Appropriateness of the External Credit Ratings

Aurizon Network Pty Ltd

September 2017

Building a better working world

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Ernst & Young ("EY or "we") was engaged on the instructions of Aurizon Network Pty Limited ("Aurizon Network") to comment on the appropriateness for the level of the current external credit ratings and related issues in accordance with our contract dated 25 August 2017.

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19 September 2017

Mr David Collins
Level 4, 192 Ann Street
Brisbane QLD 4000

Expert report on Aurizon Network's current external credit ratings

Dear David

Ernst & Young ("we" or "EY") was engaged on the instructions of Aurizon Network Pty Limited ("Aurizon Network") to comment on the appropriateness of the level of the current external credit ratings and related considerations in accordance with our contract dated 25 August 2017 ("Agreement").

The enclosed report (the "Report") sets out the outcomes of our work. You should read the Report in its entirety. A reference to the Report includes any part of the Report.

Purpose of our Report and restrictions on its use

Please refer to a copy of the Agreement for the restrictions relating to the use of our Report. We understand that the deliverable by EY will be used for the purpose of providing supporting evidence from an independent expert on the accuracy of Aurizon Network's current credit ratings (the "Purpose").

This Report was prepared on the specific instructions of Aurizon Network solely for the Purpose and should not be used or relied upon for any other purpose.

This Report and its contents may not be quoted, referred to or shown to any other parties except as provided in the Agreement. We accept no responsibility or liability to any person other than to Aurizon Network or to such party to whom we have agreed in writing to accept a duty of care in respect of this Report, and accordingly if such other persons choose to rely upon any of the contents of this Report they do so at their own risk.

Nature and scope of our work

The scope of our work, including the basis and limitations, are detailed in our Agreement and in this Report.

Our work commenced on 25 August 2017 and was completed on 19 September 2017. Therefore, our Report does not take account of events or circumstances arising after 19 September 2017 and we have no responsibility to update the Report for such events or circumstances.

In preparing this Report we have considered and relied upon information from a range of sources believed after due enquiry to be reliable and accurate. We have no reason to believe that any information supplied to us, or obtained from public sources, was false or that any material information has been withheld from us.

We do not imply and it should not be construed that we have verified any of the information provided to us, or that our enquiries could have identified any matter that a more extensive examination might disclose. However, we have evaluated the information provided to us by Aurizon Network and nothing has come to our attention to indicate the information provided was materially mis-stated or would not afford reasonable grounds upon which to base our Report.

Our conclusions are based, in part, on the assumptions stated and on information provided by Aurizon Network and other information sources used during the course of the engagement. Neither Ernst & Young nor any member or employee thereof undertakes responsibility in any way whatsoever to any person in respect of errors in this Report arising from incorrect information provided by the Aurizon Network or other information sources used.

This letter should be read in conjunction with our Report, which is attached.

Thank you for the opportunity to work on this project for you.

Yours sincerely

Sebastian Paphitis
Partner
Capital & Debt Advisory

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1. Executive Summary

The Report should be read in its entirety including the applicable scope of the work and any limitations.

EY was engaged by Aurizon Network to comment on the appropriateness of targeting and maintaining external credit ratings of BBB+/Baa1, to support its submission to the QCA as part of the current Access Undertaking ("UT"), namely UT5.

External credit ratings are used by third party investors as one of the factors they consider to analyse the business and form a view as to whether they will take part in debt and bond raisings. This is particularly the case for businesses such as Aurizon Network with large scale debt raising requirements and resources sector exposure. As such, the Board and Management of Aurizon Network have consistently and publicly maintained their commitment to target robust capital and financial risk management policies in support of this, including holding BBB+/Baa1 credit ratings.

The track record of this capital and financial risk policy includes the following history:

- Publicly released statements and documents showing policy adoption
- Moody's Investors Service ("Moody's") and Standard & Poor's ("S&P") consistently issuing BBB+/Baa1 credit ratings for Aurizon Network since 2013, reflecting their view of the credit strength and risk of default
- Track record of successfully raising Medium Term Notes ("MTNs") in both the domestic and international debt capital markets at BBB+/Baa1 credit ratings, reflecting the willingness of external investors to support Aurizon Network's credit at this level
- Sustained BBB+/Baa1 ratings and ability to raise debt through a full market cycle, which was evident in the resources market downturn in late 2015/early 2016 which saw 56% of global resource issuers being downgraded by Moody's[1]

The appropriateness of targeting and maintaining external credit ratings of BBB+/Baa1 by Aurizon Network has also been supported by empirical evidence through a review of comparable large scale corporate borrowers with regulated and unregulated asset pools, which were also found to hold credit ratings of BBB+/Baa1 or higher. This has been conducted through samples of median ratings within two main related peer groups; global rail (including domestic regulated below rail); and S&P/ASX 100 companies.

Maintaining BBB+/Baa1 credit ratings also supports continued and cost effective access to debt capital markets and maximises investor investment appetite through the economic and resources sector cycle. Within this Report we have also commented on some of the key reasons why maintaining BBB+/Baa1 ratings are important, which include:

- Improved ability to meet the ongoing large scale financing requirements of over c.$3.4bn debt portfolio
- Delivering lower cost of funding and access to domestic and global debt capital markets across the resources market cycle
- Maintaining stakeholder and investor confidence across both debt and equity markets
- Managing higher leverage levels needed to support maintenance of the Regulated Asset Base ("RAB") whilst still having a high quality credit ratings profile

[1] Moody's, "Mining – Global – Ratings Review Summary – Final", 20 May 2016

- Lengthening the weighted average debt tenor to better match the RAB life
- Mitigating the consequences of a downgrade in a resources sector downturn

In conclusion, based on the above factors, it is our view that BBB+/Baa1 are the appropriate credit ratings for Aurizon Network and that it is important for these credit ratings to be maintained to enable it to be able to perform its business in the most cost effective manner and retain capacity to refinance its debt facilities as and when they become due for renewal.

