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EDITED TRANSCRIPT

AZJ.AX - Preliminary 2016 Aurizon Holdings Ltd Earnings Presentation

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PRESENTATION

Lance Hockridge *- Aurizon - MD & CEO*

The headline issues are consistent with what we said at the end of July. I'll talk a little more about safety in a moment. But a bit of a mixed year albeit the first year in the history of the Company that we've had a full twelve months of zero LTIFR. Again, from a results point of view, consistent as I say with that which we announced in July. Worth observing though the extent to which these numbers underline the stability and the strength of the coal business.

On the other hand, we will talk a little more during the course of our presentation about opportunity and about challenge in our freight business. Operating ratio and ROIC are there. Importantly, in the kind of environment in which we have been operating and in which we expect that we will continue to operate, transformation is so critically important and during FY16, you can see that we've delivered AUD131 million of transformation benefit. That brings the total over the last three years to AUD383 million.

With respect to our target of AUD380 million by FY18, that of course, means there's AUD250 million to go and our level of confidence, of course, has increased. We'll talk a little more, both with respect to the detail of what we have been doing, and what we will be doing. Another key element of what we're talking about today is the strength of our free cash flow.

Cash flows being up 35% during the year and, of course, with the further reductions, and Keith will talk a little more about this, in our capital requirements, together with the impact of the Moorebank decision, we continue to see increasing strength in our free cash flows over the next couple of years.

With respect to shareholders, Board has announced today another dividend at 100% of the underlying NPAT level at AUD0.133. Means some AUD830 million of distributions for the year, including the AUD300 million plus around the buy-back. With respect to the buy-back, there's been some interest, of course, in our announcement this morning about stopping the buy-back.

It's important though to see it in the context in which it's presented. That is, it is a point in time, it is about a period of time conservatism with respect to our balance sheet and, of course, the world knows only too well that we are actively engaged in the GRail process. That is what this is referring to, along with our desire to ensure that we maintain the current investment grade balance sheet rating that we have.

But specifically, it's about GRail that this is referring to at the moment. Going then to the Above Rail for the period, the numbers are there and are pretty apparent. The coal revenue excluding fuel was down 2% which is the same, of course, as the volume decline. Again, speaks to the continuing strength of our coal business.

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Freight, on the other hand, our operating cost was down 20% but overall, we are in loss making mode in freight. Again, I'll return to talk about the freight performance review that the we have underway. We're well aware, of course, of the impact of the QNI bad debt et cetera.

With respect to transformation, again, I'll talk in a little more details around this, but significantly, we are in implementation mode around the announcements that Mike has made around a new operation structure that will see an entire management layer eliminated from operations over the next few months.

The operating metrics are all tracking where we would want them to be. With respect to customers, the observation that I would make is generally that especially in the coal space, that since last we were together at the half year, we've seen increasing stabilization in both the volumes and in the sentiment associated with coal.

There was a good deal of interest back at the half year about our observation that on the back of our model, we believe that some 26% of our coal volumes were at or below breakeven. You can see that at the end of June, that number had, using the same inputs, been reduced to 10%. Indeed, I can tell you that if we reran those numbers today, literally today, that number would be down to about 2%.

From a Below Rail point of view, again, a very strong year. A year of increased throughput, increased profitability at AUD506 million. June was an all-time throughput record in the network business. You can see there in the operating performance bars, the indicators of the kind of quality of performance to our customers, that network has been consistently delivering and upon which they've been improving throughout the year.

That kind of performance, that quality of performance, certainly is a material benefit to not just Mike as an Above Rail operator, but all of the people who use the network. I make the point with respect to RAB that at AUD5.6 billion, that's an asset value that's grown some 81% since privatization, not including the deferred elements of which we're all aware. All done, of course, and delivered on or ahead of time, on or ahead of budget, explicitly at the request of our customer base.

We'll talk a little more about UT5 and about the true up this year, as well as the other things that are impacting through MAR on the network financial performance in FY17, which I think has some impact on how you're looking at the guidance for the current year. Transformation, as I say, is fundamentally critical to this business and it has, across the time since privatization, been delivering, and another AUD131 million during the current year.

If we think about those large areas of delivery in FY16, as you can see here, there are a couple of broad areas to which we would draw your attention. The first is the benefits that we've seen and continue to see and you'd expect to see increased around the implementation of those enterprise agreements that we were finally able to sign off about this time last year.

Those arrangements, the consequential impact of those arrangements, were implemented during the latter part of calendar 2015, of the early part of this year, and you can see the specific examples of what that's meant for us. The takeaway from this is, in my view, twofold. One, as we anticipated, we are seeing more opportunity and more value than we had expected as a result of these changes, and there is a good deal more yet to come in that space.

Secondly, the impact of technology continues to really drive a number of the enabling transformational projects in the business, and there is an update there around a number of those issues that we've been talking to you about. From the centralized support area, there was a further 16% reduction in head count in corporate and support areas during FY16.

Clearly there is more to come. There is more to come on the back of the announcement about the reduction in the number of EVPs and what the consequential impacts of that will be. There's more to come on the back of, for example, the work that Mike is doing in operations, and therefore a reduced need for support across the totality of the business.

Again, what that speaks to is our elevated level of confidence about achieving at least the targets for transformational savings that we've set for ourselves. Finally, then, before I hand to Keith to give you a little more detail and flavor, to our safety performance. On the one hand, we are delighted with the lost time performance.

FY16 was the first year in the history of this organization of nearly 150 years where the Company went a full year without a lost time injury. One understands how important that is in its own right, as well as from the culture of the organization, and the culture in particular improvement in the organization.

It's for that reason that we found the deterioration in the total recordable rate to be somewhat regrettable. The first time that we've had a step back in our performance. What I can report to you though, is that on the back of a very concerted effort, particularly over the last six months, we've not only addressed that performance, but we've turned it around to being back into the space of improvement that we would want and expect.

Let me then invite Keith to, as I say, give you some greater flavor and detail around the numbers.

