

Submission No 2

**FOLLOW UP OF THE AUDITOR-GENERAL'S
PERFORMANCE AUDITS SEPTEMBER 2010 - FEBRUARY
2011**

Organisation: NSW Trade & Investment
Name: Mr Mark Paterson AO
Position: Director General
Telephone:
Date Received:

Theme:

Summary



Trade &
Investment

Office of the Director General

OUT12/6474

Mr Jonathan O'Dea MP
Chair
Public Accounts Committee
Parliament of New South Wales
Macquarie Street
SYDNEY NSW 2000

Dear Mr O'Dea

Auditor-General's Report on Coal Mining Royalties

I refer to your letter of 8 March 2012 requesting a submission outlining the Department of Trade and Investment, Regional Infrastructure and Services' response to the Auditor-General's report on Coal Mining Royalties.

While the Department accepted the Auditor-General's recommendations, it disputed the conclusions and the commentary within the report. A letter was sent to the Auditor-General in response to the report (copy attached).

The Department has addressed the recommendations within its control, but the recommendation for the review into the merits of transferring the royalty function to the Office of State Revenue is NSW Treasury's responsibility.

Please find attached the Department's response to the audit.

Yours sincerely

Mark I Paterson AO
Director General

11/4/12

Encl.

DGO10/959

Mr P Achterstraat
Auditor-General
The Audit Office of NSW
GPO Box 12
SYDNEY NSW 2001

Dear Mr Achterstraat

Thank you for your letter of 29 October 2010 seeking a formal response to the final report for the performance audit on administering coal mining royalties in NSW.

All of the report's recommendations are accepted.

However there are concerns with the report's conclusions and the tone of the commentary for each section which do not accurately portray how effective or efficient the current royalty system is. The Department has provided the Audit Office with commentary and supportive evidence, much of which is not reflected in the final report.

The report indicates there may be a revenue leakage within the auditing program. It states "*it is difficult to say exactly*" but still provide an estimate of \$8 million over 5 years, or approximately 0.27% of royalty collected in that period. This calculation is extremely subjective and relies on assumptions that all audits will produce additional revenue.

In regard to the accurate and current information on coal royalty payments, the granting of a coal lease is a detailed process involving numerous government agencies. The Department believes that its systems and controls are sufficient to ensure that each coal lease is accurately identified.

In respect of the consideration to transfer the royalty administration to OSR this would need to be reviewed, particularly in relation to whether OSR has the appropriate expertise to fulfil the task. I note that no other State has royalties administered by their Office of State Revenue. In all instances it is the relevant industry Department.

Yours sincerely

BARRY BUFFIER
ACTING DIRECTOR-GENERAL

Response to the Performance Audit on Administering Coal Mining Royalties in NSW.

I have received the Performance Audit Report and provide comment on the Audit Office's recommendations, findings and related matters.

Recommendations

In response to the recommendations I advise the following:

1. Accepted.
2. Accepted.
3. Accepted.
4. Accepted.
5. Accepted.
6. Accepted.

All of the report's recommendations are accepted.

However, I do have concerns with the report's conclusions and the tone of the commentary for each section which I consider is not objective and not based on sound evidence. The Department has provided revised and up to date information to the Audit Office as part of the audits procedures and protocols, much of which has not been accepted or acknowledged by the report.

The conclusion that the Department cannot assure the people of New South Wales that the royalties owed are being paid in full is a criticism that could be made of any revenue regime operating within the State, as full compliance cannot be guaranteed.

Audit Findings

Accurate and current information on coal royalty payments

The performance audit states that the Department could not demonstrate that information on which lease holders should be paying royalties is accurate or current. The Department strongly refutes this claim as there are robust systems and controls for identifying mining leases for royalty purposes.

The client base for the coal royalty regime is well defined through the administration of the *Mining Act* and its regulations. It is illegal to mine without an authority and the planning and approval process for the establishment of a mine stretches across many other Government agencies. It would be impossible to commence coal mining operations without the Department's knowledge or approval.

All information regarding mining leases is maintained within the Titles Administration System (TAS), which records details for each authority, including: location; the method of mining; leaseholder details and security assurance.

Each authority is allocated to a royalty client within the Royalty Administration System (RIMS). A number of reports have been developed to maintain the accuracy and consistency between Department's systems. These reports have been in existence since 2005 and have been reviewed during the Auditor-General's annual financial audit. During the performance audit this issue of validation reports was not raised, other than an off hand request to demonstrate how the royalty system included new leases.

