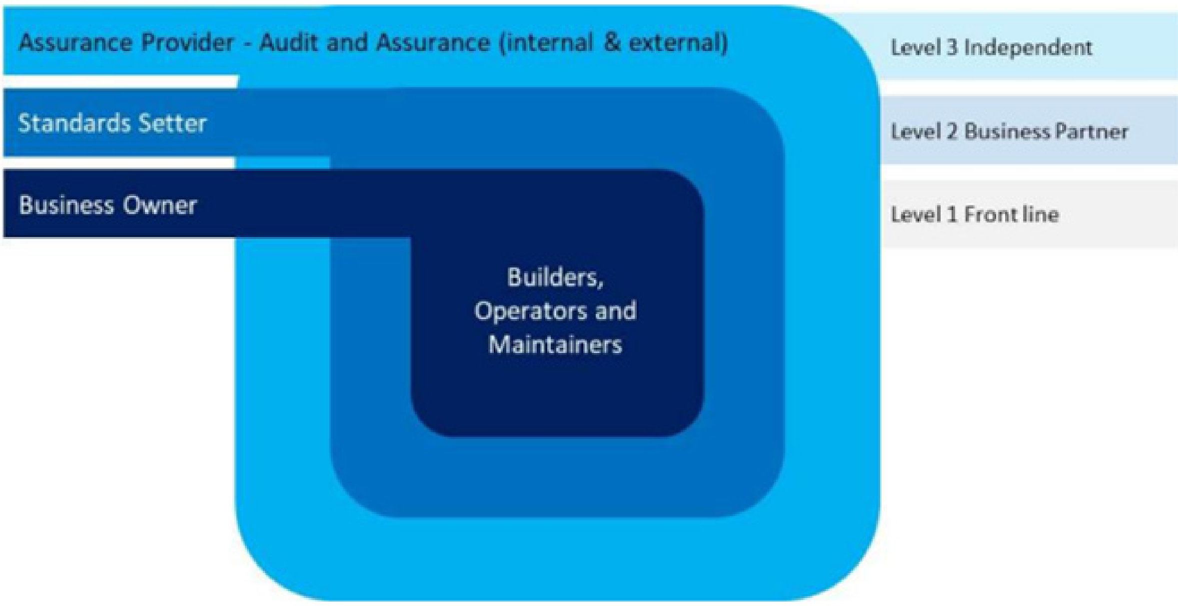
When TAHE commenced operations on 1 July 2020, its interim 12-month Operating Licence and Statement of Corporate Intent both included safety as a requirement in addition to the commercial objectives of achieving a sufficient rate of return. Further TAHE listed safety as one of its top three non-financial performance indicators. To satisfy this metric, TAHE must establish a fit-for-purpose safety and assurance framework (as previously recommended in 2017) and conduct an annual safety assurance review of third-party service providers.

In March 2021, TAHE established an Asset, Safety and Environment Committee (ASEC) to provide oversight and assurance over the asset and safety requirements across its assets, undertakings and third-party operations. The ASEC was established as a board committee and its objectives include:

- oversight of TAHE’s Asset, Safety and Environment (ASE) Assurance Framework
- assist the Board in the effective discharge of its governance and oversight responsibilities for ASE across its assets, undertakings and third-party operations
- assist the Board in obtaining assurance that appropriate frameworks and systems are in place to effectively manage ASE risks and comply with all legislative requirements
- review the performance of transport agencies and delivery partners in these areas and their compliance to those frameworks and systems
- support the Board in fulfilling its responsibility to exercise due diligence in relation to ASE matters.

TAHE's ASE Assurance Framework uses a three-layer approach to assurance with accountabilities set out for each layer. This model is intended to allow TAHE to assess its risk exposure controls and check that its agents, third-party operators, maintenance and service providers can comply with the relevant legislation, regulatory obligations, accreditations, and contractual requirements. By putting this framework in place, TAHE has met one of the ABS milestones for establishing a framework for safety management and accreditation that was set in 2015, and reported in Exhibit 7. The three layers of the ASE Assurance Framework are represented in Exhibit 8.

Exhibit 8: TAHE's ASE Assurance Framework



Source: TAHE Asset Management and Assurance Framework July 2021.

Accountabilities under this framework differ depending on the nature of the asset: regulated or non-regulated. A regulated asset is one that is essential for the operation of the railways such as tracks, trains, electricity, water and communications. An unregulated asset is one that is not essential such as land or concourse shops. Exhibit 9 illustrates the different approaches for these different types of assets.

Exhibit 9: Accountabilities and duties under the ASE Assurance Framework

Assurance	Regulated assets		Unregulated assets	
	Responsible party	**Actions**	**Responsible party**	**Actions**
First level	Sydney Trains, NSW Trains and UGL Limited as the asset operator and maintainer	Monitoring: • contract compliance • service agreements • operating licences • accreditations • legislative obligations	The appointed asset builder, operator or maintainer	
Second level	TfNSW Safety, Environment and Regulation division	Monitoring: • compliance with asset management frameworks • standards • supplier assurance • systems set by the Asset Management Branch	TfNSW or an external provider TAHE	TAHE's role is to ensure that the provider: • has the necessary capability and competency • is independent from the first line of assurance
All asset types				
Third level	TAHE		Undertaking an independent and objective line of assurance including: • the implementation of effective internal controls • performance reviews to verify reliance of the underlying assurance activities provided by the first two lines of assurance	

Source: Audit Office of New South Wales research based on TAHE Asset Management and Assurance Framework July 2021.

TAHE reports its performance against a number of criteria to its Board on both a quarterly and monthly basis. Safety is one of these criteria and figures are included in these reports on both the number of critical events and the number of injuries. TAHE also produces an annual statement of how it approaches each of its principle objectives, including examples of how TAHE has balanced the delivery of these objectives through the year.

In evidence to the Public Accountability Committee Inquiry into TAHE, the former Secretary of Transport for NSW (December 2017 to February 2021) noted that he had concerns relating to safety, control and accountability in the medium to long-term and that these potential issues arose from a conflict between TAHE's structure and the government's policy of integration and connection in the transport system.

In August 2021, the then Minister for Transport directed the Office of Transport Safety Investigations (OTSI) to review TAHE's safety governance arrangements. This review was designed to determine whether the arrangements put in place adequately managed the potential conflict between TAHE's need to generate a commercial return and safety. OTSI concluded that the arrangements should have the desired effect, but noted that the arrangements were not fully developed or implemented at the time of the review.

In evidence to the Public Accountability Committee on 16 December 2021, the current Secretary of Transport for NSW (appointed in March 2021) stated that he was satisfied that TAHE will deliver fit-for-purpose safety, operational governance and commercial outcomes. The Secretary also noted that safely is managed by accredited rail transport operators (Sydney Trains and NSW Trains) and that decisions about assets, including maintenance, will be made subject to the same safety assurance regimes that existed prior to the establishment of TAHE.

TAHE's Statement of Corporate Intent 2022–23 identifies five compliance performance indicators that refer directly or indirectly to safety. These are:

- zero material safety incidents, that is no incidents related to asset condition that result in permanent disability or fatality
- zero material legislative breach of the RSNL and *Work Health and Safety Act 2011* (WHS Act)
- delivery of TAHE annual asset assurance program
- successful completion on time of the TAP 4 program business case and forward compliance programs
- zero material harm incidents under Part 5.7 of the *Protection of the Environment Operations Act 1997*.

Safety was an important consideration throughout the design and implementation of TAHE

In 2014, TfNSW identified that making TAHE a SOC would result in a risk that the government's ability to regulate and manage safety may be reduced. TfNSW argued that integrating rail operation and maintenance not only improves coordination of these activities, but it also reduces safety risks. Improving the safety management framework was an outcome of both the Glenbrook and Waterfall Special Commissions of Inquiry.