2. Introduction

2.1 Background

Aurizon Network is a wholly owned subsidiary of ASX-listed Aurizon Holdings Limited ("Aurizon Holdings") (previously known as QR National Limited). Aurizon Network is externally rated by S&P and Moody's with current credit ratings of BBB+/Baa1.[2,3]

Aurizon Network manages, operates and maintains the 2,670km Central Queensland Coal Network ("CQCN") serving Queensland's Bowen Basin coal region. The CQCN open access network is the largest coal rail network in Australia connecting multiple customers from more than 40 mines to three ports in the Bowen Basin. The CQCN comprises four major network systems: Moura, Blackwater, Goonyella and Newlands as well as an interconnecting system Goonyella Abbot Point Expansion ("GAPE"). The CQCN is operated under a 99-year lease from the State of Queensland. [4]

As the sole CQCN below rail operator, Aurizon Network is regulated by the state competition regulator, the QCA and is required by statute to be ring-fenced from other Aurizon businesses. Access to a network system in the CQCN is pursuant to terms and conditions of access that have been approved by the QCA. The process is established through an Access Undertaking ("UT"), currently UT4, which defines the regime for open access to the CQCN and regulates Aurizon Network's revenue over a specified period.

As part of the UT process at each regulatory reset, the QCA sets Aurizon Network's maximum allowable revenue ("MAR"). MAR is one of the major drivers of Aurizon Network's credit metrics, and therefore its credit ratings. In advance of a decision from the QCA on UT5, Aurizon Network is seeking to present to the QCA its view on the appropriateness and importance of maintaining its BBB+/Baa1 external credit ratings.

2.2 Scope of Work

EY has been engaged by Aurizon Network to comment on the appropriateness of the external credit ratings of Aurizon Network to support its submission to the QCA as part of UT5.

In accordance with the scope of work within our Agreement, this Report:

- Comments on the historical and current Board policy and external credit ratings profile, and the importance of this approach over the recent downturn in the resources market
- Provides examples of other comparative credit ratings (that are publicly available) domestically and in other markets that provide an independent support for the appropriateness of maintaining BBB+/Baa1 ratings or higher
- Comments on the investor confidence implications and positive commercial rationale supporting the Board's policy in relation to the credit ratings
- Provides a view on the appropriateness of Aurizon Network's current external credit ratings and the importance of maintaining these credit ratings contemplating the above factors

EY has not reviewed Aurizon Network's credit profile, business performance, and capital and risk management policies as part of our scope.

[2] Moody's, Credit Opinion: Aurizon Network Pty Ltd, 16 February 2017
[3] S&P, Aurizon Network Pty Ltd, 17 May 2017
[4] Aurizon Network, 2017 Annual Report, 14 August 2017, pages 2 and 25

2.3 Structure of this Report

The remainder of this Report describes the approach we have adopted to comment on the appropriateness and importance of Aurizon Network's current external credit ratings including:

- Reviewing alignment of the ratings to the existing Board's capital management and financial risk management policy in place since the Aurizon Network ratings were established in 2013
- Making observations from market data on comparative peers
- Considering external investors' perception of the ratings and how this view would flow through to commercial factors impacting the business

3. Approach to Reviewing the Appropriateness of Aurizon Network's External Credit Ratings

In commenting on the appropriateness of Aurizon Network's external credit ratings, we have focussed on the important role these ratings play in communicating the capital strategy, financial risk policy and operating profile of the business to external third party investors. External credit ratings are used by these third party investors as one of the factors to understand the business and in particular form a view as to whether they will participate in debt and bond raisings.

Therefore, in the case of Aurizon Network and its existing credit ratings of BBB+/Baa1, it was important to review the following areas:

- The alignment of the ratings to the existing Board capital management and financial risk policy, that has been in place for the entire period that Aurizon Network has been rated, and the history of the external credit ratings held over this period
- Observations from market data showing comparative peers to Aurizon Network also independently forming the view that holding credit ratings of BBB+/Baa1 and above is appropriate for these large scale borrowers with regulated or unregulated asset pools
- The consideration of how external investors would perceive the current external ratings of BBB+/Baa1 versus lower ratings and how this view would flow through to commercial factors such as the cost of funding, total funding appetite (including the capacity to refinance), tenor of debt, leverage capacity and general investor confidence in the business

To inform our view, EY has undertaken the following steps, as agreed with Aurizon Network:

- Considered existing information available to Aurizon Network in relation to its external credit ratings including existing external credit ratings reports by S&P and Moody's, public announcements released by Aurizon Network, securities brokers and other unrelated parties
- Reviewed Aurizon Network's debt structure including the recent public bond issuances in Australia and Europe
- Identified and commented on the current external credit ratings of comparable domestic and global peers to Aurizon Network
- Provided a view as to the appropriateness of Aurizon Network's external credit ratings vis-à-vis its business
- Outlined the rationale for our view contemplating factors relevant to the Aurizon Network business model, industry landscape, economic cyclicality, ratings strengths and weaknesses and optimal debt and capital funding strategies

Based on our review and supporting evidence detailed in the Report, our view is that BBB+/Baa1 are the appropriate credit ratings for Aurizon Network.

3.1 Aurizon Network's Ratings Policy and History

Since the Initial Public Offering of the business, the Board of Aurizon Network (and Aurizon Holdings) has consistently and publicly maintained its commitment to a capital management and financial risk policy which involves the business holding external ratings at the BBB+/Baa1 level.

This commitment has been communicated to the debt and equity capital markets, external credit ratings agencies as well as independent unrelated entities.

The internal and external commitment to this approach and policy, and the ability of Aurizon Network to meet its stated targets provides an important basis on which investors can view the business. In addition, credit ratings agencies also seek evidence of commitment to a particular rating through their discussions with the Board and Management of Aurizon Network, as well as through public statements and activities in the capital markets that support these ratings being maintained.