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Keith Neate *- Aurizon - EVP & CEO*

Thank you Lance and good morning everybody. As previously announced, underlying EBIT for the year was AUD871 million, down AUD99 million on the prior year. The key driver pretty clearly was the fall in revenue, which is down AUD322 million on 4% lower volumes.

I'll talk to the Above Rail, Below Rail split shortly, but year-on-year, the revenue movements by commodity as disclosed in the accounts, show network up AUD19 million on essentially flat volumes, coal down AUD13 million on a 2% volume decline, iron ore down AUD27 million on a 7% volume decline, freight, which is a key driver of the result, down AUD184 million, reflecting not only a 9% volume decline, but lower TSC payments and the disposal of CRT in 2015.

Finally, other revenue down AUD117 million which includes the sale of Redbank in 2015 and termination of the QR maintenance contract last year. Operating costs are down 12% due to the transformation benefits which are up almost 7% year-on-year, plus a AUD54 million reduction in fuel costs on lower prices.

Finally, depreciation up AUD42 million, all in the Below Rail business. With regards to the earnings reconciliation, the key driver here, as previously disclosed, are the impairments, a total of AUD528 million in the year.

I won't go through the detail. The only comment I'd make here is to reconfirm the investment in West Pilbara project and in Aquila have both been written down to zero, so Aurizon has no further exposure to either. I would note as well the tax benefit from the impairments with regards to the Aquila write-off will only come through when those shares are disposed.

Turning to the underlying EBIT grid, again, as I just noted, the highlight that you can see here is the lower volumes in the Above Rail business across all commodities with weighting quite heavily to the freight business which is down AUD111 million on the lower volumes and TSC payments.

Just a reminder, the EBIT waterfall charts show volume movements net of access and fuel charges as they're both pass throughs. On a normalized basis, that is excluding the impact of Redbank, CRT, TSC and the QR contract, Group revenue would be down 3% and EBIT would be up AUD19 million or 2%.

The next bar shows Below Rail revenues increasing AUD71 million. I'll talk about that in a moment, and Lance will cover transformation of AUD131 million with further commentary later on. Other costs of AUD77 million include AUD43 million for the Below Rail depreciation, labor and consumable escalations of AUD39 million and a net benefit of AUD20 million in volume related costs on the lower volumes.

The other cost bar also includes the number of movements for one-off on notable items such as the employee share gift, the QNI bad debt and redundancy costs. For transparency, we've included a separate schedule of these movements in the appendix to the pack.

The net impact of them across the full year is a favorable AUD8 million. Turning to the Above Rail business, again, key driver on this chart is the freight volume and Lance will talk more about performance review in respect to the freight business that is now underway to address it.

Net of fuel and access the Above Rail coal volume impact was some AUD24 million with all of the volume reduction occurring in the first half of the year. Second half volumes were consistent with the prior period at some 102.4 million tons. Iron ore volume is down 1.9 million tons, or AUD19 million, mainly due to Karara Mine ceasing its DSO railings.

But it's also worth noting that in FY17 it will include the impact of restructuring the KML contract which was effective from the start of this financial year. Turning to the revenue quality movement of AUD24 million, the biggest impact here is attributable to coal, AUD17 million, and is due mainly to the shift in [hall mix] and the lower incentives as the miners continue to optimize contract management opportunities during the year.

We highlighted this issue in the first half results, but with over 95% of coal contracts now under new form arrangements, as the VMA Goonyella contract switched over from the start of this financial year, we don't anticipate too much more of an impact in this space in future years.

With regards to transformation, Above Rail delivered AUD123 million this year, and is already well advanced with its FY17 program. In that regard, excluding access and fuel, Opex/NTK improved 8% year-on-year. Labor productivity measured by NTK/FTE was up 7% and Loco and Wagon productivity were both up by over 10% as well.

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The underlying EBIT bridge movement for Below Rail is relatively straight forward as you can see. Access revenue up AUD88 million recognized on the basis of tariffs as set out in the final UT4 decision and actually tons, and offset by a lower demand for other services at around AUD17 million.

Operating costs for the year essentially flat, but include an AUD18 million increase in energy costs, on commissioning of two feeder stations and increased wholesale energy prices, which are expected to step up again in FY17. But these costs, as you know, will be recoverable over the next two years through the EC and AT5 tariffs.

Depreciation up AUD43 million. Key impacts here were the commissioning of the WIRP program during the year and the change in accounting policy for rail renewals. Effective this year, all rail renewals will be capitalized rather than expensed, and this is consistent with the QCA draft final decision.

Such the recovery of the cost is now through return of and return on capital, rather than as a maintenance cost allowance. While this change in policy resulted in a reduction in operating cost, it was matched by lower regulatory revenue allocation. Again, the increase -- I'll just touch back on the depreciation charge again, the depreciation increase will be recoverable over time and is MPV neutral and simply reflects the differing treatments under the regulatory and statutory accounting treatments.

Capex for the year of AUD703 million was at the top end of the guidance range of AUD700 million. Sustaining capital was up about AUD19 million, reflecting an acceleration of a number of both Below and Above Rail projects, but it was offset by an equivalent reduction in transformation Capex.

That was driven by two key projects. First, having achieved a 50% operational improvement in wheel wear, it means the business case for the automated wheel workshop that we've referred to before no longer meets target returns and so has been put on hold.

Secondly, as part of the freight performance review, investment in the Multi-Commodity Wagon Replacement Program has also been deferred. We continue to review opportunities for improved capital allocation and returns and in that regard, are forecasting further Capex reductions in future years against previous guidance in the order of AUD50 million to AUD150 million.

Longer term non growth Capex is now forecast to be in the range of AUD500 million to AUD550 million per annum. Cash flow, the only key point to raise with regard to cash flow, as mentioned by Lance earlier, is the free cash flow improvement. Despite a AUD300 million reduction in cash from operations due to lower EBITDA and higher taxes paid in the year free cash flows up 35% to AUD478 million principally reflecting a significant reduction in Capex.