In 2015, Treasury and TfNSW jointly developed a high-level model for TAHE which attempted to balance the fact that, as a SOC, TAHE would have an independent Board who could make decisions which are potentially inconsistent with the government's policy positions for rail services. Treasury contended that as TAHE is ultimately subject to direction by the Portfolio Minister this would mitigate this problem. Nonetheless, to minimise this risk, one of the Guiding Principles for the design of TAHE was that there would be no impact on safety risks.

The initial scoping work for TAHE took place between May and September 2014, and one of the workstreams set up at that time focused on safety. This workstream had objectives including:

- identifying and managing compliance with all legislative safety requirements
- assigning obligations and accountabilities between owners and operators
- developing a management plan for all legislative safety requirements.

This workstream stopped meeting in September 2014 and when meetings recommenced in September 2015, it was part of a work group examining safety, risk, regulatory and legal matters. This audit has requested, but not received, documentation about the functions and outputs of this and other work groups.

When TAHE was classified as a PNFC entity in May 2015, Treasury included a transition plan as part of its submission to the ABS (as shown in Exhibit 7). This included a set of milestones to be met between 30 June 2015 and 1 July 2019. By 1 July 2017, TAHE was supposed to have developed a framework for safety management and accreditation, including any legal and contractual changes necessary. However, achieving these milestones was delayed by the lengthy gestation period for TAHE and, in July 2017, this target was revised to 1 July 2018.

In June 2017, the TAHE Steering Committee decided that TAHE would need to develop a safety assurance framework. Initial steps in this process included:

- working with TfNSW's Asset Standards Authority and independent safety bodies
- conducting an Initial Safety Change Assessment to determine the necessary level of assurance
- engaging with the Office of the National Rail Safety Regulator.

Following this decision, the Initial Safety Change Assessment (conducted by a manager from the then Asset Standards Authority team within TfNSW) was completed in September 2017 and determined that there were safety risks arising from the creation of TAHE and no safety benefits. Further, the assessment noted that there could be a deterioration in asset condition over time and the worst-case scenario was 'catastrophic'. The Assessment also found that the design of TAHE required:

- that the Configuration Management and Asset Assurance Committee review the assessment of safety risks during TAHE's Gateway reviews
- an independent verifier to carry out independent review and verification of the change.

In September 2017, an independent verifier was appointed for three years to review the changes to safety resulting from the creation of TAHE, pursuant to the Independent Safety Assessor (ISA) requirements set out for TfNSW. The independent verifier was a former CEO of the then Independent Transport Safety and Reliability Regulator.

The final design of TAHE addressed TfNSW's safety concerns

Since 2012, rail safety in Australia has been overseen by the Office of the National Rail Safety Regulator (ONRSR) under the *RNSL*. Each state has adopted its own version of this legislation and in New South Wales this is the *Rail Safety National Law (NSW) 2012* which details the regulation of safety and how and why operators must be accredited.[5] The RSNL provides a consistent and unified regulatory framework and clarified stakeholder responsibilities across all Australian states and territories has resulted in a strengthening of national rail safety.

Under the RSNL, Sydney Trains is registered as a Rail Infrastructure Manager (RIM) and Rolling Stock Operator and is obligated to maintain the rail infrastructure (Metropolitan rail network) and rolling stock to ensure safe railway operations. Similarly, NSW Trains is registered as a Rolling Stock Operator and is also required to maintain rolling stock. TAHE is not accredited as it does not operate rail services and, as a result, it is prohibited from undertaking maintenance even though it is an asset owner. This situation is managed by TAHE contracting out maintenance to the rail operators.

Sydney Trains manages maintenance on the Metropolitan rail network. Placing maintenance duties with rail operators was specified in the Guiding Principles for the design of TAHE with the aim of ensuring that the transition to a commercial entity did not impact on vertical integration and increase safety risk. Through this arrangement, the vertical integration of operations and maintenance within Sydney Trains was preserved.

[5] Accreditation for rail operators is granted by the ONRSR only when the rail operators have demonstrated the competence and capacity to manage risks to safety associated with their railway operations.

3. Implementation of TAHE

3.1 Implementation of TAHE

The NSW Government can direct TAHE if required, but the Board remains independent at the current time

TAHE, like other SOCs, is independent from government and not subject to Ministerial 'direction and control'. However, there are limited circumstances set out in the SOC Act (Sections 20N, 20O and 20P) where the Portfolio Minister can direct SOCs, with the approval of the Treasurer. These are:

- in connection with activities that are not in the commercial interests of the SOC
- when a public sector policy is to apply to the SOC
- when it is necessary to give the SOC direction in the public interest.

In all of these cases, the Portfolio Minister must provide the Board with written instructions and the Board must comply. Further, in the case of public sector policies and in the public interest, the Board must also ensure, as far as it is practicable, that any subsidiaries also comply.

The Treasurer and Minister for Finance and Employee Relations are the shareholders of TAHE and annually agree performance expectations through a Statement of Corporate Intent. Treasury Policy and Guidelines Paper TPP17-10 'Commercial Policy Framework: Guidelines for Governing Boards of Government Businesses' is one of several papers that make up the Commercial Policy Framework. This paper outlines the NSW Government's expectations for standards of corporate governance for commercially-focused government businesses. It includes seven principles for detailing best practice in corporate governance and representing the shareholders' expectations of how a board should function. These are:

1. Lay solid foundations for management and oversight
2. Structure the board to add value
3. Act ethically and responsibly
4. Safeguard integrity in corporate reporting
5. Make timely disclosure
6. Acknowledge the rights of Shareholders
7. Recognise and manage risk.

Treasury provided TAHE with an exemption from full compliance with the Commercial Policy Framework for the first 12–18 months of its operations. However, TAHE's Statement of Corporate Intent for 2022–24, which was endorsed by the Board on 20 September 2021, states that TAHE 'will work towards adherence' to the NSW Treasury Commercial Policy Framework policies and applicable Treasury policy papers under the framework.

Consistent with these guidelines, TAHE has developed a suite of documentation that outlines its approach to corporate governance. These include a Board Charter, a Code of Conduct for the Board of Directors, and a Corporate Governance Statement.

The SOC Act requires that all operating decisions are to be made by, or under the authority of, the Board. The TAA specifies that the functions of TAHE can only be exercised under one or more Operating Licences issued by the Portfolio Minister. Further, Section 10 of the TAA details TAHE's objectives which include:

- to undertake its activities in a safe and reliable manner
- to be a successful business and, to this end
  - to operate at least as efficiently as any comparable businesses
  - maximise the net worth of the State's investment in TAHE
- to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates
- where its activities affect the environment, to conduct its operations in compliance with the principles of ecologically sustainable development contained in Section 6(2) of the *Protection of the Environment Administration Act 1991*
- to exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates.

These legislative requirements mean that TAHE must balance generating an income with maintaining rail safety. However, TAHE's Operating Licence gives some direction to the Board. The Operating Licence is granted by the Portfolio Minister and it is the key legal instrument that authorises TAHE to exercise its listed statutory functions under the TAA. Operating licences are often short-term in nature and its applicable period is determined by the Portfolio Minister. Further, under the TAA, the Portfolio Minister could change, substitute, impose or revoke the conditions of any existing Operating Licence.

On 30 June 2020, the then Portfolio Minister (the Minister for Transport) approved the issuing of an interim 12-month Operating Licence to TAHE, to enable it to commence operating on 1 July 2020. The current Operating Licence was also granted to TAHE by the former Portfolio Minister on 1 July 2021. Schedule 2 of the current Operating Licence states that TAHE is 'to have regard to safety integrity and the policies and objectives of the NSW Government in relation to integration of transport modes' which places the emphasis on safety and offers some direction to the Board.

