



AURIZON NETWORK PTY LTD

Cost Review of 2017 Flood Claim – Tropical Cyclone Debbie

October 2017

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1. EXECUTIVE SUMMARY

1.1 Introduction

Aurizon Network Pty Ltd (“Aurizon Network”) operates Australia’s largest export coal rail network, the Central Queensland Coal Network. This 2,670 kilometre multi-user track network comprises of four major coal systems and one connecting system serving Queensland’s Bowen Basin coal region: Newlands, Goonyella, Blackwater and Moura with Goonyella Abbot Point Expansion the connecting system link.

The Queensland Competition Authority (the “Authority”) is responsible for the economic regulation of the below-rail infrastructure owned by Aurizon Network who is subject to an Access Undertaking (“UT4”) approved by the Authority that sets out the detailed terms and conditions under which Aurizon Network will provide access to declared services.

In March and April 2017, Central Queensland experienced extreme flooding and severe damage to the Network resulting from Tropical Cyclone Debbie. Aurizon Network is seeking to recover operating expenditure costs through the “review event” process in accordance with Clause 5.3 of the UT4 (2017 Flood Claim). All applicable capital expenditure costs attributed to Tropical Cyclone Debbie will be submitted as a component of the “2016/17 Capital Expenditure Claim” to the Authority by 31 October 2017.

The value of 2017 Flood Claim submitted to the Authority (excluding future operating expenditure) was **\$15,263,920**.

1.2 Scope and Objectives




Aurizon Network required RSM to review the Tropical Cyclone Debbie Recovery operating expenditure costs that have been included in the 2017 Flood Claim submitted to the Authority and the capital expenditure costs excluded from the 2017 Flood Claim, to form a limited assurance conclusion as to whether:

- The operating expenditure costs included in 2017 Flood Claim did not contain duplicated costs;
- The operating expenditure costs and capital expenditure costs specific to the Tropical Cyclone Debbie recovery reconciled to Aurizon Network’s accounting system (SAP);
- A consistent methodology was applied to define capital expenditure and operating expenditure; and
- The operating expenditure costs within the 2017 Flood Claim were additional to the approved scope of the FY17 Maintenance Allowance under UT4.

1. EXECUTIVE SUMMARY (CONT.)

1.3 Summary of Adjusted and Unadjusted Review Findings

We have summarised below our review findings indicating which items were adjusted by Aurizon Network. Each issue raised has been assigned a risk rating to indicate our assessment of the degree of exposure in respect to the accuracy of the 2017 Flood Claim, and the urgency of required action. The risk rating definitions are described in **Appendix 2** of this report.

Finding	Risk Rating	Issue	2017 Flood Claim (reduction)/ increase
Adjusted Review Findings			
1. Operating Expenditure and Capital Expenditure Classification		<p>Based on our sample selection, we noted two operating expenditure transactions included within the 2017 Flood Claim that should have been classified as capital expenditure and therefore excluded from the 2017 Flood Claim. These transactions were allocated to site code GA-009.</p> <p>Site code GA-009 was originally classified as operating expenditure, however due to a change in the scope of works and by applying Aurizon Network's capital expenditure test criteria methodology, some of the works completed under this site code should have been classified as capital expenditure.</p> <p>Through further investigation and analysis conducted by Aurizon Network, the site code was split into an operating expenditure component and a capital expenditure component based on specific scopes of works. GA-009A (totalling \$222,532) comprised of all the operating expenditure components of the works conducted, and GA-009B (totalling \$1,416,300) comprised of all the capital expenditure components. The impact of this adjustment was a reduction in the 2017 Flood Claim by \$1,416,300.</p>	(\$1,416,300)
2. Application of Operating Expenditure Methodology		<p>We noted instances where large invoice transactions for works completed were split equally across different operating expenditure site codes included in the 2017 Flood Claim and capital expenditure site codes excluded from the Claim. The transactions were described as "ballast". An equal allocation to each site code indicated a potential inconsistent application of Aurizon Network's capital expenditure test criteria methodology. Through further investigation, Aurizon Network added an additional criteria to the capital expenditure methodology to exclude "ballast undercutting". This resulted in Aurizon Network re-classifying two site codes, and a net reduction of the 2017 Flood Claim by \$25,311.</p>	(\$25,311)
Unadjusted Review Finding			
3. Incorrect Application of Labour Rates		<p>From a review of a sample of labour rates included in the 2017 Flood Claim, we noted that incorrect labour rates were applied for nine engineering team members, where team members hourly pay rates were either over-charged or under-charged. The total of these adjustments resulted in an under-charge in the 2017 Flood Claim of \$18,828. <u>This was not adjusted by Aurizon Network as it represented 1% of the total labour costs and would result in an increase to the 2017 Flood Claim.</u></p>	\$18,828

