

# Summary of consultation with audit experts

## Introduction

1. Earlier this year Authority staff met with the following four external organisations to discuss their auditing experience and to gain an understanding of auditing best practices that could be applied to the electricity market's audit regime:
  - (a) PA Consulting Limited (PA Consulting)
  - (b) External Reporting Board
  - (c) Audit New Zealand
  - (d) Gas Industry Company.

## PA Consulting

2. PA Consulting provides energy market auditing services in Asia-Pacific and North American markets.
3. In February 2015, the Authority engaged PA Consulting to identify best practices in electricity industry auditing and to develop a best practice comparison framework.
4. PA Consulting reviewed auditing practices in other international energy markets. The following international energy markets have similarities with New Zealand's audit regime for audited entities, general audit objectives, and market structure,<sup>1</sup> and the compliance risks faced by the audited entities:
  - (a) the Elexon balancing and settlement code audit in the United Kingdom
  - (b) the Australian energy market operator audits of metering services providers in Eastern Australia
  - (c) the Western Australian electricity, gas, and water licence audits.
5. PA Consulting's comparison of New Zealand's audit regime to operational audits that are carried out in overseas electricity markets found:
  - (a) Operational compliance audits are common for market and system operators. New Zealand is a notable exception in this respect. However, the Authority has the ability to request ad hoc compliance reviews as required.
  - (b) Regular audits of meter data providers are common in New Zealand, Eastern Australia, the United Kingdom, and the Philippines markets.
  - (c) Audits of metering equipment providers are common in overseas markets. Typically the audited entities are required to undergo a certification process at

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<sup>1</sup> Both the United Kingdom and Eastern Australia have full retail competition. Western Australia only has retail competition for large customers.

the time of registration. The market rules or higher legislation allows for either regular or periodic random audits.

- (d) Regular audits of meter test houses are less common in overseas markets. The reason for this is the variation in the governance of meter test houses.
6. Although specific audit objectives vary between the different international electricity markets depending on the entity being audited, the high level principles of the audits are generally consistent. PA Consulting consider an audit should:
- (a) assure market stakeholders the market is operating properly and in accordance with the market objectives, rules, and subsidiary documents
  - (b) improve the operational efficiency of the market by:
    - (i) Detecting inefficient business processes that may lead to non-compliance or outcomes that are inconsistent with the market's objectives. An auditor should be able to recommend measures to mitigate compliance risks and/or improve efficiency.
    - (ii) Identifying instances where market requirements cause non-compliance or inefficiencies. Some breaches can be indicative of a poorly drafted requirement that cannot be complied with. An auditor should be able to recommend changes that would facilitate compliance while meeting market objectives.
    - (iii) Increasing investor confidence in the market. Compliance with obligations that have materially financial impacts on the market is typically a good indicator of the integrity and stability of the market and can foster investors' confidence in the market.
7. Many markets require auditors to align their methodology with an internationally accepted standard, such as ISAE 3000 (Assurance Engagements Other than Audits or Reviews of Historical Financial Information).<sup>2</sup>
8. A risk-based approach to focusing auditors' efforts is becoming increasingly common in more mature electricity markets. Risk-based approaches are used in the United Kingdom, Western Australia, Eastern Australia, and the Philippines.
9. The variation in auditing practices across markets is because:
- (a) compliance risks can vary significantly by audited entity and by market
  - (b) governance of audited entities can vary by market.
10. When specifying best practice for the New Zealand audit regime, it is important to consider which practices are most appropriate in the context of the New Zealand regime.

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<sup>2</sup> The New Zealand version of this standard can be found at <http://xrb.govt.nz/includes/download.aspx?ID=135611>

## External Reporting Board

11. The External Reporting Board (XRB) is an independent Crown entity responsible for the development and issuing of accounting and auditing and assurance standards in New Zealand.
12. In February and April 2015, the Authority met with XRB to discuss how audit standards could be incorporated into the audit regime.
13. XRB identified two standards that could be incorporated into the New Zealand audit regime:
  - (a) ISAE (NZ) 3000 (revised) Assurance Engagements Other than Audits or Reviews of Historical Financial Information.<sup>3</sup>
  - (b) SAE 3100 Compliance Engagements.<sup>4</sup>
14. These standards are derived from international practices and provide mandatory requirements and guidance for assurance practitioners (other than those that carry out reviews of historical financial information).
15. Key aspects of these standards are:
  - (a) **Ethical requirements:** the standards require that assurance practitioners comply with the requirements of the “Professional and Ethical Standard 1 (revised) when conducting audits.<sup>5</sup>
  - (b) **Engagement criteria:** the terms for compliance engagement, planning, and performance that are placed on the assurance practitioner (auditor).
  - (c) **Relying on the work of internal auditors:** the standards set the framework for an auditor to obtain and understand aspects of internal audits.
  - (d) **Quality control:** the standards require a quality control review for audits.
16. While these standards include aspects that will probably benefit the electricity industry, they also include requirements that are not applicable to the New Zealand audit regime. XRB has recommended the Authority develop a set of fit for purpose requirements based on these standards rather than adopting the full standard.