On 16 September 2022, the current Operating Licence was extended by 12 months and now applies from 1 July 2021 until 30 June 2024. This was done, at the request of TAHE, to give TAHE time to make 'informed long-term business decisions and its forward plan 2023–24'. The next Operating Licence will be issued by the current Portfolio Minister, the Minister for Infrastructure, Cities and Active Transport, in July 2024.

In developing the TAHE model, Treasury and TfNSW have attempted to minimise the degree to which the Board of TAHE can make decisions that deviate from NSW Government policy, while still being commercial with an independent Board. For example, appointing the Secretary of Transport for NSW to the TAHE Board enhances the opportunity to drive alignment between TAHE and TfNSW on strategic transport policy outcomes. However, there is risk inherent to a commercial TAHE model that misalignment with desired policy outcomes cannot be removed altogether.

Nonetheless, limitations could be placed on TAHE by the Portfolio Minister through its Operating Licence, so there is a risk that the Board of Directors may be unable to operate with sufficient independence when making decisions about TAHE's operations. Ultimately, this could impact the way that TAHE is treated in the NSW Budget. However, at the current time, TAHE's Board is operating independently and consistent with the requirements of the SOC Act.

A potential conflict of interest exists for the Secretary of TfNSW as a member of the TAHE Board, but it is being managed

The TAHE Board is comprised of between three and seven independent directors who are appointed by the Voting Shareholders, and the TfNSW Secretary is also a member of the Board. The presence of the Secretary of TfNSW is a statutory requirement in the TAA.

Under the SOC Act, the Directors of TAHE are required to:

- act honestly
- exercise reasonable care and diligence
- not make improper use of information or their position as a Director.

Schedule 10(1) of the SOC Act requires that any conflicts of interest be disclosed and Schedule 10(2) details when it is possible for a Director with a conflict of interest to vote.

However, TAHE has appointed TfNSW as its agent for the management of track access agreements, administration of the Country Regional Network and for the administration of certain assets. This raises the issue of a potential conflict of interest for the Secretary of TfNSW and may create issues with confidential information that arises through either of the Secretary's roles. Clause 5.4(j)(ii) of the TAHE Constitution states that the Secretary of TfNSW may disclose any information received about the affairs of TAHE to TfNSW or the Department of Transport, unless the Board resolves otherwise.

Further, Clause 5.4(k) deals with direct or indirect interests arising from the office of the Transport Secretary. In this case, the interest is taken to have been disclosed (as in Clause 5.4(b) of the Constitution) and the TfNSW Secretary may take part in discussions, votes or any other form of decision-making undertaken by the Board on the matter.

The former Secretary of TfNSW sought advice on the possible conflict of interest arising from his dual positions as Secretary of TfNSW and a TAHE Board member in 2020, and the advice received was revisited by the current Secretary in December 2021. The advice given to the Secretary drew upon the TAHE Constitution but also added that:

> 'the Transport Secretary should ensure that information passed to TfNSW is not improperly used by TfNSW, for example, in contractual negotiations. There may also be circumstances where the Transport Secretary is obliged to disclose to TAHE information known to him through his role in TfNSW, in order to avoid TAHE suffering a detriment. Abstention or silence may not be enough to satisfy his duty as a director in such a case'.

The TAHE Board has maintained a Register of Interests since July 2020. This audit has not seen any declarations by the Secretary for TfNSW, but there was an instance where the Secretary abstained from voting on an item relating to access and licence fees.

4. Use of consultants

4.1 Transparency in the use of consultants

There is a lack of public transparency on the true cost of consultancies relating to the design and establishment of TAHE

The design and implementation of TAHE was a significant structural change process over several years. However, public transparency about the cost of its design and implementation is limited. Our review of annual report disclosures made by the audited agencies (Treasury in particular) shows that there were multiple top tier firm contracts on topics such as organisational structure, financial, tax and accounting advice all reported in general terms without being attributed to TAHE. This lack of transparency is exacerbated by a lack of clarity on the purpose and cumulative cost of consultants used in the process of designing and implementing TAHE.

4.2 Compliance with policies and the NSW Procurement Framework

Government agencies engaged a proliferation of consulting firms to design and implement TAHE, with many instances of non-compliance with the NSW Procurement Framework

Over the period 2014–2021, 16 separate consulting firms were employed to work on aspects of the design and implementation of TAHE. The contracts had a total final cost of $22.56 million. Exhibit 10 summarises the number of engagements by agency.

Exhibit 10: Consultancy contracts over the period 2014–2021

Agency	Number of engagements	Number of different consultants used by agency	Number of contracts with variations	Maximum number of variations to a contract
TfNSW	21	7	8	7
NSW Treasury	9	8	2	3
TAHE	6	5	3	1
Total	**36**	**--**	**13**	**--**

Source: Audit Office of New South Wales analysis of Treasury, TfNSW and TAHE data.

The 16 consulting firms were employed to work on 36 contracts covering aspects of the design and implementation of TAHE, ranging from providing expert advice to project management, and administrative support and secretariat services.

Consultants are legitimately used to provide advice on how to achieve the outcomes determined by government, including advising agencies on the risks and challenges in achieving those outcomes. Similarly, consultants can provide expert knowledge in the service of achieving those outcomes and managing the risks. However, the heavy reliance on consulting firms during the design and implementation of TAHE heightened the risk that agencies were not receiving value for money, were outsourcing tasks that should be performed by the public service, and did not mitigate the risk that the advice they received was not objective and impartial. Further, there were risks that the relationship between consultants and agencies could have become unclear and consultants' roles might have blurred the distinction between providing independent advice on a range of options and facilitating a pre-determined outcome. This risk was amplified because a small number of firms were used repeatedly to provide advice on one topic. As the Sedgwick report (2022) noted, the roles of consultants need to be clearly delineated so that everyone involved is clear on roles played by each party.

There are ten instances where the start date, for either an initial engagement or a variation, precedes the approval date (five initial engagements and five variations). This raises the risk that the approvals process was not followed and that some of these contracts might not have been approved if the work was not already underway.

Three consulting firms (Boston Consulting Group, Ernst and Young and KPMG) were employed multiple times over the period 2014 to 2021. Boston Consulting Group was employed five times (three times by TfNSW and twice by TAHE), Ernst and Young was employed eight times (seven times by TfNSW and once by TAHE) and KPMG was employed seven times (five times by TfNSW and once each by TAHE and Treasury). When a small number of firms are used repeatedly to provide advice on one topic, the risk is created that there will not be any diversity of views or different opinions.

There is also one instance of a consulting firm being employed by more than one agency at the same time (KPMG was employed by both TfNSW and Treasury in 2020). The agencies relied upon KPMG to manage any real or perceived conflict of interest, but a lack of effective communication, use of available governance structures consistently, and open sharing of information between Treasury and TfNSW, resulted in disagreements and a design process that was not as collaborative or cohesive as it could have been. Exhibit 11 details the simultaneous engagement of KPMG by Treasury and TfNSW in 2020.

Exhibit 11: The same consulting firm was separately employed by Treasury and TfNSW at the same time to provide advice on TAHE

Treasury engagement

In 2020, Treasury engaged KPMG to perform tasks connected with the delivery and fiscal management strategy of TAHE. Treasury approved the engagement on 17 April 2020, although the contract start date was reported to be two months earlier on 3 February 2020.

The initial engagement had an upper limit of $600,000 and an end date of 30 June 2020. Despite the value of the engagement Treasury did not use a formal tender for this engagement. However, the NSW Procurement Framework permits direct negotiation as an alternative to a tender in situations where the engaged party is considered to be in a unique position to offer services that cannot be offered by others. Nonetheless, the engagement must provide value for money for the state and the audit team was advised that Treasury selected KPMG as a single source to perform services as KPMG had previously advised on technical matters, and continuity of service represented value for money.

Treasury made three variations to the contract with KPMG with a combined value of $2.14 million and a final due date of 31 December 2021. The final cost to Treasury was $2.5 million, which was $1.9 million more than originally planned. This engagement took 17 months longer to complete than originally intended.

