



ESSENTIAL SERVICES COMMISSION

**GAS INDUSTRY
GUIDELINE No. 8**

OPERATIONAL AND COMPLIANCE AUDITS

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GAS INDUSTRY
GUIDELINE No.8

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1. BACKGROUND

1.1. Audit objectives

1.1.1. The Commission requires audits to be conducted of the performance of distributors and retailers under the *Gas Industry Act 2001* against key licence obligations and the quality of regulatory data – for example, performance indicators and forecasts - reported pursuant to the licences.

1.1.2. The audits are also designed to enhance the licensees' understanding of their compliance with key licence conditions and provide a basis for implementing performance improvements and innovations. The auditors will need to have relevant skill and expertise and sufficient independence to ensure that the quality and credibility of audit findings are not compromised by conflicts of interest.

1.2. Licence obligation

1.2.1. This guideline applies to distribution and retail licences under the *Gas Industry Act 2001* which include a requirement that licensees appoint an independent auditor to, at the request of the Commission, conduct audits of:

- (a) their compliance with licence obligations, including obligations to comply with industry codes and guidelines; and
- (b) the reliability and quality of information reported by them to the Commission, and the consistency of that information with the Commission's specifications.

1.2.2. The licences referred to in 1.2.1 further provide that:

- (a) audits must be conducted by an independent auditor appointed by the licensee and approved by the Commission, subject to any terms and conditions specified by the Commission;
- (b) the scope of the audit is to be approved by the Commission, and must meet any minimum requirements specified by the Commission, but need not cover obligations, policies, practices, procedures or systems of the licensee where compliance is audited under a separate regulatory requirement; and
- (c) the audits must be conducted, and the results reported to the Commission, in accordance with any applicable guidelines.

2. OVERVIEW OF AUDIT FRAMEWORK

2.1. Purpose of the guideline

2.1.1. This guideline sets out how the Commission will exercise its licence powers to request audits, approve auditors and the scope of audits, and outline how audits are to be conducted and reported.

2.1.2. This guideline is designed to:

- (a) *ensure that audits are conducted in an independent, rigorous and comparable manner* by establishing minimum requirements for the independence and expertise of auditors, and the conduct and reporting of audits;
- (b) *foster a culture of continuous improvement* by minimising the probability that significant non-compliance will go undetected, and providing licensees with an opportunity to rectify non-compliance before the Commission considers enforcement action; and
- (c) *maximise the cost-effectiveness of the audits* by taking a risk-based approach to defining their scope.

2.2. A staged approach

2.2.1. This guideline sets out a staged approach to approving and conducting the audits (summarised in the flow chart in Attachment 1).

2.3. Frequency and timing of the audits

2.3.1. The Commission anticipates that audits will be conducted no more than annually. The frequency and scope of audits will be determined through the risk assessment described in section 4.2 of this guideline.

3. APPOINTING THE AUDITOR

3.1. Skill and experience

3.1.1. The auditor and the audit team must have:

- (a) skill and substantiated experience in, and detailed knowledge of, quality assurance, including operational or compliance auditing;
- (b) where relevant, skill and substantiated experience in, and detailed knowledge of, science or engineering, asset management, information systems and customer service; and
- (c) detailed knowledge of the gas industry.

3.1.2. The audit team must be led by a partner (or equivalent) of the auditor. The team leader must sign and take full responsibility for all audit reports.

3.1.3. Auditors are required to enter into a tripartite deed (“audit deed”) with the Commission and the licensee. Amongst other things, the audit deed further specifies obligations of auditors and any sub-contractors to demonstrate and maintain their skill, experience and detailed knowledge.

3.2. Independence and duty of care

3.2.1. The auditor must not do, and must not recently have done, work which would create, or could be seen to create, a conflict of interest with its duty to the Commission. The audit deed elaborates on this requirement and qualifies its application in the context of protocols agreed with the Commission.