1. EXECUTIVE SUMMARY (CONT.)

1.4 Limited Assurance Engagement

In providing limited assurance, we conducted our review in accordance with Auditing Standard *ASAE 3000 - Assurance Engagements Other than Audits or Reviews of Historical Financial Information*. A review consists of making enquiries, primarily of persons responsible for ensuring operating effectiveness and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

1.5 Conclusion

Our Limited Assurance Report on **pages 4 to 6**, provides our unqualified conclusion for the scope of this review. We identified one **medium risk** and two **low risk** findings, of which two were adjusted by Aurizon Network immediately in the 2017 Flood Claim. The remaining low risk finding was not adjusted as it was deemed to be immaterial.

The findings are summarised in **section 1.3** above and are further detailed in **Appendix 1** of this report.

Signed

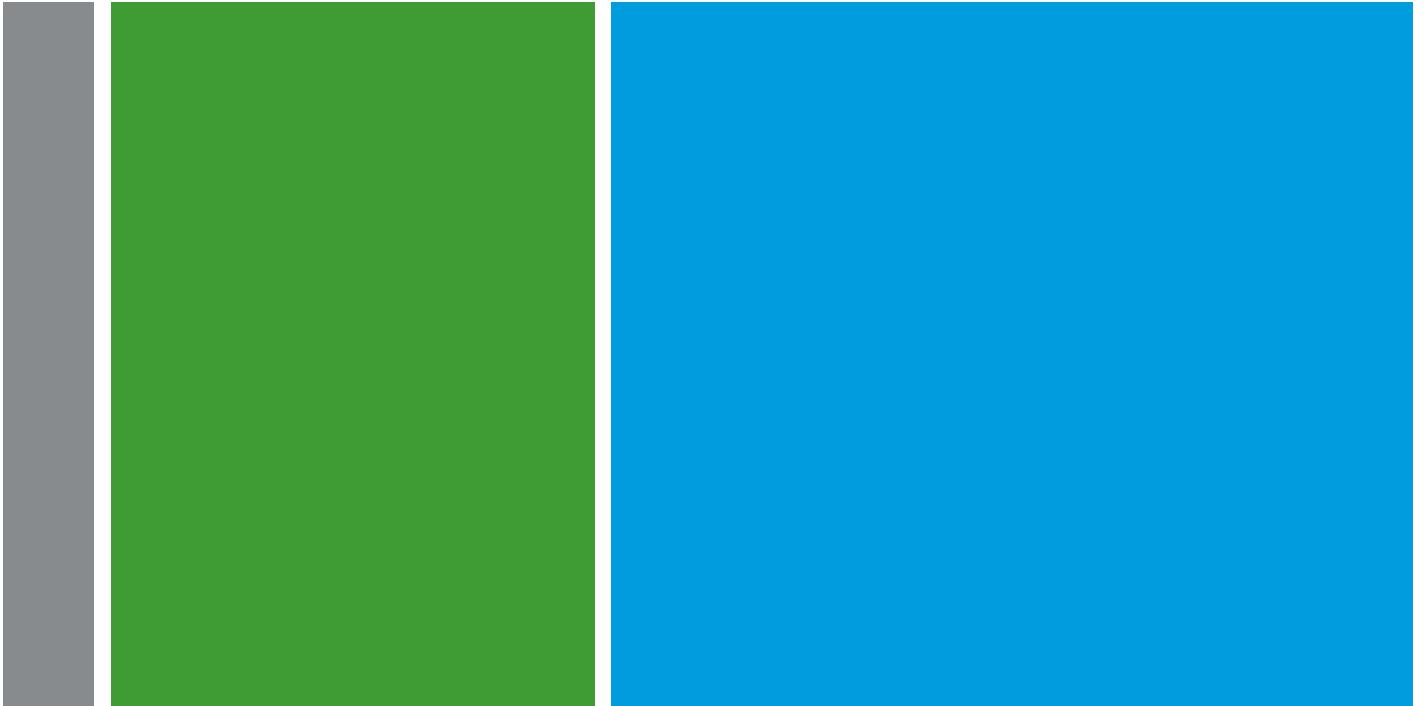


J M IMBERT

Director

RSM Australia Pty Ltd

18 October 2017



AURIZON NETWORK PTY LTD

INDEPENDENT LIMITED ASSURANCE REPORT

Cost Review of 2017 Flood Claim – Tropical Cyclone Debbie

LIMITED ASSURANCE REPORT

To the Management of Aurizon Network Pty Ltd (“Aurizon Network”) and the Queensland Competition Authority (the “Authority”)

We have conducted a limited assurance engagement to assist Aurizon Network in assessing the costs included in the 2017 Flood Claim (excluding future operating expenditure). The following tasks were required by the Aurizon Network for this engagement:

- Review of the 2017 Flood Claim for the existence of for duplicated operating expenditure costs;
- Reconciliation of operating expenditure costs and capital expenditure costs specific to the Tropical Cyclone Debbie recovery to Aurizon Network’s accounting system (SAP);
- Review of the consistency of the applied methodology in defining capital expenditure and operating expenditure; and
- Review of the 2017 Flood Claim for the existence of costs included that fall within the approved scope of the FY17 Maintenance Allowance under UT4.

The value of 2017 Flood Claim submitted to the Authority (excluding future operating expenditure) was **\$15,263,920**.

Aurizon Network’s responsibility for the 2017 Flood Claim

Aurizon Network is responsible for determining that the basis of accounting is an acceptable basis for the preparation of the 2017 Flood Claim in the circumstances. Aurizon Network is also responsible for establishing and maintaining such internal control as determined by management to be necessary to enable the preparation of a 2017 Flood Claim that is free from material misstatement, whether due to fraud or error and for monitoring compliance with the Access Undertaking.