This observation of Aurizon Network's approach provides support for the view that the current BBB+/Baa1 ratings are appropriate for the business. The Board and management are best placed to form this approach in light of their role in operating and managing the business, and their longstanding policy to maintain them demonstrates a commitment to these ratings levels.

This observation in relation to the existing position was also evidenced by our review of publicly released statements, public documents and annual credit ratings reports issued by Moody's and S&P from 2011 to 2017 (refer to Table 2). A summary of quotes extracted from the aforementioned sources are summarised in the table below.

Table 1: Quotes Extracted from Public Sources

Year	Quotes Supporting BBB+/Baa1 ratings
2011	QR National Limited, 2010-11 Annual Report, September 2011 ► *"Focus on maintaining a strong credit rating"*
2013	Aurizon Network, Debt Investor Presentation, October 2013 ► *"Network has obtained credit ratings from Moody's (Baa1 stable) and S&P (BBB+ stable)"* ► *" Network is committed to maintaining strong investment grade credit ratings going forward"*
2013	Incenta Economic Consulting, Aurizon Network: Review of Benchmark Credit Rating and Cost of Debt, November 2013 ► *"A benchmark credit rating of BBB+ is appropriate"*
2013	Aurizon Network, Credit Rating and Cost of Debt, December 2013 ► *"Aurizon Network (AN) is committed to maintaining a strong investment grade rating"*
2014	Aurizon Holdings, Corporate Announcement, November 2014 ► *"Aurizon Holdings Limited ("Aurizon") today announced the intention to undertake an on-market buy-back of up to 5% of its issued share capital (107 million shares). Lance Hockridge, Aurizon Managing Director & CEO, said 'The buy-back reflects Aurizon's strong balance sheet and highlights our ability to return capital to shareholders, while also maintaining the flexibility to fund appropriate growth projects and our commitment to our current BBB+/Baa1 credit ratings"*
2015	Aurizon Holdings, Debt Investor Update, August 2015 ► *"Aurizon Network is rated by Moody's (Baa1 / stable) and S&P (BBB+ / stable) and is committed to maintaining a strong investment grade rating"*

2016	Moody's, Rating Action: Moody's Confirms Aurizon Holding's Baa1 Rating; Outlook Negative, April 2016 ► *"Network's Baa1 rating is supported by our expectation that management will prioritise rating stability to maintain investor appetite for future debt refinancings"*
2016	Moody's, Rating Action: Moody's Confirms Aurizon Network's Baa1 Rating; Outlook Negative, April 2016 ► *"We believe that management has sufficient economic incentives to maintain the rating at the Baa1 level"* ► *"Moody's believes that management views rating stability as important in maximizing investor appetite for future debt refinancings, given that the vast majority of the consolidated Aurizon group's debt has been raised at the Network level"* ► *"Network's regulatory returns are predicated on the regulator continuing to regard the company as a Baa1-rated entity when setting its regulatory returns"*
2016	Aurizon Holdings, Corporate Announcement, April 2016 ► *"Aurizon notes that Moody's has completed its review and reaffirmed its credit ratings for Aurizon at Baa1 (negative) and Network at Baa1 (negative). Standard & Poor's BBB+ ratings for both Aurizon and Aurizon Network remain unchanged. Aurizon remains committed to maintaining its strong balance sheet and current credit ratings"*
2017	Aurizon Holdings, Half Year Results 2017 Investor Presentation, February 2017 ► *"Board supports current credit ratings in light of market outlook (Moody's Baa1 (negative) and S&P BBB+ (stable))"*
2017	Moody's, Credit Opinion: Aurizon Network Pty Ltd, February 2017 ► *"The stable outlook reflects our expectation that the company will manage its capital structure such that its ratio of FFO/debt remains towards the centre of the Baa1 rating tolerance level of 16-20%"* ► *"We believe that management views rating stability as important in maximizing investor appetite for future debt refinancings, given that the vast majority of the consolidated Aurizon group's debt has been raised at the Network level"*
2017	Aurizon Holdings, Full Year Results 2017 Investor Presentation, August 2017 ► *"Board supports current credit ratings – Moody's Baa1 (stable) and S&P BBB+ (stable)"*
2017	Morgans, Equity Research: Aurizon Holdings, August 2017 ► *"Capital management - Activated an on-market share buyback of up to $300m. The gearing target is now set at ~40% vs 39.6% at FYE-17. The Board continues to support Baa1/BBB+ credit ratings"*
2017	Aurizon Holdings, Debt Investor Update, August 2017 ► *"Board supports current credit ratings - Moody's Baa1 (stable) and S&P BBB+ (stable)"*

Source: As listed above

In addition, the above commentary is supported by the consistency of Aurizon Network's (and Aurizon Holdings') actual external credit ratings of BBB+/Baa1, since the initial ratings were obtained in 2013 and 2011 respectively, as summarised in Table 2 below.

Table 2: Aurizon Holdings and Aurizon Network Credit Ratings

Aurizon Network Limited							
	2017	2016	2015	2014	2013		
S&P (Outlook)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)		
Moody's (Outlook)	Baa1 (Stable)	Baa1 (Negative)	Baa1 (Stable)	Baa1 (Stable)	Baa1 (Stable)		
Aurizon Holdings Limited							
	2017	2016	2015	2014	2013	2012	2011
S&P (Outlook)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)	BBB+ (Stable)
Moody's (Outlook)	Baa1 (Stable)	Baa1 (Negative)	Baa1 (Stable)	Baa1 (Stable)	Baa1 (Stable)	Baa1 (Stable)	Baa1 (Stable)