## Audit New Zealand

17. In January 2015 the Authority met with Audit New Zealand (Audit NZ). Audit NZ is the Authority’s public sector financial auditors.
18. Audit NZ provided an overview of general audit practice in New Zealand, the stages of an audit, audit standards, and the level of assurance provided by audits.
19. Audit NZ advised the Authority that initial stages of an audit typically include a risk assessment. Audited entities have differing risk profiles which impact on the scope of

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<sup>3</sup> <http://xrb.govt.nz/includes/download.aspx?ID=135611>

<sup>4</sup> <http://xrb.govt.nz/includes/download.aspx?ID=137121>

<sup>5</sup> <http://xrb.govt.nz/includes/download.aspx?ID=132632>

an audit and the level of effort auditors and audited entities expend on auditing activities.

20. Audit NZ adopts International Standards of Auditing (ISA) which specifies guidelines an auditor should follow to provide sufficient assurance.
21. Audit NZ's advice is consistent with advice the Authority received from XRB and with PA Consulting's review of international practices.

## **Gas Industry Company**

22. The Gas Industry Company (GIC) is New Zealand's gas industry body. GIC is responsible for developing industry arrangements to ensure gas is delivered safely, efficiently, and reliably to new and existing customers.
23. Under Part 4 of the Gas (Downstream Reconciliation) Rules 2008 (gas industry rules), GIC commissions performance audits within the gas industry. GIC is required to arrange performance audits of the allocation agent and allocation participants at regular intervals.
24. There are many similarities between GIC's performance audit regime and the Authority's audit regime. The parties that are required to undergo gas audits are commonly also electricity industry participants.
25. Two auditors approved by the Authority also provide gas audit services.
26. The purpose of GIC's performance audits is to assess compliance with the gas industry rules, as well as their participants' systems and processes that enable compliance with the gas industry rules.
27. Audited entities include the allocation agent and allocation participants. Allocation participants include retailers, distributors, meter owners, and transmission system owners. To date, only the allocation agent and retailers have been subject to audit, with distributors and meter owners scheduled for audit later this year.
28. The key differences between GIC and the Authority's audit regimes are set out in Table 1.

**Table 1: Key differences between GIC and Authority audit regimes**

<b>GIC audit regime</b>	<b>Authority audit regime</b>
GIC sets the audit scope and prepares the terms of reference for performance audits.	The scope is set by the Authority's audit guidelines, and the audited party sets out the terms of reference for audits.
Engagement of auditors is by the GIC; however, the participant still pays for the audit.	Engagement of auditors is by the audited party. The audited party pays for the audit.
Participants recommend an auditor; however, GIC decides on which auditor will be used.	The audited party selects the auditor from a list of auditors approved by the Authority.
Audit reports are sent to all affected participants and GIC for comment. Comments must be considered by the auditor when finalising the audit report.	Audit reports are sent only to the audited party for comment.
Once the comment period (10 business days) is finished the auditor finalises report.	There is no maximum comment period. The auditor finalises the audit report based on the terms of engagement between the auditor and the audited party.
Breaches are alleged by the auditor.	Breaches are alleged by the market administrator on receipt of the finalised audit report.
The audit report is published on GIC's website.	An audit summary is published on the Authority's website. This summary includes the following details: <ul style="list-style-type: none"> <li>• the auditor</li> <li>• the audited party</li> <li>• the scope of the audit</li> <li>• if the audited entity was found compliant or non-compliant.</li> </ul>
The audited party can request confidential information is redacted from the draft and final reports, however GIC receives the full report.	The audit report is not published or made available to parties other than the Authority and the audited entity.

29. GIC has found there are benefits to the gas industry from the following aspects of the gas audit regime:
- (a) the regulator controlling the scope and quality of the audit
  - (b) all participants being informed of the outcome of the audit and having the opportunity to comment on issues raised in the draft audit report.
30. GIC faces some challenges with their audit regime, such as:
- (a) GIC does not have criteria for determining appropriate intervals between each audit
  - (b) The scope of the audits are limited to allocation agents. Gas registry and metering obligations are not yet subject to audit and could contribute to inaccurate market settlement. Meter owner audits are planned for later in 2015
  - (c) The period in which the participant and GIC can provide comment on an audit report is short but manageable given the small number of audits GIC handles each year.