Our independence and quality control

We have complied with the relevant ethical requirements for assurance engagements, which include independence and other requirements founded on fundamental principles of integrity, objectivity, professional competence, due care, confidentiality and professional behaviour.

In accordance with Australian Standard ASQC 1 - *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements*, RSM maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Our responsibility

Our responsibility is to express a limited assurance conclusion. We conducted our review in accordance with *ASAE 3000 - Assurance Engagements Other than Audits or Reviews of Historical Financial Information*. Our procedures were designed to provide limited assurance, as defined by ASAE 3000.

Our review consisted of making enquiries, primarily of persons responsible for ensuring operating effectiveness and applying analytical and other review procedures. Our review was substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and, consequently, does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Inherent limitations

Due to the inherent limitations of any internal control structure, it is possible that fraud or errors may occur and not be detected. We have not reviewed the overall internal control structure and no opinion is expressed as to its effectiveness. A review is not designed to detect all weaknesses in control procedures or all instances of non-compliance as it is not performed continuously throughout the period, and the tests performed are on a sample basis having regard to the nature and size of the entity. The conclusion expressed in this report has been formed on the above basis.

LIMITED ASSURANCE REPORT (CONT.)

Use of this report

This limited assurance report has been prepared for Aurizon Network and the Authority. We disclaim any assumption of responsibility for any reliance on this report to any other persons or users, or for any purpose other than that for which it was prepared.

We disclaim all liability to any party other than Aurizon Network or the Authority in respect of, or in consequence of, anything done, or omitted to be done, by any party in reliance, whether whole or partial, upon any information contained in this report. Any party, other than Aurizon Network or the Authority, who chooses to rely in any way on the contents of this report, does so at their own risk.