Growth in free cash flow is expected to continue through further reductions that I just mentioned, realization of transformation benefits and obviously our exit from the Moorebank project. Total cash distributions for the year were up 78% to AUD830 million, including dividends of AUD529 million and the buy-back of 70.3 million shares in the year to some AUD301 million.

Lastly, the funding update focus in the funding and treasury space continues to be diversification of funding sources and lengthening the tenure. In that regard, Aurizon network issued its second Euro bond during the year with a 10 year, 500 million EMTN issued, priced in May 2016 at a coupon of 3.125%. All proceeds were used to repay existing bank debt that was maturing in 2019.

As a consequence, the weighted average tenure has increased by a third to some 5.8 years. Interest cost for the year was an average of 4.7%, although we do expect this to increase to around 5% with a full year impact of the latest bond. Gearing has increased during the year to 37% in line with expectations and includes Below Rail at around 52% of RAB in line with the QCA target of 55%.

The expected growth in free cash flow in the next few years will undoubtedly provide us with greater flexibility to manage gearing in conjunction with other growth and capital management initiatives and is underpinned by our Board's commitment to maintaining its investment grade credit rating. With that, I will hand back to Lance.

Lance Hockridge *- Aurizon - MD & CEO*

So then I'd spend a moment or two thinking about some of the elements of business conditions, starting with continuing transformation and here we take the opportunity to remind you of the magnitude and the momentum, the sustainability of the transformation program which is the core focus of our business, especially in these current market circumstances.

AUD383 million, as I say, delivered over the last few years, a further 600 head count out of the business in FY16, some 8% reduction in headcount in that year. We've already called out some 300 further headcount reductions in the current year. There will be more beyond that, but certainly that that we've already done.

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You can see there across all of the operations metrics the extent of the improvement again, notwithstanding the market conditions. All of this underpins our confidence with respect to the target that we have through FY18. To give you a little more flavor, a little more granularity around that and thinking about what we propose to do in the current financial year, for example, there are four initiatives that we have set out here, three in operations and one in the corporate area, which alone will deliver in a full year between AUD70 million and AUD80 million of transformation benefit in the Company.

The revised regional model in operations which, as I say, takes out an entire layer in that part of the world that Mike manages, and 20% of the total management head count in that part of the business. Leveraging the labor productivity again, referring back to the EAs and the way that we're running the Company these days.

We signed the agreement with Progress Rail last week with respect to the outsourcing of non-core maintenance activities, in particular, at Redbank in Western Brisbane. This initiative alone will deliver AUD15 million of Opex and AUD7 million of Capex savings once implemented.

I might also say that it also is a great example of working in partnership where Progress Rail intends to take some 70 or 80 of what were previously a rise in employees into their new business. Finally, in this space, I've mentioned before the impact of the reduction in the number of EVPs, resizing and refocusing the business around the current market conditions and what we expect the impact of that will be this year and the next.

If I, then talk a little about the coal market and this slide and the following couple of slides talks to our usual points of update with respect to the market. To my earlier comments we've seen a period of stabilisation especially in the coal market, more detail on the next page but the Australian share of the seaborne market in both met and thermal is at strong levels. You see there 65% market share in met and 23% in thermal. As we had been anticipating we have seen the rundown and disappearance of uneconomic volumes particularly those met coal volumes out of the appellations for example.

We've also in met -- in thermal I beg your pardon, seen reductions out of both the US and Indonesia. Again we make the point that whilst so much of the focus is on China and there is no doubt about the extent to which China makes the market in a range of areas, but China is not number one nor number two in either met or thermal coal destination for Australian producers.

Talking of those producers they in turn, of course, are impacting through their own productivity transformation efficiency programs on their FOB cost, details on the next page. But this in turn is through the entire value chain continuing to underpin and enhance the competitiveness of the Australian coal supply chain. As we think about the customers, I mentioned in my opening remarks about the improvement in their financial status over the last six months with 10% compared with 26% at cash negative margins and indeed even better than that as I say we believe today.

If we think about our contracts, importantly again the weighted average remaining contract life is 10.5 years and there are no major contract renewals until FY22. That of course has been materially improved on the back of the Mt Arthur contract that was executed following on from the half year. Nearly 80% of the volumes are now under new form contract and 96% by FY18. Contract utilisation remains at 92%.

Let me then say a few more words about the other part of our business, the freight part of the business. Again I would note that there are significant areas across this -- business is in fact a poor way to describe it because it is a range of businesses and a range of geographies many of which are in very good shape, many of which have opportunity for growth, but equally it is apparent that there are many areas across this portfolio which simply don't meet the corporal hurdle rates.

In the intermodal space we've spoken about the strategy that we've got and you can see the evidence of the progress and improvement that we've been making in that space. Even in the last six months we refer to our commencement of operations at Enfield for example, the divestiture of our interests in Moorebank, the increased level of contracting that we have especially with some of those major retail customers. The progress is good. It has to be sustained, it has to be lifted.

In what we've loosely called the DBF area, as I say, there are a range of contracts, there are a range of businesses. Included amongst them frankly are a number of what I would describe as the legacy arrangements that you will recall from pre-privatisation days to which the TSC refers for example. You can see that TSC revenues have or will fall off by between AUD70 million, AUD80 million in that part of the business. It's an opportune time therefore for us to really apply the blowtorch to all of those parts of the business and to ensure that we are either operating at or on a path to operating at the corporate levels, hurdle levels of profitability and return.

In that respect nothing is off the table. We expect that we will focus a lot about revenue opportunity, revenue uplift opportunity at one end of the spectrum but at the other end of the spectrum I have no doubt that there may well be other responses to what we consider to be unsustainable parts of that business. That review has commenced, is under way and will be driven forward as quickly as reasonably is able.