TfNSW engagement

TfNSW also engaged KPMG, on 14 April 2020, to give operational and accounting advice on TAHE. This advice was specifically on the alignment of:

- the fiscal requirements of Treasury
- organisational, functional and strategic planning structures of New South Wales
- operational requirements so transport services can operate safely and effectively.

This initial engagement was to cost $149,286 and had an end date of 5 June 2020. TfNSW made two variations to this initial contract and the details are in the table below.

TfNSW's procurement policy requires three written quotes for contracts between $150,000 and $250,000. In a briefing note to the then Secretary of TfNSW, TfNSW noted that it was given an exemption to this requirement by the Associate Director - Service Delivery Sourcing but the audit team has not seen evidence of this exemption and the reason for it.

TfNSW's procurement policy also requires comprehensive analysis of the market and a risk assessment of procurement if direct negotiations are to be utilised for an engagement. Again, the audit team has not seen either an analysis of a market or a risk assessment of procurement.

TfNSW contract variations

Contract stage	Approval date	Variation amount*	New contract total*	Revised end date
Original	17–04–2020		$149,286	05–06–2020
Variation 1	04–06–2020	$73,642	$222,918	30–06–2020
Variation 2	30–06–2020	$697,280	$920,198	18–11–2020

* All values exclude GST.

Source: Audit Office of New South Wales research based on TfNSW documentation.

TfNSW made two variations to their engagement with KPMG and the scope of works. The first variation was due to unanticipated work arising on a government submission. For the second variation, KPMG provided a proposal to support the development of operating models for TAHE and accompanying government submissions. The second variation to this contract is above the threshold for a tender but TfNSW did not go back to the market to confirm that they were receiving value for money for this work. The audit team has not been provided with a copy of this proposal and is unable to draw conclusions on this point.

The NSW Procurement Policy Framework requires agencies to conduct an assessment of the market prior to rolling-over or extending a contract to maintain competition between providers. There is no evidence that any assessments were done before agreeing to these variations.

The final cost to TfNSW was $920,198, which was $770,912 more than originally planned and more than six times the value of the original engagement. Further, this engagement took six months longer to complete than originally intended.

Potential conflicts of interest

There is a potential, or at least perceived, conflict of interest in the same consultancy firm working for both agencies separately on the same project.

TfNSW did note, in a briefing to the then TfNSW Secretary on 17 April 2020, that Treasury had already engaged KPMG to provide accounting advice on TAHE. Further, this experience is used to advocate for the engagement of KPMG for TfNSW at this time. There is no evidence that any consideration was given to the possibility that the two 2020 engagements might be in conflict with each other. No conflict of interest declarations were provided by any of the parties involved in these engagements despite specific requests for this information by the audit team.

TfNSW advises that these KPMG engagements were key inputs into the meetings of the TAHE Advisory Board in 2020 and that all parties were aware of the fact that the same consultancy was engaged by two agencies at the same time.

In June 2020, KPMG established a Conflicts, Oversight and Governance Committee which had the goal of 'effectively and proactively' managing the risk of a real or perceived conflict which might arise from this situation. In July 2020, TfNSW raised questions about a possible conflict between the engagements and was informed by KPMG that there was no issue and that KPMG would manage any future issues though the Conflicts, Oversight and Governance Committee.

KPMG's work for Treasury was focused on a fiscal risk management strategy and the impact of new accounting standards. The TfNSW engagement resulted in two reports on an operating and financial model for TAHE. The first report concluded that there were problems with the modelling of TAHE's costs and benefits and raised the possibility of safety risks. The second report questioned the estimated Budget impacts of TAHE.

Despite the presence of the Conflicts, Oversight and Governance Committee and KPMG's insistence that there was no conflict between their engagements, disputes arose around the findings of these reports. Treasury contended that there were errors with the accounting treatment and fiscal advice given in the reports produced by KPMG for TfNSW, and requested that all references to their advice about the fiscal model be removed. In evidence to the NSW Parliament's Public Accountability Committee, the former Secretary for TfNSW stated that meetings discussing this difference of opinion were reportedly not as constructive as they could have been and that there were concerns that the tone of the meetings 'might affect the outcome of trying to get a collective view'. If this potential conflict of interest had been identified sooner, appropriate mitigation and contract management strategies could have been put in place before disagreement occurred. Further, the management of this conflict (real or perceived) was left to the consultancy, when it should have been managed by Treasury and TfNSW. If these agencies communicated more effectively, used available governance structures consistently and shared information openly about their use of consultants and the nature of their engagements then these disputes could have been avoided.

Source: Audit Office of New South Wales research based on TfNSW and Treasury documents.

The estimated final cost of the all the consultant engagements on TAHE was $22.56 million compared to a total initial cost of $12.94 million. Exhibit 12 summarises the costs of the engagements.

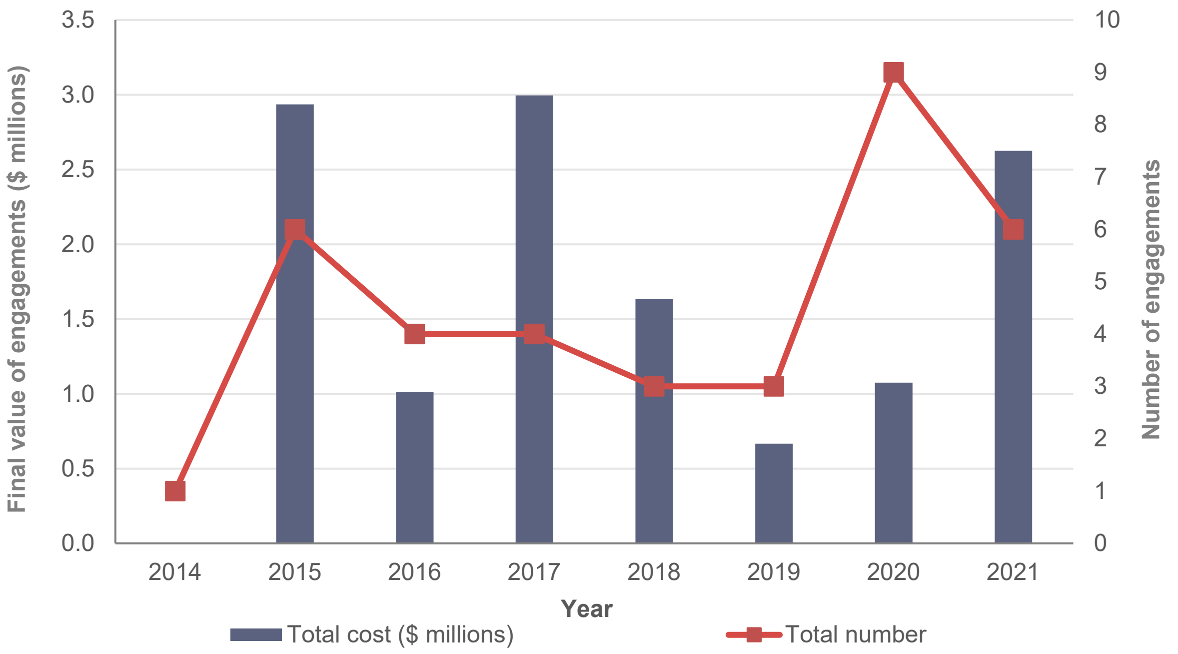
Exhibit 12: Costs of consultancy contracts over the period 2014–2021 ($ million)

Agency	Maximum initial engagement	Maximum variation	Maximum total engagement cost	Total initial costs	Total final costs
TfNSW	2.5	2.78	3.30	9.79	**16.88**
Treasury	0.360	2.14	2.50	0.98	**3.30**
TAHE	1.22	0.17	1.22	2.17	**2.38**
Total	**--**	**--**	**--**	**12.94**	**22.56**

Source: Audit Office of New South Wales analysis of Treasury, TfNSW and TAHE data.