3.2.2. The auditor and any sub-contractors may be placed in a position where their duty to another and their duty to the Commission conflict; in such an event, the auditor’s primary duty must be to the Commission. The duty of care is and a procedure for addressing conflicts of interest are also specified in the audit deed.

3.2.3. Apart from its obligation concerning conflicts of interest, an Auditor must also ensure that no member of the audit team performs fee earning work for the relevant licensee and that no work is undertaken which either influences any members of the audit team or which could reasonably be considered to give rise to a material risk of any members of the audit team being influenced in relation to the relevant audit or the audit deed. The audit deed elaborates on this requirement and qualifies its application in the context of work undertaken in connection with the audit, certain financial auditing services under the Corporations Act and work undertaken under protocols agreed with the Commission.

3.3. Commission approval

3.3.1. Commission approval of the auditor and the audit team is required, to ensure that the audit is conducted by personnel who meet the requirements of this guideline.

3.3.2. To obtain approval of the auditor and the audit team, a licensee should make a submission to the Commission on its nominated firm which provides details of:

- (a) the firm’s field of work, core expertise and experience and corporate structure;

- (b) work which has been done by the firm for the licensee in the previous two years, and work which the firm is currently doing for the licensee or has bid for;
- (c) the work history and skills of each team member, and the role s/he would play in the audits; and
- (d) advice of any potential conflict of interest and, if so, the manner in which the potential conflict of interest is proposed to be managed.

3.3.3. If the firm meets the approval criteria stated in Clauses 3.1 and 3.2, the Commission will give its in-principle approval to the appointment of that firm. The Commission envisages that auditors may be engaged for up to five years. Final approval will be conditional on satisfactory execution of the audit deed. If an audit deed is terminated, any approval of the relevant auditor lapses.

3.3.4. If the firm does not meet the approval criteria, the Commission may reject the nomination.

3.4. Conditions

3.4.1. The audit deed between the licensee, the auditor and the Commission may include, amongst other things, the following conditions:

- (a) Members of the audit team must not perform any other fee-earning work for the licensee during the term of the audit deed, other than services in respect of an audit carried out under the licence or financial auditing services carried out under the Corporations Act 2001 (Cth).
- (b) The auditor must ensure that members of the audit team are not influenced by commercial interests arising from other work or prospective work undertaken by the auditor (subject to the application of protocols agreed with the Commission and other qualifications specified in the audit deed).
- (c) After an audit report has been submitted, specified obligations may be re-audited at the direction of the Commission (subject to any qualifications on the right to require a re-audit agreed by the Commission in the audit deed).
- (d) The auditor is to keep:
 - (1) a record of all contacts with the licensee in relation to each audit;
 - (2) a record of all significant and material changes made to any draft audit report and reasons for the changes; and
 - (3) any other records and material required to be kept under the audit deed.
- (e) The auditor must provide to the Commission or a check-auditor engaged by the Commission, on request, any of the above documents, as indicated in the audit deed.

3.4.2 The contract is to be terminated early if:

- (1) the auditor has not observed its primary responsibility to the Commission; or
- (2) the auditor or a division of it has been engaged to do work for the licensee which includes the provision of strategic advice or management services unless approval has been granted by the Commission under this guideline and the audit deed; or
- (3) the audit team is changed in a way which unacceptably reduces its competence or otherwise breaches the requirements of this guideline or the audit deed; or

- (4) any ring fencing arrangement, protocol or other arrangement agreed under the audit deed is not implemented or implemented but contravened; or
- (5) the auditor has otherwise not acted in accordance with this guideline, the audit deed, or any decision by the Commission's under either this guideline or the audit deed.

3.4.3. The licensee may not require the auditor to change an audit finding, and may not withhold payment or terminate the contract in respect of an adverse audit finding which has been competently made. If the licensee wishes to withhold payment or terminate the contract due to poor performance, the Commission must be consulted.