In turn then if I can talk to network and to regulation. Even as I stand here today of course UT4 is not finally done and dusted though we would hope, Alex, that it is to all intents and purposes done. We are certainly focused though around UT5 and what needs to be done in the UT5 space. You're all aware that the Competition Authority has called for a submission which we intend to have in by September 9. So we think about the context in which we're doing this.

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We have had record volumes for four years in a row. We've had the kind of improvement, sustained improvement in the operating metrics to which I referred below. That RAB that I referred to earlier gives us a headline capability across the Central Queensland network of 300 million tonnes. That of course what was asked for by the customers, endorsed by industry. The maintenance regime that we have in place therefore underpins the continued utility of that kind of capacity. More particularly in underpins the continued utility of being able to operate at those high levels of performance to which I've referred.

We believe that a stable regulatory regime therefore is 100% critical in ensuring that we continue to be able to deliver for our customers, our above rail providers and their customers at the levels that they would want especially in a world in which, back to my market observations of a moment ago, the criticality of Australia's place in the world is at an increasing level.

We certainly have begun already a broad ranging engagement plan around UT5. We've had workshops already as well as meeting, for example, with individual customers and the Resource Council in Queensland. We expect that the submission that we will make will be a focused submission. It won't be thousands of pages but it will address the key issues. So what are some of those key issues? What are the key focus areas? Well firstly from a revenue point of view we all understand WACC and the implications of WACC and bond rates at the moment, but fundamentally we believe given the kinds of things that I've been saying that the WACC has to reflect appropriately the risks that our Company takes in delivering all of these services.

It must reflect our ability to be able to fund and our ability to be able to maintain a BBB+ rating given the current state of the capital markets. That maintenance regime, again that I was referring to a moment ago, must ensure not just safety compliance but the ability for the network to be able to operate at superior levels of operational performance. Certainly we've got to be able to recover the other allowances consistent with the efficient costs as has been determined through the lengthy UT4 process.

In the policy side of the house, we are, as you would expect, very concerned and very focused about those amount of capital that have been deferred to come quickly into the RAB. We're not a bank in that sense. We have expended those monies and whilst we all understand the systemic impact of MPV neutral nonetheless we are not getting a return today on those expenditures.

We continue to believe whilst there has been progress as a result of the finalisation of UT4, we continue to believe that there are significant areas where QCA acts and continues to act beyond its powers. We are determined and certainly propose through all of our engagement to follow through on those issues. Again, whilst there's been an improvement at the backend of the UT4 process with respect to asset stranding clearly there is still more to be done in that space.

Finally, in this whole area and not so much I guess by way of UT5 submission, but submission about the adequacy of the regulatory arrangements we continue to call out the lack of a merits based review in thinking about the below rail regulation.

Let me then finally turn to outlook and guidance. We know from our conversations with you that you've already focused clearly on these areas and so you can see the revenue guidance. Underlying EBIT we're guiding to AUD900 million to AUD950 million on these range of assumptions. From an above rail point of view the overall numbers and coal in the range of 200 to 212 [million] tonnes. On an assumption of stable pricing which is what we do see and experience at the moment with the exception of that that we've already been talking about in relation to the Karara relief.

In the below rail area, I particularly make the point that I think that there is a delta here with respect to some of the expectations. That the step up in the cost, and Keith has referred to this, roughly half around depreciation and half around that increase in the wholesale energy costs to the Company. Again a reminder that those are things that through the normal processes will be recovered and is therefore a timing issue, but will impact on our FY17 numbers.

We certainly continue on all of the basis that I've discussed with you this morning to have increased confidence around the delivery of the transformation benefits. Again, the comment here with respect to the redundancy cost to be explicit about that, we expect that those costs will be below the line. We are being transparent about having regard to the scale of the changes that we have underway but there will be significant attendant costs with putting that in place. We expect, as has been the case in the past, that given the materiality of those costs as I say, they'll be so called below the line and therefore are not deducted from the AUD900 million to AUD950 million.

Finally, then, with respect to FY18, our target as you know is to achieve an operating ratio of 70%. Clearly there are many headwinds as we think about our ability to be able to deliver on that number. The kind of levers, the kind of things that we have to get our brain around in that regard of course are the volumes and the extent to which there would need to be even some modest uplift in above rail volumes over the next two years. But it is an area of great confidence. We do need to deliver on those transformation benefits.

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UT5 is a risk. Recognising the reality of what's happening in the capital markets at the moment, it is a tall order for us to be able to prosecute and win the arguments that I described in talking about the UT5 process a moment ago. On the other hand, from a positive point of view, the opportunities that will come from the freight performance review will, over that period of time I am confident, deliver significant benefit for us.

Finally, then, in way of summary, this is a solid, resilient business. It is a business which has seen some stabilisation in the fortunes of particularly our largest customer base over the last six months. The challenges remain and will remain in front of us over the next year or two. Our objective, however, continues to be very focused about improving our returns through the effective allocation of capital and having the right portfolio mix, achieving the ROIC targets for the Company.

We've spoken, both Keith and I, about cash flow generation and the benefits that will come again through the continued transformation program, the reduction in our capital program over the next couple of years and in terms of what happens to those dollars, certainly Board has restated its commitment to a 70% to 100% payout range, but absent a superior project we would expect to return surplus funds to shareholders.

Thank you and we would be happy now to take your questions.

QUESTION AND ANSWER

Ian Myles *- Macquarie - Analyst*

Hi Lance, Ian Myles from Macquarie. A couple of questions for you, if you think about freight, this has been a problem for probably two or three years and I think we've proven it to ask you every two or three years, what's changed in the outlook for you to then launch a review now as opposed to 24 months ago when the business was arguably no different at a fundamental level?

Lance Hockridge *- Aurizon - MD & CEO*

I think it's a good question Ian and a lot of it goes to what I was referring to on the way through with the run off in some of those legacy arrangements that we've got. There is a level at which we've come through the contract renegotiation process in parts of that business. We've had the opportunity to look at some of the more cyclical parts of that business and overall we believe that the outlook is going to continue to be challenging. So given all of those factors we're very much faced with the need to get on with the kind of review and change that I've spoken about.