Source: Moody's, S&P

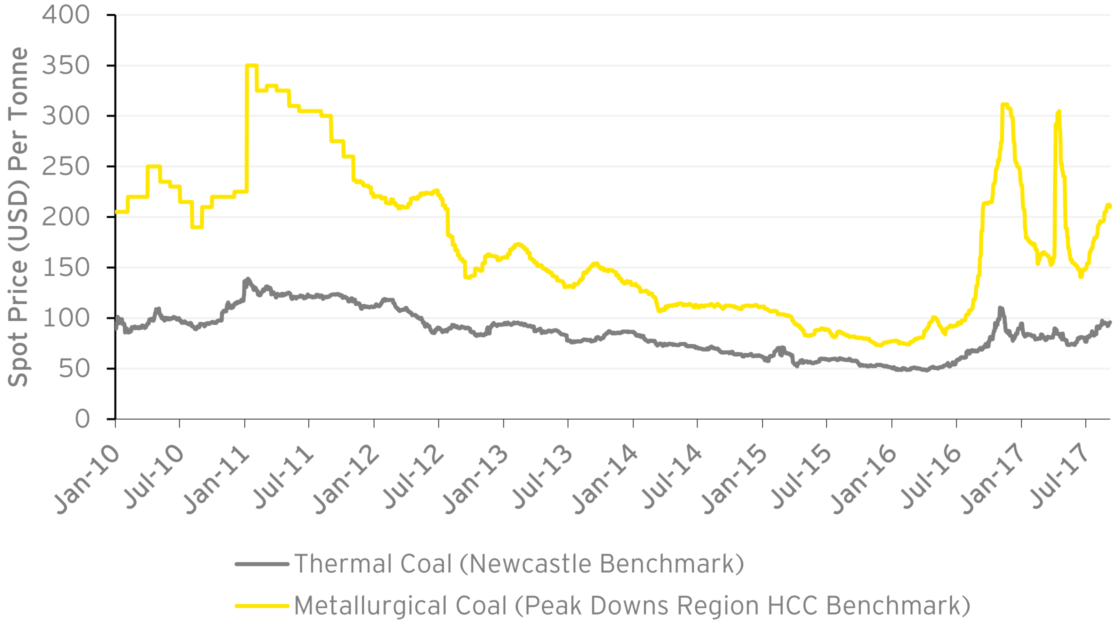
The consistency of approach adopted by the Board and Management of Aurizon Network, coupled with stable ratings by two independent rating agencies, provides confidence to a range of external stakeholders, such as banks and investors, in the policies adopted.

3.2 The Track Record of This Policy Through Recent History

One of the key considerations for the Board and Management of companies such as Aurizon Network in maintaining a BBB+/Baa1, is how it aids the business manage through the resources cycle (in this case more specifically the coal sector) and how it provides a ratings buffer in any potential market downturns.

Despite having the benefit of regulated revenue streams, the business operates in and is considered by many investors as being exposed to the cyclicality associated with the resources sector. This is most evident given the recent experience in the Australian economy of a material cyclical downturn in the resources sector, particularly coal, during 2015 and 2016. This downturn in coal prices that was experienced is reflected in the chart below, noting that the majority of coal hauled on Aurizon Network's track is metallurgical.

Figure 1: Thermal and Metallurgical Coal Prices (2010-September 2017)



Source: Bloomberg

This major cyclical downturn in the coal market involved a number of resource companies filing for bankruptcy and voluntary administration (e.g. Peabody Energy, Bandanna Coal and Cockatoo Coal) and many others seeing their own external ratings downgraded. [5] For example, Moody's undertook the following ratings actions in response to the resources market downturn[6]:

- 56% of global resource issuers reviewed were downgraded including BHP Billiton (A1 to A3) and Rio Tinto (A3 to Baa1)
- 26% of global resource issuers reviewed were downgraded by at least two notches

Moody's also undertook a ratings review on Aurizon Network and other coal logistics companies such as Dalrymble Bay Coal Terminal ("DBCT"), citing increasingly challenging conditions stemming from soft commodity markets increasing the risk of mine counterparties failing to renew contracts, or contracts being terminated early or renegotiated. Subsequently, DBCT was downgraded by one notch to Ba2 along with other coal logistics companies by Moody's. Coal prices have since rebounded from the 2016 cyclical downturn with some resource companies receiving rating upgrades including Glencore Australia[7] and Rio Tinto[8].

The outcome of Moody's review for Aurizon Network was to raise the tolerance level for the FFO/Debt threshold for Aurizon Network for a Baa1 rating from 15% to 18% and to place the business on "negative" outlook (whilst S&P maintained both the credit rating and FFO/Debt tolerance level). The impact of the exposure to the resources sector saw its credit rating placed on review by Moody's and the view from investors that the business was impacted by the downturn.

Whilst the external rating was placed on "negative" outlook, impacting access and cost of funding (refer to Sections 3.4.1 and 3.4.2, respectively), the ability to hold the overall ratings at the BBB+/Baa1 levels assisted the business in continuing to raise debt capital. In February 2017,

[5] Moody's, Mining - Global - Ratings Review Summary - Final, 20 May 2016
[6] Ibid
[7] Moody's, Rating Action: Moody's Upgraded Glencore's Ratings to Baa2/P-2, Outlook Stable, 24 March 2017
8 Moody's, Rating Action: Moody's Upgrades All Rio Tinto Group's Sr. Unsec. Ratings to A3; Outlook Stable, 27 February 2017

Moody's revised Aurizon Network's outlook to "stable" and revised the tolerance level for the FFO/Debt rating back to 16%, indicating that this is the minimum necessary level to maintain the current Moody's credit rating. The experience of Aurizon Network through this period and its ability to maintain strong investment grade credit ratings reflect positively on the Board and Management's approach and policies to managing its capital base and financial risks. The approach provided a buffer during this market downturn and enabled the business to maintain a stable capital and funding structure.