Determination of Royalty and when payable.

The report states *“the rules for calculation coal mining royalties are complex. DII has not made it easy enough for coal mining lease holders to work out what they owe.”* The ad valorem coal regime, introduced into New South Wales in 2004, was developed from consultation with NSW Treasury and the industry, and recognises the various operations within the State. To calculate royalty owed, the Ministerial Determinations provide sufficient information for collieries to calculate their royalty obligations.

In addition to the Ministerial Determination, royalty templates (monthly and annual) and examples were issued to all collieries in early 2009 following amendments to the coal royalty regime. An expanded annual return template was issued in June 2010 to collieries to improve the level of information and ensure returns were accurate. Coal guidelines have been finalised and will be published on the Department's web site.

The statement that reliance is placed on staff to clarify rules, and that they are not consistent, is incorrect. All clarification is referenced to the Ministerial Determination which defines the regimes form and structure. The regime was developed in consultation with the Industry and clarification is infrequent and generally sought from colliery employees with minimal industry experience.

The report highlights that Queensland's guidelines are comprehensive and are changed to address *“lessons learnt from mining lease holders' feedback”*. Queensland has updated its determination 3 times in the past nine years, twice for regulation updates and the other for a word conversion. The New South Wales Determination provides clear guidance and is consistent and in some points more detailed than Queensland's.

On time, accurate and valid returns.

The report indicated that other jurisdictions use independent verification for royalty liability. These States have a royalty regime that is profit based and therefore can rely solely on the audited financial statements of the mining operation, and as such cannot be applied to the New South Wales coal royalty regime. The auditors were advised that the Department proposed incorporate reconciliations to ledger accounts to provide a limited assurance for the annual royalty return, which has not been included in this report. The benefits of site audits cannot be replaced by limited assurance returns. The auditors have not recognised that an inspection of royalty records is not the same as audited financial statements. Royalty records cannot be matched electronically against other database systems as occurs with some taxes and duties.

The report's comments are based on an expectation that the coal industry can provide accurate monthly estimates. This shows lack of understanding of the external factors which frequently inhibit the industry such as foreign exchange variations, demand for specific commodities, commodity prices, supply chain issues, weather and colliery events.

Royalty Audits

Much of the statistics, graphical data and value of revenue leakage mentioned in the conclusion are misleading and inaccurate. The Department has on numerous occasions provided the auditors with current data. However, this has not been reported. None of the reports estimates in this conclusion are based on sound evidence.

The report indicates that between 2005-06 and 2009-10, the Department completed two thirds of audits planned. This is incorrect. In fact 92% of audits (196 out of 212) planned during the period have been completed or are being finalised. The report states that in regards to the 2009-10 audit program *“things are getting worse.”* The Department has supplied the audit office with current data

that has not all been furnished in the audit conclusions. This therefore does not appear to present a balanced or objective viewpoint. The Department informed the auditors that all collieries planned to be audited for 2009-10 have been inspected and these reports are due to be completed by the end of November. The report's graphs, Exhibits 7, 8 and 9 do not include the actual completed audits or adjusted audited revenue and are therefore misleading.

The report implies that a recovery rate of 0.13% is a result of poor auditing practices. This does not consider that compliance levels for a small client base (63 collieries) are extremely high.

The report indicates there may be a revenue leakage within the auditing program. It states "*it is difficult to say exactly*" but still provide an estimate of \$8 million over 5 years, or approximately 0.27% of royalty collected in that period. This calculation is extremely subjective and relies on assumptions that all audits will produce additional revenue. In fact using the reports own logic with the completed audit data, this "*revenue leakage estimate*" would be less than \$4 million over 5 years or 0.13% of revenue collected, which is consistent with the Department's current recovery rate.

The report concludes that the Department is not doing enough audits and indicates that a 100% audit program is an appropriate standard, but this conclusion is based on other jurisdictions that have different tax regimes and far fewer clients. Northern Territory, South Australia and Victoria were highlighted as undertaking 100% audits, but in each case they have only 10 to 20 major operations. New South Wales has 97 major mining operations and it has never been the intent to undertake a 100% audit program, with the exception of when a change in the regime occurs, as it did in July 2004 and January 2009.

The audit concludes that a separation is required between the Department's role as regulator of the mining industry and facilitator of increased investment in the industry. This implies a conflict of interest. This statement is not correct as the role of the Minerals Division is primarily compliance associated with the *Mining Act* and *Mine Safety Acts* in respect of safety, rehabilitation, environmental management, title conditions and royalty compliance. The Department does not approve mining, this is the role of the Department of Planning. There is clearly a separation of regulatory and approval functions.