Ian Myles *- Macquarie - Analyst*

The other issue is you've been getting fantastic productivity out of your business which is great but a coal environment or a haulage environment where there's really no growth, that's leading to this ongoing release of equipment, (inaudible) and the like. Should we be continuing to expect just a periodic write down of this equipment every year given -- your productivity's keeping it going but there's simply no growth, or alternatively can you show us or maybe hint where growth may emerge over time.

Lance Hockridge *- Aurizon - MD & CEO*

Absent the growth that you refer to Ian, the short answer to your question is yes that it is inevitable that as we drive the productivity in the Company consistent with what has been the case now over a number of years. Now ultimately, of course, that will get to the point of having reached an inflection point. Exactly when that is will very largely, I think, be dependent upon what the market circumstances are.

Perhaps if we go straight to the...

Keith Neate *- Aurizon - EVP & CEO*

We'll do, sorry, one question down the front here Paul.

Paul Butler *- Credit Suisse - Analyst*

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Hi, Paul Butler, Credit Suisse. A couple of questions if I could. What's the timing on GRail that you expect?

Lance Hockridge *- Aurizon - MD & CEO*

The formal submissions have to be in September 24 -- September 22, I beg your pardon. Beyond that it's in the hands of the vendor, but we're, as you can imagine, actively engaged in preparing for that submission at the moment Paul.

Paul Butler *- Credit Suisse - Analyst*

Yes, okay and on the iron ore business, you've not given guidance on volume but I'm just wondering whether you could sort of comment on that.

Lance Hockridge *- Aurizon - MD & CEO*

Yes, good point.

Paul Butler *- Credit Suisse - Analyst*

And also a little bit more detail on what's happened with the Karara business.

Lance Hockridge *- Aurizon - MD & CEO*

With respect to iron ore volumes consistent with FY16, there will be some further minor rundown potentially in the Mt Gibson volumes, but essentially year-to-year with that caveat. With respect to Karara, you want to...

Keith Neate *- Aurizon - EVP & CEO*

In terms of the rate relief?

Paul Butler *- Credit Suisse - Analyst*

Yes.

Keith Neate *- Aurizon - EVP & CEO*

Well look obviously that's commercial in confidence with KML but it's -- as we have in the past, it's a value exchange. So there's upsides for us in terms of the future of the contract and near term rate relief for them. But we're not going to disclose any details.

Paul Butler *- Credit Suisse - Analyst*

Sure, what I'm sort of after is the circumstances that persuaded you that that was the right course of action. I mean are we likely to see that on other contracts?

Lance Hockridge *- Aurizon - MD & CEO*

We've had, and I think we've been transparent, that there's been a limited number of contracts where we've approached request for rate relief in a similar way that Keith describes on a value exchange basis, but it's a very small number Paul. Why we did it with respect to Karara is consistent with what we say about looking to, looking

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through the business to the resource, to the fundamental competitiveness. That is a resource which as you know is effectively 100% owned by the Chinese and the support that's being given to the business by the ultimate Chinese owner is material in our consideration. Equally, we weren't Robinson Crusoe so to speak around that relief process. It was a wide ranging process that involved other suppliers, state government agencies, et cetera and particularly given that that, again to go to the resource, is that the early part of its time it has, assuming that it can be made economic, it's a long life project Paul.

So our assessment was that given a consistent approach amongst all of those stakeholders that this is a business which could be made to be sustainable over the long term. I note, for example, that at current ore prices that Karara is washing its face.

Paul Butler - ***Credit Suisse - Analyst***

If I can ask one on UT5? Look I presume and I sort of agree with you that the WACC or the way the WACC was formulated for UT4 doesn't appear to offset the risk of asset stranding. Clearly in UT4 the QCA viewed that perhaps it did, I'm just wondering how do you go about persuading the QCA that they need to change their approach and particularly because, as you've said, the customer market conditions have improved from where they were six months ago? Do you have confidence that you're going to be able to get some change there?

Lance Hockridge - ***Aurizon - MD & CEO***

Time will tell of course but it's a very wide ranging approach. It's an approach that involves firstly the level and the nature of our interaction with the QCA to make these arguments. It is the use of external advisors around these very sorts of issues. It's engagement with the customer base about why this is important because at its heart, the one thing that's for sure and for certain is that if the picture that we've painted this morning remains the consistent position our customer base will certainly want to continue to rail at the kind of performance levels that we're referring to. They therefore need the assurance around the adequacy of system performance. It's also about the Queensland Government. This is important, not the least from their own revenue point of view of course, from a royalty point of view, but from the point of view of underpinning the continued vibrancy, if I can use that word, of the coal sector in Queensland.

Is it a tall order? Yes, it is. It's not -- what we're arguing is not the same as the approach that's being taken in previous undertakings and so we're not trying to gild the lily here but this is pretty fundamental. These issues and these arguments go to the heart of being able to deliver a system and an operating capability of the standard that the customer base and that the state and the community needs.

Paul Butler - ***Credit Suisse - Analyst***

Thanks.

Lance Hockridge - ***Aurizon - MD & CEO***

So we'll do Owen and then Scott.

Owen Birrell - ***Goldman Sachs - Analyst***

Hi Lance, Owen Birrell here from Goldman Sachs. Just a couple of questions from me. Firstly, you talk about, I guess, the robustness of the Australian coal export market and it's obviously been shown by the record volumes that you're delivering in below rail. But if I look at above rail, particularly in Queensland, you're losing share, I'm just wondering if you could provide a bit of colour around what you're seeing in the competitive landscape there. What are you doing versus your competitors that means that they're beating you on the volumes?

Just a second question on the Pilbara Rail investment. It's written down to zero now. Is that effectively dead in the water or is there still some optionality or option value associated with that, which may not be evident today? But in the future do you have any more levers you can pull on that?