3.5. Changes to the audit team

3.5.1. If the licensee or the auditor proposes to change the audit team, the Commission's approval is required.

4. APPROVING THE AUDIT SCOPE

4.1. Identifying obligations

4.1.1. Prior to each audit, the Commission, in consultation with the licensees, will review the obligations of the licensees which are open for inclusion in the audit. 'Obligation' means anything the licensee is required to do pursuant to its licence, in particular complying with performance requirements and reporting regulatory information to the Commission (regulatory information includes performance information for comparative reporting and forecasts for price review purposes).

4.1.2. Based on an assessment of the consequences of non-compliance, the Commission will then nominate those obligations which should be included, as a minimum, within the scope of that audit.

4.1.3. Where a licensee has implemented a service innovation which it proposes that the Commission describe in a comparative performance report, then the Commission will generally require that the innovation is audited to ensure it is being delivered, except where compliance may be reliably demonstrated without scrutiny by the auditors.

4.2. Assessing risk

4.2.1. The risk associated with non-compliance is a product of the *likelihood* of non-compliance and its *consequences*.

4.2.2. A number of generic 'consequence factors' will be considered by the Commission in assessing risk. Where relevant, these include:

- (a) cost to customers or the public;
- (b) danger to public health or safety;
- (c) damage to property;
- (d) loss or reduction of essential service;
- (e) environmental damage;
- (f) adverse public reaction; and
- (g) threat to actual or comparative competition (eg - making invalid comparisons between licensees' performance).

4.2.3. The Commission will also consider the likely or known extent of non-compliance in assessing risk. This will include assessment of previous audit results.

4.2.4. In considering these issues the Commission will seek to minimise the potential for unnecessary or overlapping audit, where an obligation is audited under a separate regulatory requirement.

4.2.5. While the Commission will conduct a risk assessment to ensure that the audit meets its information needs, it is equally if not more important that licensees conduct their own risk assessments to ensure that all high risk obligations are identified. As discussed below, licensees should ensure that all high risk obligations are audited, not only those identified by the Commission.

4.3. Specifying the minimum audit scope

Obligations to be audited

4.3.1. The risk assessment will be used by the Commission, in consultation with the licensees, to identify the minimum set of obligations to be audited; this will constitute the minimum audit scope. Priority will be given to auditing high risk obligations. Low-medium risk obligations will be audited less intensively and less frequently than high risk obligations.

4.3.2. Notwithstanding the Commission's risk assessment, licensees have a responsibility to ensure that any obligation which they identify as carrying a high risk, and which is eligible for inclusion in the audit, is audited and reported even if the Commission has not included the obligation in its minimum audit scope.

Compliance issues

4.3.3. Where specific compliance issues have been identified for an obligation which is included in the minimum audit scope, those issues must be addressed by the auditor in its report.

Time frame

4.3.4. For some obligations, auditors will be required to assess compliance over a period of time, as well as at the time of the audit. This is particularly important, for example, in assessing regulatory information to be published by the Commission; the reliability of the information should be assessed over the period to be covered by the Commission's report.

4.3.5. The time frame to be covered will be specified by the Commission in the minimum audit scope.

4.4. Approval of licensees' submissions

4.4.1. Following consultation, the Commission will advise licensees of the minimum audit scope - including the obligations to be audited, compliance issues and the time frame of the audit.

4.4.2. The licensees should then submit their proposed audit scope to the Commission. It should comply with the minimum scope and should specify any additional obligations to be audited, in particular any obligation which the licensee or its auditor has identified as high risk and which has not been included by the Commission in its minimum scope.

4.4.3. If a licensee's audit proposal meets the Commission's minimum requirements, the Commission will approve the proposal.

4.5. Briefing the auditors

4.5.1. When the auditors have been appointed and the audit scope approved, the Commission will brief the auditors in the presence of the licensees, prior to the audit commencement to ensure that the Commission's requirements are clearly understood by licensees and the audit team.