The number and value of consultant engagements changes continuously over time. Exhibit 13 illustrates the distribution of the total number and total final value of these engagements over the period 2014–2021, using the initial start date of the contract as the date for each engagement.

Exhibit 13: Total number and total value of engagements from 2014–2021



Source: Audit Office of New South Wales analysis of Treasury, TfNSW and TAHE data.

Further, there are 13 contracts (36% of the total) with at least one variation and 23 contract variations in total. Of these there are eight cases where the value of a variation exceeds the value of the initial engagement. Whilst some contract variations are the result of unexpected and unpredictable events, a large number of variations or large value variations raise the risk that the initial engagements were not effectively or accurately scoped.

Exhibit 14 gives an example of an engagement with many large variations over an extended period of time. Of these seven variations, only one (variation three) is below the threshold for a tender. Another of the variations (variation seven) is more than three times the size of the initial engagement. Finally, the combined value of the seven variations is approximately 7.5 times the value of the initial engagement.

Exhibit 14: An example of a contract with multiple variations

TfNSW's engagement of Minter Ellison for legal services

Transport for NSW established (and manages) the NSW Government's Legal Services Panel, which is a whole-of-government arrangement. Core legal work is excluded from the scope of the panel – these matters must be referred to the Crown Solicitor's Office, pursuant to Premier's Memorandum M2016-04.

On behalf of the TAHE project team, TfNSW engaged Minter Ellison to provide legal services relating to the development of TAHE.

TfNSW approved the engagement on 17 December 2015 , although the start date on the contract was a month earlier on 17 November 2015. The initial engagement was valued at $300,000 and had an end date of 31 December 2016. During this time, Minter Ellison was to develop:

- a timeline required to meet the various stages of the implementation of TAHE
- an Asset Register and a list of Material Contracts.

Seven variations were made to this contract, and over time, the scope of works changed. In an email from Minter Ellison to TfNSW about the third variation, TfNSW was advised that 'without having scoped the due diligence it is not possible to give a meaningful estimate [for the work]'. This issue continued with the fourth variation where the workload and scope were described as 'fluid'. The sixth variation (in June 2019) included a revised scope of works. The seven variations to this contract are detailed below.

Contract variations

Contract stage	Approval date	Variation amount*	New contract total*	Revised end date
Original	17–12–2015		$300,000	31–12–2016
Variation 1	24–3–2016	$275,000	$575,000	No change
Variation 2	11–8–2016	$275,000	$850,000	No change
Variation 3	03–10–2016	$125,000	$975,000	No change
Variation 4	13–2–2017	$150,000	$1,125,000	31 –12–2017
Variation 5	11–08–2017	$300,000	$1,425,000	30–06–2018
Variation 6	03–06–2019	$150,000	$1,575,000	30–06–2019
Variation 7	15–6–2020	$965,000 **	$2,540,000	30–06–2020

* All values exclude GST.

** Calculated value as this information was not provided.

Source: Audit Office of New South Wales research based on TfNSW documentation

The final cost of this engagement was $2.54 million which was $2.24 million more than originally planned and it took three and half years longer to complete.

During the lifetime of this engagement, TfNSW had two procurement policies. These policies were:

- the Procurement Manual for Goods and Services (the Procurement Manual), effective from 17 July 2015 until 17 May 2016
- the Procurement Policy (the Procurement Policy), effective from 18 May 2016 until 1 September 2021.

In November 2015, TfNSW invited two firms on its Legal Services Panel to tender for this contract. The audit team has not considered if this work constitutes core legal work that must be referred to the Crown Solicitor's Office (pursuant to Premier's Memorandum M2016-04, or its predecessor M1995-39).

The Procurement Manual required a tender evaluation report to be completed for every tender but the audit team has only seen a comparison of prices. Further, a contract management plan was required for all contracts valued at $250,000 or above and the audit team has seen no evidence of such a plan.

Variation one occurred under the Procurement Manual whilst variations two to seven occurred under the Procurement Policy. According to the policy, variations need:

- to be reviewed and approved by TfNSW Legal prior to being awarded
- have an independent compliance check
- an analysis of whether further negotiation is required
- a completed contract variation form.

Of the above, TfNSW completed contract variation forms for only five of these six variations. The audit team has seen no evidence that any of the other requirements have been met. Further the NSW Procurement Policy Framework requires agencies to conduct an assessment of the market prior to rolling-over or extending a contract to maintain competition between providers. There is no evidence that any assessments were done before agreeing to these variations.

Source: Audit Office of New South Wales research based on TfNSW documents.

In the 36 engagements that took place between 2014 and 2021, there are 11 instances where the value of the variation exceeds the threshold for a tender (one TAHE engagement, two Treasury engagements and eight engagements by TfNSW).

The current version of the NSW Procurement Policy Framework (April 2022) notes that 'routinely exercising extension options or rolling-over contracts reduces competition and limits access to new suppliers, products and services'. Further, the NSW Procurement Policy Framework requires agencies to conduct a 'strategic assessment of the market prior to rolling-over or extending a contract, including how the extension will impact competition'. The audit team has seen no evidence of market assessments for any of the contract extensions reviewed for this audit. Similarly, the previous version of the NSW Procurement Policy Framework that was in force from 2015 encouraged competition as a path to greater efficiency and lower prices. The audit team has seen no evidence that value for money was a consideration in granting any of the contract extensions or variations.

Section two

Appendices

Appendix one – Responses from audited agencies, and Audit Office clarification of matters raised in the TAHE formal response

1. Response from NSW Treasury
2. Response from Transport for NSW
3. Audit Office clarification on matters in the Transport Asset Holding Entity response
4. Response from the Transport Asset Holding Entity

1. Response from NSW Treasury

Treasury

Contact: Tom Gaudiosi
Telephone: [redacted]
Our Reference: TA22/1450

Ms Margaret Crawford
Auditor General of NSW
Level 15, 1 Margaret Street
SYDNEY NSW 2000

Dear Auditor General

Performance Audit – Design and Implementation of the Transport Asset Holding Entity of NSW (TAHE)

Thank you for your letter dated 29 November 2022 and the opportunity to respond to your Performance Audit, *Design and Implementation of TAHE* (the report).

The report provides an opportunity for Treasury to reflect further on the experience of developing and implementing the TAHE reform initiative over the best part of a decade.

As a performance audit, the report is necessarily backward looking. However, the completion of this audit also provides an opportunity to look ahead to the next stage of TAHE's development. In this context, Treasury looks forward to working closely with TAHE and Transport for New South Wales to support the considerable program of work underway to more effectively manage $23.8 billion of rail assets, and the investment of over $12 billion in rail assets in the next 10 years, through commercially focused asset management practices that enable safe and reliable services, and commercial projects aimed at addressing housing affordability.

In relation to the specific recommendations in the report, Treasury wishes to record the following responses:

Recommendation 1: improved accountability and transparency for major new fiscal transformation initiatives

Accepted in principle: Treasury accepts the recommendation in principle, noting that Treasury must operate within established statutory reporting frameworks, including the *Government Sector Finance Act 2018* and the *Fiscal Responsibility Act 2012*, and established Parliamentary conventions.

Recommendation 2: reporting of budget measures subject to risk and uncertainty

Noted: Treasury considers that the intent of this recommendation would be more effectively addressed through greater transparency in the presentation of budget measures, as broadly proposed in recommendation 1, and through promoting a culture of robust and impartial advice to Ministers in the implementation of budget measures. (The imperative to promote and embed this culture is supported by the independent review undertaken by Stephen Sedgwick AO of Treasury's processes regarding the recording of TAHE in the 2021 State Financial Statements. The assessment identified areas for improvement which Treasury is in the process of implementing.)