Unidentified Company Representative

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If I can take the second one first. By definition there's option value there. The -- the relationship with the other partners is alive. But to be very clear, there is nothing which is in prospect.

And the, all of the partners are on the same page around what it would take and what it would take has a combination of things to be taken into account. But of course not the least being price and supply demand and it will take some considerable period of time at least before there would be the opportunity to even review that positon. With respect --

Owen Birrell - ***Goldman Sachs - Analyst***

So just to confirm. So nothing is being actively considered on that front --

Lance Hockridge - ***Aurizon - MD & CEO***

No.

Owen Birrell - ***Goldman Sachs - Analyst***

-- at this point in time.

Lance Hockridge - ***Aurizon - MD & CEO***

Nothing, no. With respect to above rail volumes. Of course those numbers disclosed that there are a number of moving parts. As you think about what individual contracts are. As you think about what the individual minds are in terms of their production, mine life, ramping up, ramping down et cetera. So there is all that normal interplay which is behind the question that you ask.

The single biggest delta though as you think about Queensland is that year-on-year, BMA Rail lifted 4.5 million tonnes more than they -- than was the case in the prior year. So as I say, that's the single biggest factor. But it's not the only factor that's at play around all of that. But there is nothing which is, as it were, different or untoward from as I say the normal process of what's going on with the mines and production and what's going on with the contractual arrangements.

Keith Neate - ***Aurizon - EVP & CEO***

And just for note, all of those -- all of that volume loss to BMA was in the first half of the year. The second half has been stable.

Owen Birrell - ***Goldman Sachs - Analyst***

Just following up on BMA, they're talking to 10% increases in coal volumes next year and the year after. How much can you guys get of that? Is -- are you guaranteed a proportion of an increased volume or are they more likely to put that on their own rail or to other parties?

Lance Hockridge - ***Aurizon - MD & CEO***

The -- there is no guarantee. We all understand the arrangements with respect to the current contractual arrangements. We believe that at the numbers that we were just referring to, BMA Rail is pretty much topped out in its current capacity.

The options therefore are more BMA Rail, more of our competitor, more of us. Where that takes us is performance is key. The nature, the quality of the operating performance from both a below and above rail point of view to BMA is the thing that speaks most to the opportunity and we are of course very much alive to the opportunity to which you refer and the whole team is very focused on how we can -- how we can capture that opportunity.

Owen Birrell - ***Goldman Sachs - Analyst***

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Thanks.

Lance Hockridge - ***Aurizon - MD & CEO***

We'll just do Scott and then we'll go to the phones.

Scott Ryall - ***CSLA - Analyst***

Thank you, Scott Ryall, CSLA. In terms of your targets for this year and fiscal 2018, you've highlighted volumes at surprisingly as a key lever. Can I, I don't want to you know mess around with your guidance too much in terms of picking over it with fine tooth combs and things. But you delivered about 270 million tonnes a little bit over this year and your guidance is saying it's remaining flat in the range of 255 to 275.

Does that indicate to me, am I being too picky or does that indicate to me you see flat to slightly -- you know slightly down is more of a risk factor as opposed to slightly up?

Lance Hockridge - ***Aurizon - MD & CEO***

There's too many moving pieces would be my observation and I invite Mauro if he wants to add anything here Scott. Because on the one hand you're seeing the, what I was talking with Paul about a moment ago, the normal course of mine production. And so on the one hand we see some mines ramping down for example. But other opportunities as we were just describing on the up side.

The second observation that you make or question or -- is around risk. Given the environment that we've been in and that we continue to be in, there is downside risk overall though I'd go back to -- this is my sense and sentiment and if you will.

We believe that the market has stabilised somewhat since the early part of this year. There's a long way to go even in terms of the change of ownership stuff that's going on around the industry at the moment, which speaks a little bit to the risk side. But if you think about it in terms of a bell curve, I would say that the risk is more to the upside than it is to the downside. But that's not speaking to great increases in tonnage for example.

Scott Ryall - ***CSLA - Analyst***

Okay so then I guess my follow on is you talk to above rail volume growth as one of the dependents -- dependent variables for achievement of your fiscal 2018 targets. I mean given what you've just described in terms of the volume outlook -- presumably, you are not setting yourself for anything material in terms of above rail growth? In terms of making the statement, do you think you can still hit the target of 70%.

Lance Hockridge - ***Aurizon - MD & CEO***

Scott, you are quite right and thus the use of the term headwinds when I was introducing that part of my commentary. But none of those elements that I spoke to were meant to be discreet which speaks to the point that you are making. But none of us in this room from the Company suggesting that we will get to OR70, for example, on the back of volume increases.

But we do foresee a situation in which there could be -- and we would expect there could be some modest volume growth over that couple of years. And when you think about the EBIT per ton that we achieve, that could and arguably should be part of the equation if we are to get to OR70.

Scott Ryall - ***CSLA - Analyst***

Okay, and then in terms of your network business, can you just -- you have been very clear, thank you, for your expectations on fiscal 2017 EBIT. Can you just give us a sense in terms of where you are in terms of the uplift from work, and I guess what I'm talking about there is you've got fully loaded depreciation in fiscal 2017 but

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obviously, there is a revenue ramp up plus some deferrals of CapEx. Relative to where you would be, if all of their CapEx was included and you were operating at the current WACC. How far shored are you for EBIT for 2017?

Keith Neate - ***Aurizon - EVP & CEO***

I was going to say it's about AUD20 million for the work reg fees, and honestly, in this year's numbers, there is nothing for the work non-reg fees because they are still subject to dispute.

Scott Ryall - ***CSLA - Analyst***

Okay, which is perfect for my next bit which is can you give us an update on that dispute please?

Lance Hockridge - ***Aurizon - MD & CEO***

Just hang on Alex, let us wait for a mic.

Alex Kummant - ***Aurizon - EVP Network***

All we can say is that the court proceedings are continuing, there is really no other comment we can make.

Scott Ryall - ***CSLA - Analyst***

Likely end dates or anything like that?