Summary of procedures undertaken

The procedures conducted in performing our limited assurance engagement in respect to the tasks included:

- Reconciliation of the operating expenditure costs included from the 2017 Flood Claim and capital expenditure costs excluded from the 2017 Flood Claim to SAP by reproducing the CJI3 report from SAP and ensuring the balances matched to the supporting spreadsheets used to prepare the 2017 Flood Claim;
- Reviewed the operating expenditure and capital expenditure transaction listing for duplicated costs by using Computer Assisted Audit Techniques (CAATs) software;
- Interviewed key personnel to develop an understanding of Aurizon Network's methodology to define capital expenditure and reviewed how it was applied consistently to site codes within the 2017 Flood Claim; and
- Interviewed key personnel to develop an understanding of the FY17 Maintenance Allowance under UT4 and reviewed the process of how these costs were separated and excluded from the 2017 Flood Claim.

Conclusion

Based on our review, which is not an audit, nothing has come to our attention to indicate that the 2017 Flood Claim submitted by Aurizon Network to the Authority:

- Contains duplicated transactions;
- Contains operating expenditure that does not reconcile to Aurizon Network's accounting system (SAP);
- Has been completed using an inconsistent application of the methodology to define operating expenditure; and
- Includes operating expenditure costs that are not additional to the approved scope of the FY17 Maintenance Allowance under UT4.

Signed



J M IMBERT

Director

RSM Australia Pty Ltd

18 October 2017

APPENDIX 1 - DETAILED FINDINGS

1.1 Operating Expenditure and Capital Expenditure Classification



Observation:

Based on our sample selection, we identified two transactions relating to site code GA-009 that appeared to be capital expenditure that were included in the 2017 Flood Claim as operating expenditure.

The table provides the details of each transaction:

Site Code	Cost Element	Cost Element Description	Cost
GA-009	517501	PROFESSIONAL SERVICES - OTHER	\$ 417,984.85
GA-009	519101	TRADE SERVICES	\$ 350,789.14
Total			\$768,773.99

Site code GA-009 was originally classified as operating expenditure, as it related to debris removal in Goonyella for Black Mountain. Aurizon Network advised during the works completed in Black Mountain, significant soil strengthening works was required resulting in a change of the original scope of works. Therefore, this indicated that some of the work components undertaken in this site code were capital in nature in applying Aurizon Network's capital expenditure test criteria methodology.

Through further investigation and analysis conducted by Aurizon Network and in response to the clarification of the above transactions, the site code GA-009 was subsequently split into GA-009A (operating expenditure totalling \$222,532) and GA-009B (capital expenditure totalling \$1,416,300) in which all operating expenditure related to debris removal works performed by the Mechanised Production Team and all other remaining costs were classified as capital expenditure in site code GA-009B excluded from the 2017 Flood Claim. **This resulted in a reduction of the 2017 Flood Claim by \$1,416,300.**

Risk:

Overstatement of operating costs included within the 2017 Flood Claim of \$1,416,300.

Recommendation:

The adjustment to the Flood Claim was processed by Aurizon Network. However, for future Review Event submissions, for site codes with scope variations or multiple scope of works, we recommend these are tracked and reviewed to ensure appropriate classification of operating and capital expenditure.

Management Comments:

Aurizon Network has made the adjustment detailed above and reviewed the classification of remaining site codes to ensure accuracy, in particular for changes relating to scope variations or multiple scope of works.

For future flood events, in addition to adopting RSM's recommendation above, Aurizon Network will consider how to better capture data for operating expenditure and capital expenditure to ensure appropriate delineation of costs.

APPENDIX 1 - DETAILED FINDINGS (CONT.)

1.2 Application of Capital Expenditure Methodology



Observation:

Aurizon Network initially applied the following methodology in testing each site code for capital expenditure, which is excluded from the 2017 Flood Claim:

1. The total materials cost (incurred or to be incurred) for the work order is greater than \$40,000; and
2. For linear assets, the physical distance over which the renewal of infrastructure is required to be undertaken for that activity, is greater than 75 metres;

We noted instances where large invoice transactions for works completed were split equally across different site codes that included both operating and capital expenditure site codes. The transactions noted were described as ballast costs. We clarified the justification for equal apportionment of transactions over both capital and operating expenditure codes with Aurizon Network, as it indicated a potential inconsistent application of Aurizon Network's capital expenditure test criteria methodology.