5. CONDUCTING THE AUDIT

5.1. Audit methodology

5.1.1. To ensure that the audits are comparable, the methodology employed must comply with generic minimum requirements.

5.1.2. As a minimum, the auditor must ensure that the audit team:

- (a) **Analyse documented procedures** to assess whether they are consistent with the regulatory definition of the obligation. Documented procedures include anything which guides staff in complying with the obligation, for example training manuals, customer service manuals, and procedures for generating, entering and reporting regulatory information.
- (b) **Interview responsible staff** to assess whether they understand and comply with the documented procedures.
- (c) **Analyse information systems** to assess the extent to which they produce information which complies with regulatory definitions. This will require an examination of:
 - (1) system design and security; and
 - (2) the design of queries and calculation formulae which are used to generate regulatory information.
- (d) **Analyse quality controls** to identify whether non-compliance is detected and fed back for correction.

For performance information, this includes procedures to independently verify that event data has been properly generated and entered, for example by matching job orders to maintenance crews with system data on outages.

The adequacy of complaints feedback processes is important, for example:

- (1) the accuracy with which complaints of non-compliance with the obligation are identified;
 - (2) the speed and reliability with which complaints are passed to the responsible person;
 - (3) the impartiality with which the complaint is analysed; and
 - (4) the extent to which justified complaints are acted on, both in providing redress to the complainant and minimising the risk of recurrence.
- (e) **Identify changes in systems and documented procedures** which may indicate that data accuracy or reliability has varied significantly over the audit time frame, and which may lead the auditor to conclude that the current compliance level is not representative of compliance over the time frame.
 - (f) **Analyse relevant data** in the licensee's information system to:
 - (1) ensure that the data in the system matches the data previously reported to the Commission; and
 - (2) identify any missing data or unusual figures or trends which might suggest errors in data entry or manipulation.
 - (g) **Analyse a sample of cases or data.** It is not enough to ensure that procedures are robust; the auditor must also establish the extent to which the obligation has actually been delivered (to assess, for example, the accuracy of the reported data).

To use the outage example referred to above, the auditor should obtain a sample of job orders to maintenance crews and a sample of customer complaints about supply interruptions and assess whether they correspond to interruption events recorded in the relevant information system.

If changes have occurred in documented procedures during the audit period, the sample should include cases or data from before and after the changes to gauge if accuracy or reliability has significantly altered.

(h) **In cases of significant non-compliance, assess the licensee's plan to ensure compliance**, in particular whether the plan is adequate and will be effective. Significant non-compliance means:

- (1) for regulatory information - a confidence grade worse than B or an accuracy grade worse than 2 (as defined in Part 6); and
- (2) for any other licence obligation - a compliance grade worse than B.

5.1.3. The importance of the above steps will vary according to the nature of the obligation. In some cases, there may be no requirement for regulatory information relating to the obligation in question, hence no scope for a data audit.

5.1.4. In conducting the audit the auditor may seek clarification from the Commission regarding any uncertainty or difficulties that arise. Nothing done or not done by the Commission in addressing, or endeavouring to address, a query will not however relieve the auditor of any liability, or exclude or limit any Commission right or remedy, under the audit deed.

5.2. The audit approach

5.2.1. The auditor must undertake a critical but cooperative examination of the possible causes of non-compliance; licensees' assumptions should be tested.

5.2.2. It is not acceptable for the auditor to merely review an internal audit assessment in arriving at a compliance assessment. While a review of an internal audit may assist the auditor's work, particularly for low-medium risk obligations, it does not of itself provide an independent assessment of compliance. Where the auditor has previously audited an obligation, professional judgement may be exercised as to the depth of inquiry required; however, any question identified in the audit scope must be pursued.

5.2.3. Auditors may make use of independent audits conducted for the Office of Gas Safety in arriving at their findings on relevant issues. The extent to which these independent audit findings may be used is a matter for the auditor's professional judgement having regard to their relevance to the audit scope and confidence levels.