Post the revision of the rating outlook to "stable", the business then also demonstrated the value of the BBB+/Baa1 ratings by being able to successfully issue MTNs, including its most recent June 2017 issuance of 7-year $425m (fixed rate) MTNs.[9]

Should a more flexible capital strategy have been adopted by a business such as Aurizon Network, involving BBB/Baa2 or BBB-/Baa3 ratings, there would have been an increased risk of any downgrade compromising access to the capital markets. Given Aurizon Network's current business scale and requirement to raise and sustain a debt portfolio of over $3.4bn, a lower level rating combined with a downgrade would have given rise to greater risk to the ongoing ability of Aurizon Network to refinance existing debt facilities.

Please refer to Section 3.4.4.

3.3 Comparative Credit Ratings

We have researched credit ratings of comparable peers to obtain a market indication of the appropriateness of targeting and maintaining BBB+/Baa1 credit ratings for similar large scale corporate borrowers with regulated and unregulated asset pools such as Aurizon Network.

3.3.1 Sample Selection

Aurizon Network's business model is distinct from other companies within the market, as it is the only Australian regulated below rail operator who leases a key Queensland State Government asset. Unlike some other regulated rail networks, Aurizon Network also has access to both public debt and equity markets (through Aurizon Holdings) and so has obtained external credit ratings in support of these processes. Aurizon Network's customers who access the rail network are largely mines within the region, which results in material exposure to the resources market. As such, Aurizon Network has no exact direct peers within the Australian market to compare against.

Notwithstanding this, in considering appropriate peer groups, we had regard to the following factors:

- Operate at similar scale, characterised by holding significant levels of debt. Analysis on the importance of funding size to BBB+/Baa1 credit ratings is detailed in Section 3.4.1.
- Hold a publicly available credit rating as at the date of this Report. We note that as part of standard industry practice, credit ratings are reviewed at least annually
- Share similar business risks as Aurizon Network including operating within a regulated revenue framework or a below rail network

[9] KangaNews, Domestic Market Fits The Bill As Aurizon Returns Home, 16 June 2017, http://www.kanganews.com/news/6943-domestic-market-fits-the-bill-as-aurizon-returns-home (accessed on 8 September 2017

Findings from the selected peers review have been categorised into the following sectors:

- Global rail firms: includes firms who charge customers to access the rail network in which it owns and/or operates in the global market
- The overall S&P/ASX 100 'basket' of externally rated companies

The median credit rating was calculated for each sector category.

From the empirical evidence drawn, we observe that comparative peers across the above sectors support a median credit rating of BBB+/Baa1, and with many holding a higher credit rating.

3.3.2 Global Rail

Aurizon Network's credit ratings have been compared against rail companies in the global market including domestic regulated rail companies. This involved considering firms with similar business models, who currently hold a public credit rating and have significant levels of debt, with reference to Moody's Aurizon Network's peer group.[10]

Table 3 below summarises the public credit ratings of this peer group.

Table 3: Global Rail[11]

	Global Rail					
Company	Country	Debt (A$m)	S&P Credit Rating	Moody's Credit Rating	QCA Accepted Credit Rating	Median Credit Rating
Aurizon Network	Australia	3,465	BBB+ (Stable)	Baa1 (Stable)	BBB+	BBB+/Baa1
Australian Rail Track Corporation	Australia	644	N/A	A1 (Stable)	N/A	
Arc Infrastructure	Australia	1,244	BBB (Stable)	N/A	N/A	
Burlington	US	29,388	A (Stable)	A3 (Stable)		
Canadian National	Canada	11,851	A (Stable)	A2 (Stable)		
Canadian Pacific	Canada	8,518	BBB+ (Stable)	Baa1 (Stable)		
CSX	US	15,409	BBB+ (Stable)	Baa1 (Stable)		
Kansas City Southern	US	3,373	BBB- (Stable)	Baa3 (Stable)		
Queensland Rail	Australia	3,000	N/A	N/A	BBB+[12]	
Union Pacific	US	20,753	A (Stable)	A3 (Stable)		

Source: Company filings, Moody's, S&P, QCA
N/A means the firm is not rated by the rating agency or the credit rating is not currently publicly available

[10] Moody's, Aurizon Network Pty Ltd Peer Group, https://www.moodys.com/credit-ratings/Aurizon-Network-Pty-Ltd-credit-rating-823421243 (accessed 8 September 2017). Note, Genesee & Wyoming Australia Pty Ltd currently does not hold a public credit rating

[11] European and Asian below rail companies have been excluded due to the observation that the business scales of these firms are not comparable to Aurizon Network and/or do not hold a public Moody's or S&P credit rating. In addition, similar to Aurizon Network, Dalrymple Bay Coal Terminal ("DBCT") is regulated by QCA and has material exposure to the commodities sector. However, DBCT holds materially lower debt levels of c.$530m and principally operates a port which is viewed by ratings agencies to be in a separate industry as Aurizon Network. As such, DBCT was excluded from the review. Pacific National has also been excluded as it is an above rail operatory only

[12] Queensland Rail does not hold a public credit rating issued by Moody's nor S&P, however, based on the *Queensland Rail's 2015 Draft Access Undertaking* report published by QCA in October 2015 (relating to the current 2016 Access Undertaking), QCA accepted Queensland Rail's proposed credit rating of BBB+

The median credit rating of the sample of comparable peers within this sector is BBB+/Baa1, providing evidence to support that the level of Aurizon Network's credit ratings are consistent with peers and are appropriate credit ratings.

