Aurizon Network

3 March 2017

Executive Summary

1. **Transformation is one of our core values**
   - Good momentum on safety, cost and operational performance
   - For UT5 we have focused on improved engagement with stakeholders to increase transparency of information and response time to questions to drive a more efficient process
2. **UT5 submitted with emphasis on correcting risk / return**
   - More risk than a regulated utility
   - Coal miners support higher WACC for Hunter Valley Coal Network but consider it lower risk than Aurizon Network
3. **Future State**
   - Desire for QCA and Aurizon Network to work with stakeholders to improve the regulatory framework
   - Post UT5 focus: incentives aligned with operators and producers, appropriate risk / return and associated costs for producers and right balance between prescription and flexibility

Solid performance as commodity markets strengthen

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Total Recordable Injury Frequency Rate (TRIFR)	› 2.47 in 1H FY2017 › Reduced from 22.34 in 2011 and 3.01 in pcp
Financial Results	› Revenue up 1% to 1.8bn – increase in Below Rail partly offset by volume driven decrease in Above Rail › Underlying EBIT up 21% to $488m, driven by transformation benefits in Above Rail and impact of finalisation of UT4 in Below Rail › Statutory NPAT of $54m reflects the impact of impairments and transformation costs › ROIC 9.6%
Transformation	› $64m of benefits delivered, $195m since 1 July 2015; on track to achieve $380m three – year target › Transformation scope to expand to improve long-term ROIC
Cash Flow	› Free cash flow (FCF) increased to $356m with stronger cash earnings and lower capital expenditure
Shareholder returns	› Interim dividend 13.6cps, 70% franked, 100% payout of underlying NPAT

Aurizon Network represents 61% of group EBIT

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Financial Results

- Total revenue increased 15% to $671m due to true-up from under recovery of UT4 revenue from prior years
- Underlying EBIT $299m

Operational Performance

- 20% reduction in system closure hours and a 1.5% increase in average payload
- Performance to plan down 1.2ppts to 91.5% from previous record high (17% increase in services cancelled, mainly mine related)

Transformation

- Technology has enabled the understanding of the asset condition and network performance over time and sustaining capital has been targeted to positively affect asset performance and network availability. Initiatives to move from time based reactive capital to condition based predictive interventions include
  - Locomotive mounted object recognition technology which detects overhead alignment issues enabling defects to be identified and fixed before failure
  - Wagon and loco mounted accelerometers and date captures to
    - Provide real time data on track alignment that is analysed to enable a more tailored, mechanised maintenance program.
    - Reduce the number of paths sterilised for use by dedicated track recording vehicles

UT5: improved engagement with stakeholders, increased transparency of information and timeliness of decisions

Customers are the heart of our business	Substantive change in approach to UT5 regulatory engagement • Collaboration with QRC on policy matters (acknowledged in submissions) • Aurizon continues to work with stakeholders to address questions / concerns
Flexibility for customers to maximise their utility of the network	• Implementing improved asset management work practices to minimise supply chain interruption • Investing in technology to improve data capture and support efficient investment decisions • Working proactively with customers to unlock new capacity without significant investment in infrastructure
UT5 is a platform for the future	Create value for customers and shareholders by prioritising management's focus on improving business practices • Evidence based discussions facilitate constructive and timely regulatory engagements • Transparency - addressing information asymmetry is critical to building trust with stakeholders • Regime which promotes reciprocal incentives

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UT5 submitted with emphasis on correcting risk / return

Consistent with the QCA Act we are seeking "a return on investment commensurate with the regulatory and commercial risks involved"

NOT A REGULATED UTILITY

- Relatively small number of customers, exposed to a single asset class (coal)
- Volatile operating environment, including increased counterparty risk and longer term structural issues with regard to future demand of thermal coal
- Fragmentation of the Regulated Asset Base (RAB) by system increasing the risk of asset stranding
- Revenue uncertainty
  - Revenue deferrals which result in expansion capital being excluded from the RAB e.g. approximately $260m of Wiggins Island Rail Project (WIRP) related capex
  - Under – recovery of $89m revenue over FY2014 and FY2015 ($45m recognised in 1HFY2017)

"REAL WORLD" EMPIRICAL EVIDENCE

Moody's, Aurizon Network Pty Ltd Credit Rating, Feb 2017:

"Network's rating tolerance level is set a materially higher level than equivalently rated regulated electricity and gas utilities in order to reflect Network's **intrinsically higher business risk**, a consequence of the higher volatility to which its key customers are exposed."