5.3. Generic compliance issues

5.3.1. There are generic compliance issues which must be addressed for each obligation. These are set out in the paragraphs below.

5.3.2. The generic compliance issues to be addressed in assessing regulatory information are as follows:

- (a) Is the information generated in accordance with documented policies, practices and procedures?

- (b) Are the policies, practices and procedures fully understood by relevant staff?
- (c) How accurately do those procedures and the reported information reflect the Commission's information specifications?
- (d) Is the reported information based on sound information systems and records?

5.3.3. For other licence obligations, the generic compliance issues are as follows:

- (a) Is the obligation reflected in documented procedures?
- (b) Is it fully understood by staff?
- (c) Has it been delivered as specified?
- (d) Is it the subject of effective compliance monitoring (eg - records of service delivery) and quality control (eg - complaints feedback)?

5.3.4. In addition to these generic issues, obligation-specific compliance issues must also be addressed as described in the previous section.

6. ASSESSING AND REPORTING ON COMPLIANCE

6.1. Standard compliance grades

6.1.1. It is important that compliance is assessed using standard confidence and compliance grades, thereby maximising the comparability of the results reported to the Commission. Standard grades are prescribed below.

Regulatory information

6.1.2. The compliance grades used to assess regulatory information focus on the reliability of the procedures for generating the information and the accuracy of the data itself.

6.1.3. Data accuracy is determined by:

- (a) the measurement systems used to generate the data; and
- (b) the methods used, if any, to extrapolate or estimate data.

6.1.4. A two part confidence grade (eg - B2, DX) should be assigned to each performance indicator, as follows:

Grade	Reliability assessment
A	All data is based on sound information systems and records, and on documented policies, practices and procedures which are: <ul style="list-style-type: none"> • consistent with the Commission's information specifications; and • fully understood and followed by staff.
B	Most data conforms with grade A. Data which does not has a minor impact on overall data integrity. For example, a minority of data may be based on: <ul style="list-style-type: none"> • information specifications which are significantly, but not substantially, different to those published by Commission; or • procedures which are not fully understood by staff; or • minor variations from documented procedures; or • estimation or extrapolation of data which conforms with Grade A; or • reliance on unconfirmed reports.
C	In many cases, but not all, data is based on: <ul style="list-style-type: none"> • information specifications which are significantly, but not substantially, different to those published by Commission; or • procedures which are not fully understood by staff; or • estimation or extrapolation of data which conforms with grade A or B; or • reliance on unconfirmed reports.
D	Other data

Grade	Accuracy
1	± 1%
2	± 5%
3	± 10%
4	± 25%
5	± 50%
6	± 100%
X	For small samples where an accuracy cannot be calculated or error would be more than 100%

Other licence obligations

6.1.5. Compliance with other licence obligations, including codes and guidelines, should be assessed using the following grading system (which uses the same categories as the reliability grading system for regulatory information):

Grade	Compliance level (% - estimated or actual)
A+	99 ⁺ -100
A	95 ⁺ -99
A-	90 ⁺ -95
B	80 ⁺ -90
C	50 ⁺ -80
D	0-50

6.1.6. In many cases it will not be possible to calculate the level of compliance, requiring the auditor to address the generic and specific compliance issues and estimate the compliance grade accordingly.

Current and period compliance

6.1.7. The auditor is required to assign grades for:

- (a) current compliance (ie - compliance at the time of the audit); and
- (b) for specified obligations, compliance over the audit time frame. The grade for current compliance and compliance over the time frame can be taken as being same if the auditor has identified no significant changes to procedures or systems over the audit period. If significant change has been identified, however, the auditor must assign a grade to represent compliance over the audit time frame.

6.1.8. For example, if a particular data set was of poor quality for half the audit time frame and, following procedure and system changes, was more reliable and accurate for the remainder of the period, compliance over the time frame should be assessed as lower than current compliance.