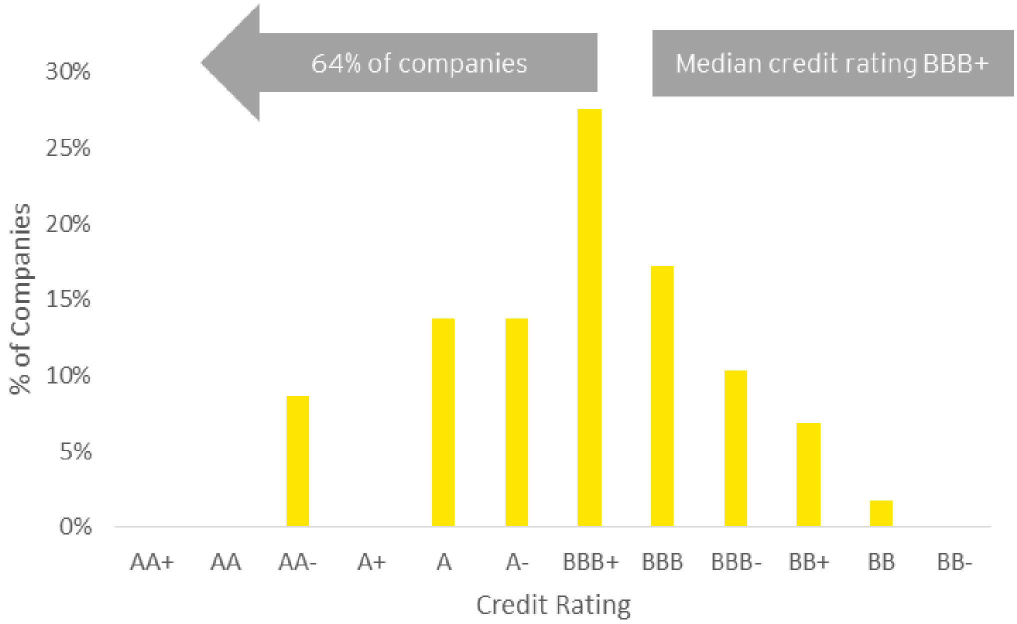
3.3.3 S&P/ASX 100 Companies

Aurizon Holdings is an ASX-listed company and is included within the S&P/ASX 100 Index. As such, we have compared Aurizon Network's credit ratings against its publicly listed peer set.

This involved reviewing the current public credit ratings available for all companies in the S&P/ASX 100 Index, by utilising the S&P CapitalIQ platform. CapitalIQ is an S&P database that provides public information on companies, such as a company's credit ratings.

The figure below illustrates that, within the S&P/ASX100 Index, 64% of companies who have a public credit rating are rated BBB+ and above by S&P.

Figure 2: Credit Ratings of S&P/ASX 100 Companies



Source: S&P

Many larger publicly listed entities contained within this index have internal capital management and financial risk policies to target higher credit ratings similar to Aurizon Network's, given the confidence this provides to their investors and the support it provides to their large scale debt raising programs (required to be undertaken on a cost effective basis and managing maturity and refinancing risks).

Given the relatively higher economic cyclicality evidenced in the underlying resources sector that Aurizon Network is exposed to, compared to other S&P/ASX100 companies, there is also an additional importance for the target credit rating to be at the higher end of this peer group and at least be at the BBB+/Baa1 levels.

3.4 Stakeholder/Investor View and Importance of Maintaining BBB+/Baa1 Credit Ratings

The table below summarises Aurizon Network's current debt portfolio composition, which shows that c.71% of Aurizon Network's current debt portfolio is funded by public debt capital markets (including MTNs).

Table 4: Debt Portfolio Composition

Debt Type	Issue Date	Amount	Tenor
Syndicated Bank Facility	Jun-2013 Dec-2015	A$525m A$490m **A$1,015m**	5 years 5.5 years
Australian MTNs	Oct-2013 Jun-2017	A$525m A$425m **A$950m**	7 years 7 years
European MTNs	Sep-2014 Jun-2016	€500m €500m **€1,000m (A$1,500m)**	10 years 10 years

Source: Company filings, Thomson Reuters

Public credit ratings are important as they communicate to investors the risk associated with an issuer or debt issuance. Holding a higher credit rating indicates a lower risk of credit default, allowing Aurizon Network to access a broader range of investors and sources of funding outside bank lending.

Maintaining BBB+/Baa1 credit ratings are important in maintaining continued and cost effective access to these debt capital markets and is one of the key investment criteria for financiers and investors. The importance of credit ratings is only expected to further increase as global regulatory regimes for financiers and investors move further towards requiring more tiered risk weightings and capital allocations based on the strength of corporate credit ratings, amongst other factors.

We have therefore also considered key factors which support the appropriateness and necessity of Aurizon Network maintaining credit ratings of BBB+/Baa1 with its investors and financiers, including the following:

- Funding size requirement
- Cost of funding
- Stakeholder and investor confidence
- Leverage
- Tenor
- Consequences of a downgrade

3.4.1 Funding Size Requirement

Aurizon Network accesses debt from the following markets: bank loans, the Australian corporate debt capital market and the offshore corporate debt capital market. As the sole operator of the CQCN rail network with c.$6.15bn of tangible assets (as proposed in UT5), Aurizon Network's optimal debt funding strategy, as articulated by the Board and Management of Aurizon Network, involves ensuring continuity for a significant funding requirement, with Aurizon Network holding a total of c.$3.4b of debt as at 30 June 2017.

The pool of available investor liquidity in debt capital markets increases at higher credit ratings which reflects investors' preference and lower risk weights/capital allocations for higher quality credits. Higher credit ratings of BBB+/Baa1 provide Aurizon Network with greater access to investor capital and protection against any fall in overall investor demand in the primary market.

Aurizon Network is also reliant on offshore debt capital markets to meet its funding requirement, demonstrated through the two offshore MTN issuances. Investor appetite in these markets is higher for investment grade issuers, with over 80% of Australian issuers who currently source debt funding from the European, UK and US markets being of investment grade quality.[13] Therefore, Aurizon Network's continued ability to tap those markets is crucial for the company's debt funding strategy and holding BBB+/Baa1 ratings provide a better basis for ongoing investor appetite.

Furthermore, there has been a progressive trend of financiers and investors reducing appetite and allocations for exposures to fossil fuel related companies (with increased appetite for Environmental, Social and Corporate Governance ("ESG") related investments), which needs to be offset by companies exposed to fossil fuel industries (such as Aurizon Network) targeting a higher quality credit rating. For example, in its 2017 Climate Change Action Plan Westpac announced it would be implementing tighter criteria for financing any new coal mines[14]. More broadly across the big four banks, corporate and project finance lending to the coal sector has fallen significantly from $3.1bn in 2015 to $99m in the first half of 2017[15].