FFO/Debt Ratio	Aurizon Network	Utilities
Moody's	>16%	>7%-8%
S&P	>13%	>7%-8%

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QCA is an outlier amongst regulators

We believe that a different approach by the QCA on 3 of the WACC parameters will drive a return closer to Aurizon Network's risk profile

Regulator	MRP	Risk free rate		Distrib'n Rate
	Siegel	Term matching	Long term	FAB data
QCA	✓	✓	x	x
NZCC	✓	✓	x	n/a
AER	x	x	✓	✓
ACCC	x	x	✓	✓
IPART	x	x	✓	✓
ERA	x	x	x	✓
ESCSA	x	x	✓	✓
ESC	x	x	✓	✓
UK Regulators (e.g., Ofgem)	x	x	✓	n/a
US Regulators (e.g., STB)	x	x	✓	n/a

MRP

- Siegel approach is one of the four methods used by the QCA to determine the MRP
- Siegel approach disregarded by all other Australian regulators and most international regulators

Risk free rate

- The QCA aligns risk-free rate term with Aurizon Network's regulatory cycle (4-year) to satisfy the theoretical NPV=0 principle
- Risk free rate aligned to the regulatory term is unique to the QCA and NZCC
- The QCA is the only regulator that uses different risk-free rate terms in the CAPM model

Distribution rate

- As acknowledged by the Tribunal, estimating distribution rate using FAB data is not contentious among regulators
- The QCA is an outlier among regulators to use ASX 20 firm approach which inflates distribution rate due to the existence of foreign tax

Coal miners support a much higher WACC for Hunter Valley Coal Network while consider it is of lower risk than Aurizon Network

- Hunter Rail Access Task Force (HRATF)[1]

  *"Our view is that a careful analysis of risks faced by ARTC compared to other regulated rail service providers on the east coast of Australia strongly supports our position that **ARTC's asset beta should be materially lower than the level observed for Aurizon and QR***

  - *Aurizon operates **several different coal systems** with limited cross system traffic, with each individual coal system having lower volumes and less diversification of users than the Hunter Valley.*
  - ***ARTC has rolling 10 year agreements**, meaning that ARTC has volumes contracted for the next 10 years. Aurizon access agreements have a term of 10 years with a right to renew, meaning that for an individual user the total future volume contracted to Aurizon will decline each year until renewal*
  - *Aurizon faces the risk that the QCA may **remove from its regulated asset base the value of infrastructure** which is deemed no longer to be required. This is not a risk faced by ARTC"*

- **HRATF is supporting a WACC >1.2% higher than the QRC**

	QRC Submission	HRATF Submission
Regulated Entity	Aurizon Network	ARTC
Regulator	QCA	ACCC
Averaging period	Adj.to June 2016	June 2016
Risk-free rate	1.62%	2.14%
Risk-free rate term	4 years	10 years
Gearing ratio	55%	52.5%
Asset Beta	0.435*	0.55^
Equity Beta	0.7	0.94
Market risk premium	6.25%*	6.0%
Debt risk premium (inc. transaction costs)	2.69%	2.80%
Gamma	0.485*	0.45
Return on equity	**6.00%**	**7.78%**
Return on debt	**4.31%**	**4.94%**
WACC	**5.07%**	**6.29%**

[1] A group comprising nine Hunter Valley coal producers including major miners such as Anglo American, Rio Tinto, Glencore and BHP

^ HVCN's asset beta is de-levered from the equity beta using the QCA's preferred Conine formula to ensure the comparability
*Mid – point of recommended range

Future of Regulation for the CQCN

Areas for improvement and consultation post UT5 include aligning incentives with operators and producers, appropriate risk / return and associated costs for producers and right balance between prescription and flexibility

1 **Incentive Structures**	• Closer alignment to the incentives of our customer base • Improved incentives within the Regulatory framework for increased productivity • Appropriate return for risk, consistent with the Pricing Principles and the environment in which we operate
2 **Technology/ Intellectual Property**	• Technology as an alternative to capital intensive rail construction • Compensation for the risk associated with innovation
3 **Electric Traction**	• Inequality of electric and diesel pricing creates a stranding risk which has implications for all of the investments made by Network, Operators and Miners. Key timing risks driving the need to engage and develop a solution: [redacted]

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* FY17 average blended rate