The report implies that royalty inspections do not go back to prior years, but the Department has a practice of including prior unaudited years when major discrepancies have been identified.

The Department had already completed and commenced recommendations made by the report regarding the audit function. The Department has developed a risk based audit policy (policy number is O-095) which has been published on the Department's intranet site. Formal procedural documents have been finalised and are part of the royalty audit conclusions. Reports have been created to monitor and analyse the auditing functions.

In regards to staff rotation, it has been the practice to rotate staff frequently. Generally the auditors are rotated after 3 years, which is shorter duration than required by other bodies, including ASIC. Over the period examined by the audit, there was only one occurrence where a royalty auditor undertook the same audit for 4 years, which is still under the industry standard.

Late or wrong payment actions

The statistics on late payments do not recognise the value of these over the total payments received. If this was the case, the matter would be immaterial. The auditors focus on the decrease in interest collected for the 2009-10 year as a discrepancy when compared to previous years. In fact the opposite is the case and it reflects the high compliance rate received for on time royalty collection.

The report assumes that there is systematic flaunting of late or underpayments during the year and collieries have an incentive to make false or misleading assessments. This again proves that the auditors do not understand the industry. Given the level of investment and the risk and penalty that may arise from fraudulent activities, the risk of this occurring is low. It should be noted that if discovered, penalties may include not approving additional leases, prosecution of leaseholders and officers and suspension of current mining titles. The flow on effects from a suspension of mining lease due to fraudulent reporting, would be devastating to the leaseholder.

The conclusion that “*as long as the lease holders pay something, they will not be penalised*” is inappropriate and cannot be justified. The Department monitors and reviews major variations when they arise.

Merits of transferring Royalty administration

Royalty auditors are required to have a detailed knowledge of the industry, the *Mining Act* and accounting principles to determine the value and quantity of minerals for the calculation of royalty. There are many advantages in having specialised staff who understand the operations of specific mining operations.

Within New South Wales there are 5 separate mineral royalty regimes in operation. These include ad valorem (on value) regimes for coal, coal reject, petroleum and minerals (mainly metallic minerals). There is also a quantum (on quantity) regime for other minerals. The *Mining Act* and its regulations identify 110 separate minerals, each with different properties, quantities and values. To audit these different minerals, an auditor must understand the various processes and issues related to the specific mineral. Ad valorem mineral and petroleum audits are by far the most complex audits undertaken. These audits include account transactions, mineral production and processing methods, assessment of arms length transactions, foreign exchange variations, understanding of mineral contracts and stock valuations which require extensive accounting experience and industry knowledge and not a reliance on worksheets, audit plans or electronic database verifications.

The royalty audit functions also rely heavily on input from other units within the Minerals Resources Branch, which would be extremely difficult to maintain if the function were separated from the Department. The synergies of maintaining specific mining related activities within one organisation are immense. The royalty unit applies and complements information identified by other units, such as Titles to provide all data regarding leases, minerals and leaseholders, Geological Survey to validate minerals, yields and analyse reports, Environmental Sustainability and Mine Safety units own audit programs to target audits and Legal to provide regular advice on interpretations of the *Mining Act*, past precedents and other mineral matters.

Software systems used by the royalty unit are integrated with the Division's other applications. RIMS is designed to support the collection of royalty and production details in an integrated manner with the TAS system. RIMS obtains information from other databases including Common Mines Environment (Comet), Cogent. RIMS is designed to maintain all land property information in regards to private mineral ownership in the State. As mentioned earlier, and acknowledged by the report, the MBT project will enhance the capabilities and functionality of RIMS and other systems. Office of State Revenue (OSR) would be expected to use these systems to undertake the royalty auditing program.

One of the major drivers for the MBT project is the projected increase in the States mining royalties. Any consideration to transfer the royalty function may jeopardise the \$8 million project and hence adversely affect the regulation of the NSW minerals industry.

The auditing function is only one of a number of functions undertaken within the royalty unit. The other functions include policy development, determining the ownership of mineral rights throughout the State, requiring detailed knowledge and analyse of land and property records and it's legislation, the assessment and payment of royalty to private mineral owners, including analysis of production records and mining operations, financial advice in regards to assessments of authorities, collection and replication of statistical data for minerals and extractive industries, investigations into illegal mining and provide intelligence to other Mineral Division units.