Maintaining a higher credit rating is therefore of increased importance to maximise investors' appetite in all market conditions and to offset any reduced investor allocations from broader regulatory and investor preference trends. This supports the necessity of Aurizon Network holding of BBB+/Baa1 credit ratings as lower level investment grade ratings could have adverse impact on investor appetite.

3.4.2 Cost of Funding

As corporate debt capital market investors have demonstrable sensitivity to credit ratings levels along with potential and actual ratings actions, credit ratings views and downgrades have significant impact on the primary and trading spreads applied to Aurizon Network's bond issuances.

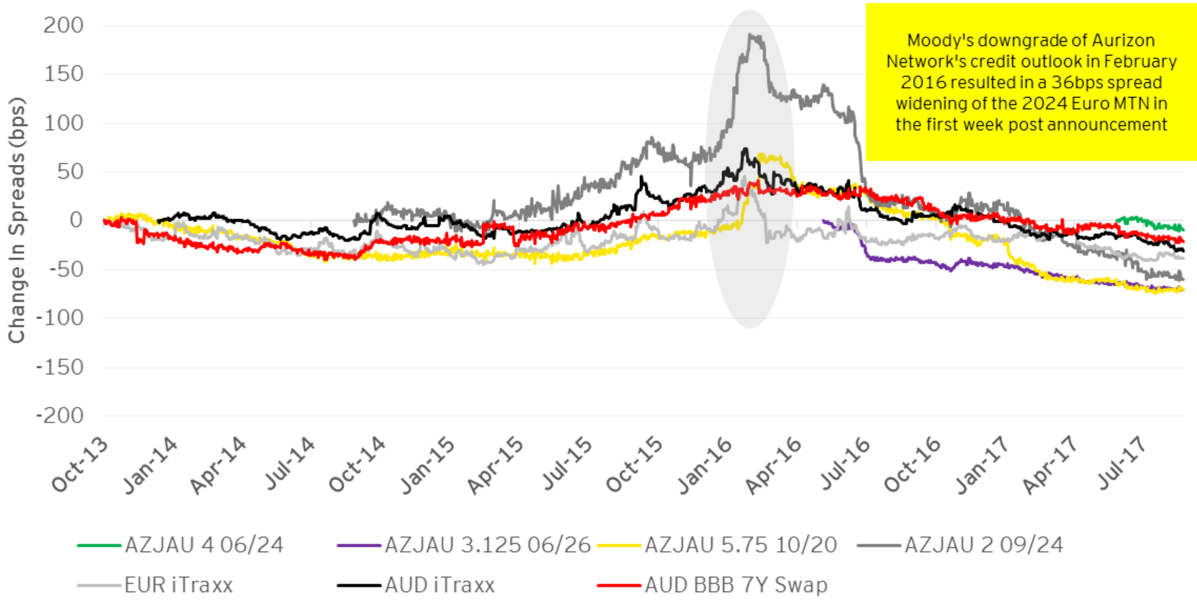
For example, on 1 February 2016 Moody's announced that as a result of a downturn in the commodities market the rating agency downgraded Aurizon Network's credit outlook from "stable" to "negative". This caused the trading spreads of its 2024 European MTNs to widen by 36 basis points ("bps") in the immediate period following the announcement. This provides evidence that bond spreads increase when there is a negative impact on credit ratings. The reduced access to debt capital markets as a result of a negative impact on credit ratings not only affects ability to attract funds but also impacts the cost of these funds. This also applies during periods of heightened market volatility, as shown in the figure below.

[13] CapitalIQ, based on Australian issuers who currently hold public credit ratings issued by Moody's or S&P

[14] Westpac Banking Corporation, Climate Change Position Statement and 2020 Action Plan, 28 April 2017, page 12

[15] Yeates C, Big Four Banks Slash Lending To Coal Miners, The Sydney Morning Herald, 24 July 2017

Figure 3: Aurizon Network Trading Bond and Corporate BBB Bond Spreads, AUD and EUR iTraxx (Rebased to 0)



Source: Bloomberg

The further widening of spreads in the following months after the Moody's ratings announcement and subsequent tightening in the context of Aurizon Network's BBB+/Baa1 ratings beyond the EUR iTraxx and AUD 7 year swap spreads indicate that investor over-reaction has and can occur. This comparison to the relatively steady EUR iTraxx and AUD 7 year swap spreads also supports the sector impact (coal risk exposure) on Aurizon Network compared to other BBB range rated corporates.

Given the resources based exposure any downgrade of Aurizon Network's current ratings are also highly likely to see greater spread volatility, which would negatively impact the company's cost of funding and investor appetite should it need to tap markets at such a time. Even in periods of stable economic conditions and relatively higher coal prices, as observed in 2017, Aurizon Network's trading spreads still exhibit volatility, albeit at lower levels.

Therefore, maintaining BBB+/Baa1 credit ratings remain important for Aurizon Network in managing such market events and retaining access to capital on optimal pricing.

3.4.3 Stakeholder, Investor and Customer Confidence

It is important for Aurizon Network to maintain BBB+/Baa1 credit ratings due to the essential role it plays as the sole leaseholder and operator of a key economic infrastructure asset. Upholding this credit profile provides stakeholders (such as customers, Queensland State Government and recipients of the commodities transported) with confidence on its long term operational and financial stability which would otherwise have significant negative impact on these parties.

In corporate debt capital markets, investors are sensitive to market and economic events that are not related to company-specific factors and is even more so in the resources sector. This has been demonstrated by the information included in 3.4.2 above and reflects the need to provide a measure of stability through the target ratings profile, along with the company's market briefings and performance updates.