Alex Kummant - ***Aurizon - EVP Network***

No.

Scott Ryall - ***CSLA - Analyst***

Okay, that is --

Lance Hockridge - ***Aurizon - MD & CEO***

We would expect to be in court in order of magnitude of a couple of months, Scott. So we may be in a better position to be able to answer your question once you step on that travellator.

Scott Ryall - ***CSLA - Analyst***

Yes, okay. And then could you give us an update on the process around hiring a COO, please?

Lance Hockridge - ***Aurizon - MD & CEO***

Yes, not a hell of a lot that I can illuminate about, but to reiterate, we have had an international search going on together with an involvement of internal candidates. We are well progressed through that process but the observation that I would make, frankly not unlike if you think back to the sort of questions that you were asking me

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a few years ago. And that will lead up to hiring the former head of operations in a circumstance, where you've got overseas candidates. The sheer logistics challenges can be frankly, quite challenging.

In summary, therefore, we are well advanced but I would be very cautious about nominating an outcome timeframe at the moment, but only for the reason that I have just said. And in the meantime, of course, the work that Mike is doing, you can see from what we are reporting on this morning is continued to really push ahead in the operations space in any event.

Unidentified Company Representative

Okay, we will go to the phones now. I think we got Simon Mitchell as the first question.

Simon Mitchell *- UBS - Analyst*

Good morning, a question on the balance sheet, you mentioned about the buy-back to manage capacity on the balance sheet for the growth opportunity. What is your view on your gearing position at the moment? Do you view yourself as having headroom or capital management given the EBITDA gearing ratio looks like with 2.4 times in the year and so that is at the top end of the comfort level for the agent?

Keith Neate *- Aurizon - EVP & CEO*

I think I heard that, Simon is a bit broken up but where we currently sit at 37%, we are comfortable that it sits at the top end of the metrics, so the two rating agencies, so we are comfortable where we are on the free cash flow generation that the business is now beginning to generate this year and is expected next year, will provide us with further headroom.

Simon Mitchell *- UBS - Analyst*

Okay, and just a question on the margin target for 2018, you have stuck with the 30% EBIT margin target, if we look at your guidance for FY 2017 and strip out the AUD70 million of revenue catch up, it looks like you can provide something like a 25% margin, so are you still targeting your 5% increase in margin in the span of one year, I understand that you are not fully recovering, we're burning in FY 2017 but is there anything else we should be thinking about that helps you get to that 30% for 2018 in terms of timing differences on the network?

Keith Neate *- Aurizon - EVP & CEO*

I think as Lance has covered off, Simon, as a whole, raft of interconnecting and interacting drivers as to whether we can get to the 70% OR, it continues to be a challenging target for management but we are fully focused on trying to achieve it.

Simon Mitchell *- UBS - Analyst*

And just on the -- back reset process, if we look at your funding cost going to, I think you are targeting about 5.1% and you said 64 of those is fixed can we just clarify that when we do come to a reset on the WACC for UT5 that you are still expecting to be able to lock your funding cost in tandem with the WACC to effectively offset any impacts on the WACC from the lower funding cost.

Keith Neate *- Aurizon - EVP & CEO*

Yes, that is correct, Simon. That is exactly the strategy that we will adopt.

Simon Mitchell *- UBS - Analyst*

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Thank you.

Unidentified Company Representative

Okay, I think next is Anthony Moulder

Anthony Moulder *- Citigroup - Analyst*

Hi, good morning, all. Just a few questions, if we start with what you have confidence in and that is the ability to deliver the transformation savings. Is the constant in that also weighted towards the reduction of headcount rather than improvement of operating productivity?

Lance Hockridge *- Aurizon - MD & CEO*

I guess it's fair to say that the two are a function of the same thing, frankly, Anthony, if I understand your question, and so if beyond the things that I have spoken about this morning, if I can give a specific example of what I mean. I know that with the work that Mike's got going on in the technology space, one of the outcomes that we would expect to see in the -- at least in some areas of our network in the timeframe we are talking about is the ability to be able to go from two to single driver operation as we do already on the North Coast line.

So that is the context in which I answer the question but yes, in the circumstance where as you know, a single head is AUD100,000 inevitably, there is a -- an inevitable focus on the efficiency from a headcount point of view.

Anthony Moulder *- Citigroup - Analyst*

The question is in context from a difference that we see in slide 39 and 19, obviously 19 shows the performance of those labor efficiencies over three years as opposed to one year further out on the pack on slide 39 which mirrors the labor cost per NTK or what is the labor efficiency and so I guess what it looks like is for the comparison of those two slides is that they represented flows in 2016 relative to what we have delivered over the last three years and I guess, a reduction of drivers from two to one certainly delivers more of that operating savings as opposed to, I guess headcount reductions at the head office.

Lance Hockridge *- Aurizon - MD & CEO*

Yes, look I think this is a function of what some people would unkindly refer to as the low hanging fruit, the extent to which there were just pure surplus savings in the earlier parts of the program.

That, though, I wouldn't necessarily for the reason that -- and the example that I just gave, see as necessarily being a staple for all time that will ebb and flow depending upon what the initiatives are at the time.

Anthony Moulder *- Citigroup - Analyst*

And on networks, I guess, reference your comment on how network rev should reflect the returns from the business and the investments that you have made today. Can you give us a guidance as to how far away UT4 you think is providing that appropriate return to you?

Lance Hockridge *- Aurizon - MD & CEO*

Yes, I mean, I think the WACC we have on the UT3 would be preferable to UT4 but 7.17 is the most -- I guess, where we would like to keep UT5 but it will be a challenge.

Anthony Moulder *- Citigroup - Analyst*

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I think it will, too. And lastly on the performance review for the Intermodal and Diversified Bulk, is there a likely exit outcome from intermodal and has been considered as part of that review?