It must also be noted that all States, with the exception of the Northern Territory, maintain the royalty unit as an integral function of their mining administration.

NSW Trade & Investment, Regional Infrastructure & Services

PERFORMANCE AUDIT - Coal Mining Royalties

IMPLEMENTATION OF RECOMMENDATIONS

Recommendations	Response	Actions to be taken	Due Date	Status	Responsibility
<p>1. To ensure information that supports the collection of coal mining royalties is accurate and current. DII should:</p> <ul style="list-style-type: none"> Develop data quality assurance standards and procedures Maintain records of annual data validation reviews Implement the electronic data integration project by June 2013 <p>2. To help mining lease holders comply with the rules, DII should develop comprehensive compliance guidance for coal royalties</p>	<p>Accepted</p> <p>Accepted</p> <p>Accepted</p> <p>Accepted</p>	<ul style="list-style-type: none"> Reports to maintain the integrity of data are in place to ensure the data within the Royalty Information System is accurate and current. The current data validation reports will be reviewed annually, prior to the issuance of the annual royalty returns. The reports will be filed for confirmation. Electronic data integration will be developed. Manual processes have been introduced to ensure data is accurate and current. Minister's Determination and examples issued. An annual royalty return template issued. Coal Guidelines, outlining processing issues and defining key points from the Minister's Determination and legislation developed. All information to be made available on the Department's website. 	<p>June 2005</p> <p>June 2011</p> <p>June 2013</p> <p>February 2009 June 2010</p> <p>September 2010 February 2011</p>	<p>Complete</p> <p>Completed</p> <p>On track</p> <p>Completed Completed</p> <p>Completed Completed</p>	<p>Mineral Resources</p>
<p>3. To improve the accuracy of returns and the efficiency of the royalty return system, DII should:</p> <ul style="list-style-type: none"> Require coal mining lease holders to provide supporting evidence with their annual returns Require coal mining lease holders to undertake an independent limited assurance audit of annual returns Implement an online royalty return system by June 2013 	<p>Accepted</p> <p>Accepted</p> <p>Accepted</p>	<ul style="list-style-type: none"> Annual returns will require confirmation of reconciliations of sales to colliery ledgers. The Department will audit 100% of the annual coal returns instead of having independent assurance. An online system will be developed 	<p>July 2011</p> <p>July 2011</p> <p>June 2013</p>	<p>Complete</p> <p>Completed</p> <p>On track</p>	<p>Mineral Resources</p>
<p>4. To ensure a more structured approach and effective audits, DII should:</p> <ul style="list-style-type: none"> develop a risk-based audit program to better target resources for each audit undertaken extend the scope from the current one year's royalties to all years since the previous audit develop audit procedures and train staff monitor and report on audit progress and audit findings, and the effectiveness of its compliance activities develop a staff rotation policy to better manage the perception of independence 	<p>Accepted</p> <p>Accepted</p> <p>Accepted</p> <p>Accepted</p> <p>Accepted</p>	<ul style="list-style-type: none"> Document risk based audit practices into a policy All annual coal returns will be audited. Audit procedures, checklists and standard templates and documents developed Monitoring of audit progress and findings Quarterly performance reporting to the Executive Director Mineral Resources Development of a Staff rotation policy 	<p>September 2010 July 2011</p> <p>December 2011 September 2010 March 2011 September 2010</p>	<p>Completed Completed</p> <p>Completed Completed Completed Completed</p>	<p>Mineral Resources</p>
<p>5. To improve compliance, DII should:</p> <ul style="list-style-type: none"> Penalise underpayments of royalties identified in audits and annual returns exceeding a certain percentage (e.g. two per cent) of royalties owed for the year Escalate penalties for consistent late payments of royalties. 	<p>Accepted</p>	<ul style="list-style-type: none"> Interest charges will be introduced for annual returns and audits where the variation is greater than 2% of total royalty 	<p>March 2011</p>	<p>Completed</p>	<p>Mineral Resources</p>
<p>6. NSW Treasury, in consultation with DII and the Department of Premier and Cabinet, should undertake a detailed review of the merits of transferring the administration of royalties to the Office of State Revenue</p>	<p>Accepted</p> <p>Accepted</p>	<ul style="list-style-type: none"> This will be in introduced within the Branch's compliance and enforcement policy Committee, chaired by NSW Treasury to undertake review and provide recommendations to Cabinet. 	<p>June 2012 June 2011</p>	<p>On Track</p>	<p>NSW Treasury</p>