Similarly, equity investors in these markets and economic events would likely perceive heightened risk on earnings, which impacts their views on the business regardless of company results and messaging. Many debt and equity investors view the Aurizon Group as a "resources play", notwithstanding Aurizon Network being a regulated company. Therefore, the need to focus investors towards Aurizon Network's BBB+/Baa1 ratings and relatively stable regulated revenue streams, is of greater importance than for other large corporate borrowers.

In addition, Aurizon Network's customer base of miners is composed of firms with a mix of strong and weaker quality credits, with these more directly exposed to movements in coal prices. Therefore, Aurizon Network's stronger credit ratings of BBB+/Baa1 creates a higher credit profile benchmark that also enables it to maintain investor and customer confidence despite its sector and customer exposures.

3.4.4 Leverage

Transportation companies such as Aurizon Network require substantial capital to invest in equipment and facilities to maintain their existing asset base (e.g. rail network) as well as to make strategic investments. This requirement drives a need for additional capital and necessarily a higher debt leverage. This is a fundamental characteristic of an infrastructure business and a strong and stable credit rating becomes an even greater imperative so as to continue to support the higher leverage.

The table below summarises Moody's factor grid for the leverage ratio (15% weighting) and FFO/Debt (10% weighting) relative to the overall credit rating.

Table 5: Moody's Factor Grid[16]

Rating	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Leverage ratio[17]	<0.5x	0.5-1.5x	1.5-2.5x	2.5-3.5x	3.5-4.5x	4.5-6.0x	6.0-9.0x	≥9.0x
FFO/Debt	≥65%	45-65%	30-45%	20-30%	12.5-20%	5-12.5%	0-5%	<0%

Source: Moody's

It was observed that as at 30 June 2017, Aurizon Network had the following sub-factor ratings:

- Leverage ratio of 3.8x sitting within the sub-factor rating of Ba
- FFO/Debt of 20% sitting within the sub-factor rating of Ba

The above sub-factor ratings indicate that although Aurizon Network has a leverage sitting below Baa and an FFO/Debt above Moody's current tolerance level set at 16%, these factors are offset by Aurizon Network's credit strengths including higher operating margin, strong competitive position and recognised commitment to maintaining a robust financial policy. These higher sub-factors contribute to Aurizon Network's ability to maintain higher credit ratings of BBB+/Baa1 but any deterioration in the leverage and FFO/Debt ratios would place pressure on the ability of these non-financial factors to support current credit ratings.

Aurizon Network's Board and Management have expressed their focus on ensuring the current credit ratings are maintained, thereby providing the business with the ability to support needed capital expenditure and protecting the business, through balance sheet resilience, in a market downturn.

Please refer to Section 3.2 for cyclical downturn consideration.

3.4.5 Tenor

Aurizon Network's tangible assets are long-dated in nature, which is evident through the 99-year lease contract with the State of Queensland for the CQCN infrastructure coupled with long useful

[16] Moody's, Rating Methodology: Global Surface Transportation and Logistics Companies, 9 May 2017
[17] Leverage ratio is calculated as Total Debt divided by Earnings Before Interest, Tax, Depreciation and Amortisation

lives across other property, plant and equipment. We have reviewed the Aurizon Network annual report for financial year 2017 and observed that property, plant and equipment have useful lives of up to 100 years, and as such Aurizon Network's capital management strategy requires long-dated debt to fund the tangible assets which have long useful lives.

We note the limitations in tenor for bank funding and as such, being able to access corporate debt markets domestically and offshore is crucial to creating funding diversity across source and tenor to mitigate refinancing risk, lengthen funding maturity and optimise funding costs while balancing equity investors return requirements.

As highlighted in Table 4, investors in corporate debt capital markets (Australian and European MTNs) have greater appetite for longer debt tenors than bank lenders, which are not likely to meet all of Aurizon Network's funding needs. Therefore, it is necessary for Aurizon Network to sustain continued capacity to raise funds through the corporate debt capital markets. As such, maintaining BBB+/Baa1 credit ratings provide enables Aurizon Network to maximise investor appetite and provide a continued ability to raise long term debt capital.

3.5 Impact of a Downgrade

Given Aurizon Network's current requirement to manage a debt portfolio of over $3.4bn, the publicly stated strategy is to increase diversification and maturity through ongoing debt capital markets issuances, involving the need to maintain a level of continued engagement with a wide pool of domestic and offshore investors.

There would therefore be a materially negative impact from rating downgrades on the existing BBB+/Baa1 ratings in terms of funding costs and access to debt capital markets, along with it being detrimental to investor engagement and ongoing support.

More broadly, ratings downgrades would see:

- Reduced investor appetite - The pool of available liquidity in debt capital markets decreases at lower credit ratings which reflects investors' preference for higher quality credits. Further, in times of market volatility, investors are more sensitive to lower rated credits. As such, maintaining BBB+/Baa1 credit ratings would assist Aurizon Network maximise investor appetite and the ability to raise long term debt capital as its existing facilities reach maturity. See section 3.4.1 for further details

- Increased funding costs - As debt capital market investors have demonstrable sensitivity to credit ratings levels along with potential and actual ratings actions, credit ratings' views and downgrades have significant impact on the primary and trading spreads applied to Aurizon Network's bond issuances. See section 3.4.2 for further details. In addition, higher volatility in trading spreads in the secondary debt market impacts funding ability and creates negative messaging to debt and equity investors

- Reduced flexibility and funding alternatives - Reducing leverage capacity and buffer, particularly in providing balance sheet resilience to market shock events such as resources sector downturns

- Market perception and investor support - It is important for Aurizon Network to maintain BBB+/Baa1 credit ratings and provide stakeholders with confidence in the long term operational and financial stability. In debt capital markets, investors can be sensitive to market and economic events that are not related to company-specific factors and this is even more so in the resources sector. This is supported by the commentary in 3.4.2 and reflects the need to provide a measure of stability through the current target ratings profile, along with Aurizon Network's market briefings and performance updates

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