Lance Hockridge - ***Aurizon - MD & CEO***

I observed and reiterate nothing is off the table but our --in the interstate box part of that business, our performance, whilst it's not been where we would want it to be, has been improving and it's been improving on the back of the things, Anthony, that we have been talking to you about.

Where we do it, how we do it, where there are opportunities to do it better, will be very much a focus in that part of the world, but again, there may be some of all where we choose that the right answer is not to do it. In the other parts of the business though -- sorry, let me come at it this way, we are all aware of the amount of effort that has gone into intermodal, it's frankly, in a range of the other spaces, when we think about some of the minor box as we call them the livestock business, for example, is a perennial issue for us because of the cyclicality of the business, the scale of the investment that is required and we have -- to my knowledge, never made money in that business, Anthony, and so the prima facie is unless we can find a different way, a pretty obviously answer in that part of the business.

Other parts of the business, we will see, I'm sure, commercial outcomes, there are whole areas where they are component parts of the business but arguably, other people could do better. But arguably, other people could do better so outsourcing will be, I'm sure, part and parcel of the response.

Again, I reiterate nothing is off the table and the objective is that we achieved the Company's hurdle rates in those businesses.

Anthony Moulder - ***Citigroup - Analyst***

Understood. And I'm assuming -- lastly, if I could AUD100 million for structuring cost that you book in 2017, is it fair to assume that they are all cash costs that will be paid over the next sort of one to two years?

Lance Hockridge - ***Aurizon - MD & CEO***

Yes, they are.

Anthony Moulder - ***Citigroup - Analyst***

Pefect. Thank you.

Unidentified Company Representative

Okay, Matt Spence is up next.

Matt Spence - ***Merrill Lynch - Analyst***

Hi, guys, I just wanted to start with the AUD100 million below the line just referred to. What was the equivalent amount that you took above the line in FY 2016?

Keith Neate - ***Aurizon - EVP & CEO***

It was AUD24 million.

Matt Spence - ***Merrill Lynch - Analyst***

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Okay, so we are going from AUD24 million to 0 but AUD100 million below the line. That is great. Thanks.

What is the invested capital in freight and the split between intermodal and bulk freight invested capital, if you got that, please?

Keith Neate *- Aurizon - EVP & CEO*

Intermodal is around AUD200 million.

Matt Spence *- Merrill Lynch - Analyst*

And in the division that you are calling DBF, diversified bulk freight?

(Multiple Speakers)

Lance Hockridge *- Aurizon - MD & CEO*

So that is another AUD200 million -- it is about AUD400 million across the --

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Keith Neate *- Aurizon - EVP & CEO*

So call it AUD200 million for Western Australian freight and another AUD200 million for Queensland freight, so AUD400 million in total.

Matt Spence *- Merrill Lynch - Analyst*

And were both of those loss making at an EBIT line in FY 2016, both intermodal and DBF?

Lance Hockridge *- Aurizon - MD & CEO*

Yes.

Matt Spence *- Merrill Lynch - Analyst*

Okay. That is it for me, thanks very much.

Unidentified Company Representative

Okay, Cameron McDonald.

Cameron McDonald *- Deutsche Bank - Analyst*

Hi, guys, and just a couple of questions, firstly, some clarity of UT5, you mentioned that you are pushing for a merits based review, what do you actually mean by that? Are you suggesting that the whole regulatory framework needs to be redesigned?

Lance Hockridge *- Aurizon - MD & CEO*

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I would be reluctant to go as far as the whole although I am tempted strongly, Cameron, but at the moment, the only basis upon which you can challenge a decision is for -- is under the judicial review principles. Without going into a long discussion around that, it has a number of shortcomings in as much as the name suggests, the challenge can only be about the process review, not about the substance of the decision.

Now there are inventive ways that you can try to make one into another but it is somewhat limited. And the way that it works, it is also depending on exactly how it is invoked but generally speaking, would involve an entire opening up of the process.

So we might want, for example, to challenge Part A or an output called element A of the draft undertaking but by virtue of doing that, it opens up the opportunity for the customers to challenge element X which frankly, might be the pricing elements for example.

So we believe that particularly given the nature of what we are talking about here with a very different environment, if I can describe it that way from a customer point of view, in other words, we've got two -- a couple of handfuls of customers, most of whom are bigger than we are. It's a question of who is being protected and we believe that a better outcome would be one in which there was the opportunity for what are -- as we all know, having lived this over recent years, at times, incredibly complex deliberations, an opportunity for there to be a review process around the merits, around the substance of the decision.

Cameron McDonald *- Deutsche Bank - Analyst*

Okay, and just one final question from me. Just on the GRail, when you look at that opportunity, if you have any -- do you have any concerns around ACCC clearance on actually acquiring that if the opportunity was there?

Secondly, what impact do you think that will have on your operating ratio at the time, given that historically, the division was in effect, set up to minimize the cost of haulage for Glencore.

Lance Hockridge *- Aurizon - MD & CEO*

With respect to the first, no doubt, others will test the view but our view, and we have taken, as you would expect the external advises that there ought not be competition issues associated with GRail. Given that, the business is conducted in house at the moment. By definition, there is no diminution in the competition as a result of the proposed transaction.

With respect to OR, firstly, let me say we would only proceed, and by proceed, I mean even make a submission, a final submission, in a circumstance where we believe that again, the Company's hurdle rates, profitability, returns, OR, et cetera, can be met as a result of doing this. There is no element of this being a "strategic play" it would be a pure business development play for us which as I said, would require the confidence levels around those hurdle outputs.

So in that context, we would expect to see healthy operating ratios in that space. I prefer to not get too specific about all of that as you can imagine, there are some commercial and competitive elements of all of that -- that will be to the extent that we are proceeding, be building into our submissions.

Cameron McDonald *- Deutsche Bank - Analyst*

Okay, thanks.

Unidentified Company Representative

Currently, we have no more questions on the line. And if there are no more questions in the room, thank you very much, everyone for your time.

Lance Hockridge *- Aurizon - MD & CEO*

Thanks everybody.

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