AURIZON

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Queensland Competition Authority
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28 October 2016

Dear Catherine,

Approval of Revised Costing Manual

We submit for QCA approval a revised Costing Manual to be used for the preparation of Below Rail Financial Statements for the years ended 30 June 2014 to 30 June 2016.

The QCA published Aurizon's proposed Costing Manual (drafted October 2014, but unapproved by QCA at that time pending the UT4 Final Decision) on 31 July 2015 for stakeholder comments. Three submissions were received from QRC, Anglo American and Vale. Aurizon Network has considered the stakeholder comments, and the costing methodologies applied in the UT4 Final Decision in further revising the Costing Manual now submitted.

The purpose of the Costing Manual is clearly stated in section 1.3 of the Manual. The Below Rail Financial Statements prepared in accordance with the Costing Manual supplement other reporting as required by the Undertaking, including the maintenance reports and RAB roll-forward and general purpose financial statements. The Costing Manual does not address whether particular capital costs should be allocated to Below Rail Services for the purposes of being included in the RAB. Schedule E of the Undertaking sets out the process for the approval of capital expenditure onto the RAB and it is unnecessary to replicate this in the Costing Manual.

As UT4 is now in place, we consider it is appropriate, and consistent with the QCA's expectations that the Costing Manual reflect costing methodologies that were approved in UT4. In this way, the reporting for the historical periods FY14-FY16 will be aligned to the methodologies approved in UT4. Combined with disclosure of expenses using line items aligned with the UT4 allowance cost categories, this will provide the transparency stakeholders are looking for between actual costs and allowances.

The most significant changes that have been drafted into this revised version from the July 2015 published version are:

- Statement of Earnings has been changed to a Statement of Earnings Before Depreciation & Amortisation, Interest and Tax (EBITDA). This change has been made because accounting and regulatory depreciation is different. Stakeholders noted that depreciation is of little use to them, because it is accounting depreciation and not aligned to depreciation of the RAB. Information on depreciation per system is presented in the RAB Roll Forward report. This is generally published after the financial statements, because, consistent with the Undertaking, the RAB roll forward occurs once the capital expenditure for the year has been approved.

- Removal of Statement of Investments. This has been removed to avoid duplication with the capital expenditure claim for each year, which is of significantly more value to the stakeholders than the highly aggregated Statement of Investments. The capital expenditure claim for the year provides significantly more detail and clarity for stakeholders.

- The notes to the financial statements to include:
    - Original and revised allocators - This is based on stakeholder feedback that if allocation percentages have varied from those used in the final UT4 decision, then the updated and original allocator should be displayed so that changes in the underlying costs can be distinguished from changes in allocation percentages.
    - Reporting on Self-insurance has been included in accordance with the requirements of section 3.7.2 of the Undertaking.

- Alignment of costing methodology for corporate costs to the methodology used in the calculation of the approved UT4 allowances. While we do not agree with all aspects of the approved methodology approved for UT4, we believe it is appropriate to replicate the approved methodology in this Costing Manual so a comparison can be made between actual costs and approved allowances. Greater detail on the functions included within corporate overhead has been included in the Manual based on the feedback from stakeholders.

- Alignment of definitions in section 6 to the approved Undertaking.

- Other editing changes to remove duplication of wording throughout the Manual.

While we have retained the Statement of Assets within the Financial Statements, we would propose the QCA give consideration to excluding this from the Financial Statements for the following reasons:

- The most significant asset is Property, plant and equipment. The QRC stated that information on depreciation and amortisation was of little value to them as it can be obtained from the RAB. We believe the same comment could be made about Property, plant and equipment. The regulatory values can be obtained from the RAB Roll Forward, and the accounting values are not relevant.

- Assets such as cash and inventory could not be split between regulated below rail business and other business as there is no reasonable basis to do this. The split would be limited to Trade and other receivables and the value allocated to non-regulated below rail services is immaterial.