In making this suggestion, Treasury is concerned about the feasibility of implementing the recommendation as expressed: few budget initiatives are ever free of risk or uncertainty, and omitting announced Government policies on the basis that there may be unmitigated implementation risks would run counter to established budget reporting frameworks.

Recommendation 3: review of record keeping practices

Accepted: Treasury supports this recommendation and is committed to improving its recordkeeping and information management maturity. In this context, Treasury commenced an Information Management Program (IMP) earlier this year (2022) that is aimed at uplifting maturity against the *State Records Act 1998* and associated instruments, including the Information Classification, Labelling and Handling Guidelines.

The IMP is reviewing:

- recordkeeping and document management practices and systems;
- workflow systems;
- management of high risk, high value and sensitive information; and
- the relevant policies, procedures and training materials.

Treasury proposes to formally incorporate actions in response to this recommendation as part of the IMP, which is being progressively implemented.

Recommendation 4: review of internal procurement policies for the engagement of consultants

Accepted: Treasury supports reviewing internal processes to ensure that its use of consultants fully complies with NSW Government policy.

Treasury has created an internal procurement toolbox to provide better instruction on *How to Buy on behalf of NSW Treasury.* The toolbox includes guidelines and checklist to support buyers through all steps of the 'Plan', 'Source' and 'Manage' process. A more thorough process to manage contract variations and extensions within the Treasury Contracts register is in development. This process, together with improved guidelines are expected to deliver better compliance in the management of contract variations and extensions.

Treasury is also developing a checklist for buyers, to ensure assessment and active management of perceived conflicts of interest when engaging consultants. These checklists will form part of the suite of guidelines in the Treasury Procurement Toolbox. There will also be ongoing education for buyers within Treasury to ensure accountability and compliance of internal procurement policies when engaging consultants.

Record keeping and release of documents by Treasury for the Performance Audit

The report makes comments on the approach taken by Treasury staff in the provision of Cabinet in Confidence material to Audit Office in response to this performance audit. At the time, Treasury staff were mindful of their obligations under established Government protocols and the relevant provisions of the *Government Sector Audit Act 1983* (which have since been amended by the Parliament). Having personally engaged with the relevant staff at that time, I am satisfied that the staff were seeking to discharge their obligations impartially and professionally. Equally, I recognise the difficulties faced by the Audit team and reiterate Treasury's commitment to ensuring more effective document management, including avoiding over-classification of documents.

I would like to thank you for the opportunity to respond to your report.

Yours sincerely

Paul Grimes PSM
Secretary

18 January 2023

2. Response from Transport for NSW

Transport

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Ms Margaret Crawford
Auditor-General
Audit Office of NSW
GPO Box 12
SYDNEY NSW 2000
By email

our ref: BNCIT0015078

Dear Ms Crawford

Thank you for the opportunity to respond to the Performance Audit Report ("the Report") on Design and Implementation of TAHE. Transport for NSW (TfNSW) welcomes the Report, its findings, and recommendations. TfNSW is committed to improving accountability and performance across the Transport and Infrastructure cluster in these areas. The Report provides TfNSW with valuable feedback for further improving the implementation of complex cross-government reforms.

TfNSW accepts the recommendation on the incorrect labelling of Cabinet-in-Confidence documents, noting that these were based on historical TAHE documentation. Since that time, TfNSW has refreshed the Transport Information Labelling and Handling Guideline to complement existing document classification guidelines from the Department of Premier and Cabinet.

TfNSW also accepts the recommendation to review internal procurement policies to ensure that the use of consultants fully complies with NSW Government policy requirements, including specifically with contract variations and extensions and ensuring there is effective identification and mitigation of conflicts of interest across consultant engagements.

Thank you to you and your team for the insights that the audit has provided.

Yours sincerely

Rob Sharp
Secretary
16 December 2022

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By 1 July 2023, NSW Treasury and Transport for NSW should:

3. Review their record keeping practices, systems and policies to ensure compliance with the State Records Act, and the NSW Government Information Classification, Labelling and Handling Guidelines document with a particular focus on the correct labelling of Cabinet-in-Confidence documents.
Response: TfNSW accepts this recommendation based on historical documentation and undertakes to comply with document labelling policies such as: • Transport Information Labelling and Handling Guidelines 2021 • M2006-08 Maintaining Confidentiality of Cabinet Documents and Other Cabinet Conventions • NSW Cabinet Practice Manual

By 1 July 2023, NSW Treasury, TAHE and Transport for NSW should:

4. Review their respective internal procurement policies to ensure that the use of consultants fully complies with NSW Government policy requirements, including: • **the use of contract variations and extensions is consistent with the NSW Procurement Policy Framework** • **instances where consultants are simultaneously working for other agencies are identified, assessed and actively managed to ensure there are not real or perceived conflicts of interest.**
Response: TfNSW accepts the recommendation to review internal procurement policies to ensure that the use of consultants fully complies with NSW Government policy requirements and undertakes to comply with the NSW Procurement Policy Framework for future engagements.

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3. Audit Office clarification on matters in the Transport Asset Holding Entity response

In accordance with section 38 EB of the *Government Sector Audit Act 1983*, the audited agencies' formal responses to the Final Report are published in this Appendix.

TAHE's formal response to the audit has misrepresented some of the findings and analysis provided in this Final Report, as well as some aspects of the audit process.

The Final Report remains accurate and complete as relevant to the audit scope. Clarification on matters raised in TAHE's formal response is provided below.

1. TAHE's formal response argues that the conclusion of this report is incorrect because TAHE's operating model is not 'unnecessarily complex (especially when compared with other contractual arrangements in the infrastructure sector which involve multiple parties for construction operations and maintenance services, such as PPP arrangements).' The response also states that TAHE's arrangements do not 'impose on the current or future Governments any additional obligations to fund capital investment in the State's rail network to those that already existed prior to the establishment of TAHE.' The response also states that the audit 'did not undertake a review of the property projects that TAHE is undertaking' to support the audit conclusion that TAHE's ability to generate returns on government investment is 'uncertain'.

   Audit Office clarification:

   In response to the above commentary, we draw attention to the following points made in the report:

   - more than 80% of TAHE's current revenue comes from access and licence fees paid by the state owned rail operators, Sydney Trains and NSW Trains (see pages 3, 6 and 25 of the report)
   - farebox recovery accounts for around 20% to 30% of the cost of services (see pages 20 and 24 of the report)
   - TAHE's own modelling shows that it remains primarily reliant on access and licence fees paid by the state owned rail operators up to 2046 (see pages 3, 6, 7, 25 and 31 of the report)
   - the state owned rail operators remain reliant on grants from the General Government Sector Budget in order to be able to afford the annually increasing fees (see pages 3, 6, and 26 of the report).

   This report does not contend that there is now a new obligation for additional capital investment in the rail network – as TAHE's response suggests. However, the report does note – based on TAHE's 35-year long range model provided to NSW Treasury – that the NSW Government may need to provide a total of $66.5 billion to the rail operators, up to 2046, to ensure the government continues to demonstrate its expected return on investment of 2.5% (see pages 7 and 31 of the report). TAHE requires continued government funding to preserve the short-term improvement to the Budget position that is derived from an accounting treatment whereby contributions to TAHE are treated as an equity investment, rather than a Budget expense (see pages 3, 7 and 31 of the report). Maintaining this accounting treatment creates the unnecessary complexity referred to in the conclusion of this report.

   In relation to TAHE's commentary on the sufficiency of analysis of its property projects, we draw attention to page 25 of this report, which notes that 'at the current time, TAHE's sources of revenue include the government and third-party rail operators, and land and property leasing, asset management and recycling. Other commercialisation opportunities may become available in the future. At the time of writing this report, it is too early to confirm the likely financial impact of the opportunities the TAHE Board is considering.'

Our ‘Transport and Infrastructure 2022’ report similarly notes that ‘at this point in time, nothing beyond the access and licence fees has been approved or finalised as the main source of revenue’ (see page 35).