Level of confidence

6.1.9. Compliance grades should be assessed by the auditor to a 90% level of confidence, based on statistical methods where possible and judgement in other cases. The Commission may direct that specified obligations be assessed to a 95% level of confidence.

6.2. Content of reports

Full report

6.2.1. Auditors should produce full audit reports which contain, as a minimum (unless directed otherwise by the Commission):-

- (a) *An executive summary* which should include the following items as a minimum:
 - (1) summary describing the level of compliance;
 - (2) key issues arising from the audit; and
 - (3) actions proposed by the Licensee to address issues raised;
- (b) *A description of the audit scope and methodology*, which should reflect those approved by the Commission.
- (c) *A brief description of the systems and procedures* which have been established to comply with each obligation, including the identification of relevant documentation and responsible staff.
- (d) *A discussion of compliance* addressing each generic compliance issue and each obligation-specific compliance issue identified by the for that audit.
- (e) *Compliance grades for each obligation included in the audit scope* and for performance indicators the audited performance figures. The report should also identify the reasoning for a final audit grade where there is disagreement between the auditor and licensees as to the final grade.
- (f) Where significant non-compliance has been detected and the licensee has a compliance plan:
 - (1) *A description of the compliance plan.*
 - (2) *An evaluation of the adequacy of the plan*, including a projected compliance grade or level at the conclusion of the plan.

Standard summary report

6.2.2. Upon request a summary audit report should be prepared using the standard reporting format issued by the Commission.

6.3. Signed statement

6.3.1. The full report must include a statement signed by the lead auditor which states that:

- (a) this guideline and the audit deed have been complied with by the auditor in conducting the audit, making audit findings and preparing the report; and
- (b) the audit findings reflect the professional opinion of the auditor to the level of confidence specified in this guideline.

6.4. Reporting procedures

The role of boards

6.4.1. The licensee must ensure that its board considers the auditor's report and forwards it to the Commission (in both the summary and full versions). This allows the licensee an opportunity to:

- (a) assess whether the report accurately reflects the licensee's performance; and
- (b) begin taking corrective action where non-compliance has been identified.

6.4.2. The licensee must not, however:

- (a) Attempt to require changes to be made to the auditor's report which conflict with the auditor's professional judgement and its primary responsibility to the Commission;
- (b) Unreasonably withhold payment or terminate the audit contract over a disputed audit finding; and
- (c) Significantly delay the forwarding of the report to the Commission.

Copy of report

6.4.3. The licensee should provide both a hardcopy and an electronic copy of the audit report.

Audit briefing

6.4.4. The auditor must ensure that the members of the audit team (including the team leader) are available to brief the Commission on their audit findings.

7. RESPONDING TO THE AUDITS

7.1. In responding to an audit report, the Commission may:

- (a) obtain and analyse records described in clause 3.4.1(e) such as the auditor's record of its contacts with the licensee, so as for example, to obtain more details of reported non-compliance or to investigate whether significant changes have been made to drafts of the report;
- (b) require further auditing at the licensee's expense in circumstances outlined in the audit deed (such as where the Commission considers that information available to it is suggestive of the report or a finding in it being unsatisfactory);
- (c) conduct (or procure that a consultant engaged by its conduct) its own audit of the full audit report(s) or an aspect of it where it might require further auditing under the audit deed or where:
 - (1) it is not satisfied that the individual audits provide adequate assurance that the licensees are meeting their obligations (eg: reporting regulatory information) in a comparable manner; or
 - (2) it requires better information on which to assess whether compliance action should be taken;
- (d) require termination of the audit contract;
- (e) review obligations which appear inadequate, excessive or trivial;
- (f) publish audit results;
- (g) require action to be taken by a licensee to comply with a particular obligation; and/or
- (h) issue orders to comply under the powers specified in the Essential Services Commission Act 2001.

ATTACHMENT 1 – AUDIT FLOWCHART