- There are no assets owned by other parts of the Aurizon Group that are included in the RAB. Since the Network restructure in June 2013, there is only approximately 1% of assets (based on accounting written down value of assets owned by Network) that are used directly within the Aurizon Network business that are owned by an entity within the Aurizon Group other than Aurizon Network. These assets are mostly motor vehicles and land and assets affixed to land which were not transferred into Aurizon Network at the time of the restructure for stamp duty reasons. Such assets are not included on the RAB. These assets have historically been recognised within the Below Rail Financial Statements.

The full balance sheet for Aurizon Network Pty Ltd can be obtained from the annual statutory financial report (which has been prepared annually from FY13). Removing the Statement of Assets from the regulatory financial statements will avoid duplication.

Costs reported will be actual costs incurred, apart from the following exceptions:

- Reported direct costs (maintenance, train control, infrastructure management and business management) are actual costs, reduced by allocations to non-regulatory services where applicable. For the business management function, there are no costs that are specifically identifiable as relating to non-regulated services. These costs are obtained by way of a notional allocation as determined by the QCA in the UT4 Final Decision. These allocations have been replicated in the Costing Manual.
- Corporate costs can only be allocated costs since Aurizon Network does not actually operate as a stand-alone entity. The corporate costs reported are proposed to be calculated in accordance with section 4.2.10 of the Costing Manual. Allocators are to be updated each year. Hence, the reported corporate overhead will not reflect the efficient costs approved as the allowance (because the update of both the parameters in the allocators and the cost base each year will change the calculated value from the approved amount) but it will reflect the methodology approved for the determination of efficient costs.

The financial statements have historically been prepared, and are proposed to continue to be prepared, using accounting records which in some respects are different to the inputs for the calculation of Maximum Allowable Revenue:

- As noted by Anglo American, the MAR is developed by relying on calculation of efficient costs incurred for the stand-alone provision of access for train services. Actual costs may be higher or lower than those approved. Insurance costs approved for UT4 are based on a hypothetical cost of Network operating stand-alone in accordance with this principle. Stakeholders have expressed concerns that they are paying a premium for costs that Aurizon Network has not outlaid. Aurizon Network reimburses the Aurizon Group for the amount the Group has determined is Network's share of the enterprise-wide insurance policy premium using an allocation methodology for each insurance premium based on data provided to the insurance broker for that cover, such as value of assets, revenue and FTEs. There may be a difference between this amount and the allowance received in the MAR for insurance. It would not be appropriate for the determination of the MAR to include costs based on outlays for insurance when the outlays are a notional group allocated amount and could be varied from period to period. The same principle applies to all operational costs and may result in differences between outlays and efficient costs. The Aurizon Group bears the risk of actual costs for insurance and other corporate services being higher than the allowances approved by the QCA. Customers will only pay efficient costs that have been included in the MAR.

There was some feedback from stakeholders proposing that reports should be presented by coal system and reconciled back to audited Network financial statements. Such changes have not been incorporated into this revised Costing Manual for the reasons below:

- In accordance with the Undertaking, cost of maintenance is already reported by system separately. We do not consider that splitting other costs by system will be value adding for stakeholders since the majority of other costs are only notionally allocated to systems for pricing purposes. We do not currently recognise the majority of costs by coal system in our general ledger because it does not provide information that is beneficial to management for decision making on the business.
- We also do not believe it would be worthwhile reporting assets by coal system. It would not be possible to split some assets such as cash, and for others such as

receivables it would be time consuming and costly to split for little value. The most significant asset is property, plant and equipment which is split by system on the RAB Roll-forward.

- As stated in our response to the UT4 draft decision, Aurizon Network is only required to report to the QCA financial information relating to the regulated services and therefore we do not consider it appropriate to provide a reconciliation of the regulatory financial statements to the publicly available statutory financial statements.

We are happy to work with you to discuss any concerns with our revisions or any additional suggested changes. We ask for the QCA to be able to approve a revised Costing Manual by the end of this calendar year to enable the Below Rail Financial Statements for the years ended 30 June 2014 to 30 June 2016 to be prepared by 30 June 2017.

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