This scenario was anticipated at the commencement of this audit, and was the reason that TAHE’s current activities and performance are out of scope for this audit. TAHE’s formal response to this report itself acknowledges that ‘the primary focus of the Final Report is the genesis of TAHE rather than its current and future performance.’

Had these property projects been within the scope of this audit, it would still not have been possible for the audit team to review them because, at the time of writing, these projects have not been developed sufficiently for TAHE to demonstrate how the financial implications of these projects might affect the conclusions outlined in detail above. TAHE’s own long-term financial model, appropriately, does not incorporate the property projects because they are not at a sufficient stage of maturity to include.

2. TAHE’s formal response states that any ‘suggestion that the payment of access and licence fees by Sydney Trains and NSW Trains to TAHE….is anything other than a proper and transparent contribution to the value of a service provided is inaccurate and is rejected’.

Audit Office clarification:

The report does not make any suggestion that the payment of access and licence fees is in any way improper.

However, the report does note that access and licence fees were increased in 2021 so that TAHE could generate a sufficient return to justify the government’s accounting treatment whereby funds contributed to TAHE are an equity investment and not an expense in the Budget (see pages 3, 6, 25 and 26).

3. TAHE’s formal response challenges the conclusions of in the report because the Audit Office did not ‘conduct any face to face meetings with key stakeholders within TAHE’.

Audit Office clarification:

During the conduct of this audit, the Audit Office analysed in excess of 48,000 documents and conducted multiple interviews with all auditees. This included seven formal meetings with TAHE staff, as well as ongoing communication between our offices throughout the conduct of the audit. For clarity, the dates and subject matter of formal meetings held with TAHE staff are set out in the table below.

That these meetings occurred in a virtual environment does not detract from their importance in the audit process. It is unclear from TAHE’s formal response what additional evidence would have been conveyed through additional face to face discussions that could not have been conveyed via the multiple other communication channels available to TAHE throughout the conduct of this audit.

At no time during the conduct of the audit did TAHE request face to face meetings with the audit team. The TAHE CEO requested a face to face meeting with the Auditor-General at the conclusion of the audit, and this meeting occurred and included the TAHE Board Chair with the TAHE CEO.

Meetings between TAHE and members of the audit team took place as follows:

Date	Purpose of meeting	TAHE attendees
27 September 2021	Pre-scoping discussion	• Executive General Manager Finance & Business Performance • General Counsel • Chief Audit Executive
5 October 2021	Financial and performance audit team meeting with TAHE	• Executive General Manager Finance & Business Performance • Executive General Manager Asset, Safety and Environment
22 March 2022	Document request	• CEO • Executive General Manager Finance & Business Performance • General Counsel • Chief Audit Executive
23 August 2022	Meeting about 2014 governance groups	• Executive General Manager Finance & Business Performance • General Counsel
15 September 2022	Preliminary Findings discussion	• CEO • Executive General Manager Finance & Business Performance • General Counsel • Chief Audit Executive
31 October 2022	Draft Report discussion	• CEO • Executive General Manager Finance & Business Performance • General Counsel • Chief Audit Executive • Executive General Manager, Strategy & Innovation
13 December 2022	Final Report discussion with Auditor-General (face to face)	• CEO • Chair of the Board of Directors

4. Response from the Transport Asset Holding Entity

Transport Asset Holding Entity

Level 15 130 Pitt Street
Sydney NSW 2000

1300 234 987

tahensw.com.au

17 January 2023

Ms Margaret Crawford
Auditor-General for NSW
Audit Office of New South Wales
GPO Box 12
Sydney NSW 2000

Dear Ms Crawford

Audit Office Final Report Performance Audit - Design and Implementation of TAHE (Final Report)

I refer to your letter dated 29 November 2022 inviting Transport Asset Holding Entity of New South Wales (**TAHE**) to provide a formal response to the Final Report.

The primary focus of the Final Report is the genesis of TAHE rather than its current and future performance which is the focus and responsibility of TAHE's Board and Management. For that reason, TAHE's response to the Final Report is focused on those aspects of the Final Report which relate to the ongoing operation of TAHE.

TAHE has now been operating for two and a half years and is clearly focused upon the ownership and strategic management of a safe and reliable rail network that serves the needs of the people of NSW, as well as creating and unlocking value and driving economic growth through the proactive management of its asset portfolio which includes significant property holdings.

The TAHE operating model, including TAHE's operating licence and long term access agreements with Sydney Trains and NSW Trains provide a sound governance and commercial framework for its ongoing operation. Those arrangements reflect its core function as the owner and strategic manager of significant transport infrastructure and property assets. They are not "unnecessarily complex" (especially when compared with other contractual arrangements in the infrastructure sector which involve multiple parties for construction operations and maintenance services , such as PPP arrangements) and they do not impose on the current or future Governments any additional obligations to fund capital investment in the State's rail network to those that already existed prior to the establishment of TAHE.

Any suggestion that the payment of access and licence fees by Sydney Trains and NSW Trains to TAHE for the provision of below rail services is anything other than a proper and transparent contribution to the value of a service provided is inaccurate and is rejected.

TAHE's current projects to drive economic growth through better use of its property assets include the Central Precinct Renewal Program, the redevelopment of the Redfern-North Eveleigh Precinct and our Affordable

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Transport Asset Holding Entity

Housing Pilot Program. The financial and social benefits of TAHE undertaking these projects, together with its core function of providing rail access, have been carefully considered. The Board and Management of TAHE are confident that TAHE will be able to deliver on the strategic financial and non-financial objectives set for it in the Statement of Corporate Intent 2022-24, and do not consider that the ongoing financial benefits of TAHE "entail significant uncertainty". TAHE has implemented an enterprise risk management framework which is sufficiently robust to deal with the uncertainty inherent in the current macroeconomic context.

The ongoing safety of the rail network TAHE owns is paramount. I note that as is appropriate, there is no finding in the Final Report that the ongoing operation of TAHE has any negative impact on the safety of the network nor is there any recommendation in the Final Report related to safety.

The Final Report only makes one recommendation with respect to TAHE, that it review its internal procurement policies with respect to the use of consultants to ensure that it fully complies with NSW Government policy requirements. TAHE has adopted this recommendation and actually completed an internal audit review in June 2022.

Finally, it should be noted that in accordance with the 'Standard on Assurance Engagements (ASAE) 3500 – Performance Engagements', *"obtaining an understanding of the activity and other performance engagement circumstances is an essential part of planning and conducting a performance engagement"*. The Audit Office did not undertake a review of the property projects that TAHE is undertaking nor did they conduct any face to face meetings with key stakeholders within TAHE. In the absence of such investigations, it is difficult to understand how any conclusions could be made by the Audit Office as to TAHE's ability to generate returns on Government investment and whether those initiatives "may not be achievable or sustainable" and how they could be categorised as "uncertain".

Yours sincerely

Benedicte Colin
Chief Executive Officer
Transport Asset Holding Entity of New South Wales

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Appendix two – Classification of government entities

Types of classification

All government entities, at state and federal levels, are harmonised under the Government Finance Statistics (GFS) framework which facilitates the easy analysis of fiscal policy. All government entities are classified to a specific institutional sector and the Australian Bureau of Statistics (ABS) has the responsibility of classifying units for the purpose of official statistics based on information provided by the states. In each state, a single agency is responsible for managing the relationship with the ABS and in New South Wales that role is taken by the Treasury.

Australian Accounting Standards Board (AASB) Standard 1049 requires the whole-of-government general and general government consolidated financial statements must be prepared in accordance with Australian Accounting Standards. Further, the NSW Government is required to comply with the principles and rules of the Government Finance Statistics, where this is not inconsistent with Australian Accounting Standards.