Through further investigation and clarification of the criteria definition, Aurizon Network added an additional criteria to the capital expenditure methodology requiring:

3. The site code does not relate to ballast undercutting.

Based on this additional criteria, Aurizon Network conducted an additional review of all site codes and as a result the following subsequent amendments were made:

- Site Code GA-004 (total of \$2,312,512) was originally classified as capital expenditure and therefore excluded from the 2017 Flood Claim. However, after re-applying the methodology, this was subsequently separated into:
 - GA-004 operating expenditure that included ballast cleaning and debris removal, increasing the 2017 Flood Claim by \$479,017.
 - GA-004B for rock fall fencing replacement remaining as capital expenditure amounting to \$1,833,495.
- Site Code GA-139 (total of \$290,649) and GA-023 (total of \$213,679) were originally classified as operating expenditure, however these activities accumulated to have material costs greater than \$40,000 over time. The site codes were reclassified as capital expenditure and resulted in an overall decrease of \$504,328 to the 2017 Flood Claim.

The net impact of the above subsequent reclassification of site codes was a net decrease to the 2017 Flood Claim by \$25,311.

Risk:

Overstatement of operating costs included within the 2017 Flood Claim of \$25,311

Recommendation:

The adjustment to the Flood Claim was processed by Aurizon Network. However, for future Review Event submissions, for each site code, we recommend that the application of the capital expenditure test criteria is clearly documented and reviewed to ensure appropriate classification of operating and capital expenditure.

APPENDIX 1 - DETAILED FINDINGS (CONT.)

1.2 Application of Capital Expenditure Methodology (cont.)

Management Comments:

Throughout the course of preparing the Flood Claim, due to discussions with RSM, Aurizon Network reviewed the capital expenditure test that had been applied and as a result made the modification described above.

The revised capital expenditure test was documented, reviewed, agreed and applied consistently to each site code to ensure appropriate classification of operating and capital expenditure, prior to finalising the Flood Claim.

This process will also be applied to future Review Events going forward.

APPENDIX 1 - DETAILED FINDINGS (CONT.)

1.3 Incorrect Application of Labour Rates



Observation

From a review of a sample of labour rates included in the 2017 Flood Claim, we noted that incorrect labour rates were applied for nine engineering team members, where team members hourly pay rates were either over-charged or under-charged to the 2017 Flood Claim.

It was advised that incorrect pay rates were internally identified by Aurizon Network by the Manager of the engineering team in December 2016 and requested they be amended manually. The manual amendments were not completely processed and therefore resulted in pay rate errors that remained in the 2017 Flood Claim.

The impact of the pay rate errors is a net undercharge to the 2017 Flood Claim of \$18,828. Given that this only represented 1% of the total labour costs and was an undercharge, Aurizon Network did make an adjustment to the 2017 Flood Claim for this exception.

Risk

Understatement of operating costs included within the 2017 Flood Claim of \$18,828.

Recommendation:

We recommend Aurizon Network adjust the 2017 Flood Claim to reflect the accurate labour rates of the engineering team.






Management Comments:

Aurizon Network investigated the error identified and confirmed it was confined to a small group of team members. Given the correction would result in an increase to the Flood Claim of immaterial value, Aurizon Network will not be making this adjustment.

APPENDIX 2 – RISK RATINGS

Risk Ratings

The risk ratings applied to assess issues identified are as follows:

Risk Ratings		
Extreme		Issues which may have a catastrophic impact upon the accuracy and/or prudence of the capital expenditure that has been claimed by Aurizon Network if they are not addressed immediately.
High		Issues which may have a major impact upon the accuracy and or prudence of the capital expenditure that has been claimed by Aurizon Network if they are not addressed as a matter of priority.
Medium		Issues which may have a moderate impact upon the accuracy and/or prudence of the capital expenditure that has been claimed by Aurizon Network if they are not addressed within a reasonable timeframe.
Low		Issues which have a minor impact upon the accuracy and/or prudence of the capital expenditure that has been claimed by Aurizon Network if they are not addressed within a reasonable timeframe.
Improvement		Standalone suggestion for improvement.

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