For financial reporting and policy framework purposes government entities are classified into one of three possible classifications:

- General Government (GG) – institutional units that provide non-market goods and services (for example, roads, hospitals, libraries) primarily financed by taxes, to regulate and influence economic activity, to maintain law and order, and to redistribute income by means of transfer payments.
- Public Financial Corporations (PFC) – corporations that are principally engaged in providing financial services (including insurance and pension fund services) to other institutional units.
- Public Non-Financial Corporations (PNFC) – corporations whose principal activity is the production of non-financial goods and/or non-financial services at economically significant prices. Non-financial services are any services that do not qualify as financial intermediation or auxiliary financial services.

General Government agencies make up the majority of NSW Government entities representing 93 out of 118 (78.8%) distinct government entities listed in the 2021–22 Budget papers. In comparison, there are 21 PNFCs (17.8% of the total) and four PFCs (3.4% of the total).

Accounting treatment of different classifications

The New South Wales Total State Sector is made up of the combination of the three group classifications above and accounts are produced each year for the General Government Sector (GGS) and the Total State Sector.

For the purposes of this audit, an important difference between General Government entities, PNFCs and PFCs is the accounting treatment of funding provided to the entity by the government.

GGS investments in either PNFC or PFC entities are measured as one of the following:

- fair value, where fair value is reliably measurable
- the government’s proportional share of the carrying amount of net assets of the PNFC sector or PFC sector entity before consolidation eliminations, where fair value is not reliably measurable and the carrying amount of net assets before consolidation eliminations is not less than zero
- zero, where fair value is not reliably measurable and the carrying amount of net assets of the PNFC sector or PFC sector entity before consolidation eliminations is less than zero.

The GGS treats investment in the PNFC or PFC sector as described above, regardless of whether it makes a return. In the case where funds provided to PNFC or PFC entities' are classified as equity investments rather than grant expenses, this would improve the appearance of the GGS Budget.

Appendix three – About the audit

Audit objective

This audit assessed the effectiveness of NSW Government agencies' design and implementation of TAHE.

Audit criteria

We addressed the audit objective by assessing whether:

1. the process of designing and implementing TAHE was cohesive and transparent, and delivered an effective outcome
2. agencies' roles and responsibilities were clear in the planning of TAHE
3. agencies effectively identified and managed selected risks.

Audit scope and focus

In assessing the criteria, this audit focused on the design and establishment of TAHE and included:

- the classification of asset owning entities in the government sector accounts from 2012
- NSW Government budgets from 2012
- work of the TAHE Advisory Board, its members and workstreams from 2016 to 2020
- related work conducted by TfNSW and/or Treasury before 2016 (for example, AssetCo and budget estimates/reviews)
- the activities of the TAHE Board in its first year of operation
- TAHE's activities in the first 18 months of its operation.

Audit exclusions

The audit did not:

- re-perform: (1) the work of consultants and (2) financial modelling
- question the merits of government policy objectives.

Audit approach

Our procedures included:

1. interviewing:
    - relevant staff in the audited agencies.
    - stakeholders, industry reference groups and other representatives
2. examining:
    - legislation, government policies, directions and regulations relating to the design and implementation of TAHE
    - strategies, plans, policies, reports, and procedures for managing, and monitoring progress in the design and implementation of TAHE
    - any relevant data pertaining to the design and implementation of TAHE
    - internal audits or reports produced by other bodies/agencies on relevant topics
3. analysing:
    - relevant data pertaining to the design and implementation of TAHE
    - relevant data pertaining to rail safety.

The audit approach was complemented by quality assurance processes within the Audit Office of New South Wales to ensure compliance with professional standards.

Audit methodology

Our performance audit methodology is designed to satisfy Australian Audit Standard ASAE 3500 Performance Engagements and other professional standards. The standards require the audit team to comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance and draw a conclusion on the audit objective. Our processes have also been designed to comply with requirements specified in the *Government Sector Audit Act 1983* and the *Local Government Act 1993*.

Acknowledgements

We gratefully acknowledge the cooperation and assistance provided by staff at NSW Treasury, Transport for NSW and the Transport Asset Holding Entity.

Audit cost

The estimated cost of this audit is $840,760.

Appendix four – Performance auditing

What are performance audits?

Performance audits determine whether state or local government entities carry out their activities effectively and do so economically and efficiently and in compliance with all relevant laws.

The activities examined by a performance audit may include a government program, all or part of an audited entity, or more than one entity. They can also consider particular issues which affect the whole public sector and/or the whole local government sector. They cannot question the merits of government policy objectives.

The Auditor-General's mandate to undertake performance audits is set out in Section 38B of the *Government Sector Audit Act 1983* for state government entities, and in Section 421B of the *Local Government Act 1993* for local government entities.

Why do we conduct performance audits?

Performance audits provide independent assurance to the NSW Parliament and the public.

Through their recommendations, performance audits seek to improve the value for money the community receives from government services.

Performance audits are selected at the discretion of the Auditor-General who seeks input from parliamentarians, state and local government entities, other interested stakeholders and Audit Office research.

How are performance audits selected?

When selecting and scoping topics, we aim to choose topics that reflect the interests of parliament in holding the government to account. Performance audits are selected at the discretion of the Auditor-General based on our own research, suggestions from the public, and consultation with parliamentarians, agency heads and key government stakeholders. Our three-year performance audit program is published on the website and is reviewed annually to ensure it continues to address significant issues of interest to parliament, aligns with government priorities, and reflects contemporary thinking on public sector management. Our program is sufficiently flexible to allow us to respond readily to any emerging issues.

What happens during the phases of a performance audit?

Performance audits have three key phases: planning, fieldwork and report writing.

During the planning phase, the audit team develops an understanding of the audit topic and responsible entities and defines the objective and scope of the audit.

The planning phase also identifies the audit criteria. These are standards of performance against which the audited entity, program or activities are assessed. Criteria may be based on relevant legislation, internal policies and procedures, industry standards, best practice, government targets, benchmarks or published guidelines.

At the completion of fieldwork, the audit team meets with management representatives to discuss all significant matters arising out of the audit. Following this, a draft performance audit report is prepared.

The audit team then meets with management representatives to check that facts presented in the draft report are accurate and to seek input in developing practical recommendations on areas of improvement.

A final report is then provided to the head of the audited entity who is invited to formally respond to the report. The report presented to the NSW Parliament includes any response from the head of the audited entity. The relevant minister and the Treasurer are also provided with a copy of the final report. In performance audits that involve multiple entities, there may be responses from more than one audited entity or from a nominated coordinating entity.

Who checks to see if recommendations have been implemented?

After the report is presented to the NSW Parliament, it is usual for the entity's Audit and Risk Committee/Audit Risk and Improvement Committee to monitor progress with the implementation of recommendations.

In addition, it is the practice of NSW Parliament's Public Accounts Committee to conduct reviews or hold inquiries into matters raised in performance audit reports. The reviews and inquiries are usually held 12 months after the report received by the NSW Parliament. These reports are available on the NSW Parliament website.

Who audits the auditors?

Our performance audits are subject to internal and external quality reviews against relevant Australian standards.

The Public Accounts Committee appoints an independent reviewer to report on compliance with auditing practices and standards every four years. The reviewer's report is presented to the NSW Parliament and available on its website.

Periodic peer reviews by other Audit Offices test our activities against relevant standards and better practice.

Each audit is subject to internal review prior to its release.

Who pays for performance audits?

No fee is charged to entities for performance audits. Our performance audit services are funded by the NSW Parliament.

Further information and copies of reports

For further information, including copies of performance audit reports and a list of audits currently in-progress, please see our website www.audit.nsw.gov.au or contact us on 9275 7100.

Professional people with purpose

OUR VISION

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

OUR PURPOSE

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

OUR VALUES

Pride in purpose

Curious and open-minded

Valuing people

Contagious integrity

Courage (even when it's uncomfortable)

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