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Essential Services Commission of South Australia

Review of GWA financial allocations

July 2015

Contents

Important notice

Inherent Limitations

This report has been prepared as outlined in the Scope Section. The services provided in connection with this engagement comprise an advisory engagement, which is not subject to assurance or other standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, Genesee & Wyoming Australia Pty Ltd management and personnel consulted as part of the process.

KPMG has indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

The findings in this report have been formed on the above basis.

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This report is solely for the purpose set out in the Purpose Section and for the Essential Services Commission of South Australia's (ESCOSA's) information, and is not to be used for any other purpose.

This report has been prepared at the request of ESCOSA in accordance with the terms of KPMG's contract dated 24 May 2015. Other than our responsibility to ESCOSA, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.

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Summary

The Essential Services Commission of South Australia (ESCOSA) has engaged KPMG to report factual findings in response to a number of questions it has asked of KPMG concerning how revenues and costs are attributed for regulatory purposes, to the Tarcoola-Darwin railway (the interstate railway) and the South Australian railway network (the intrastate railway) owned and operated by the Genesee & Wyoming group of companies. The questions and findings are set out below.

The responses to questions 1 to 3 address the period ended 31 December 2014; and the responses to questions 4 to 6 relate to the 10 years ended 30 June 2013.

Questions and findings

1. *Discuss and obtain evidence that the financial information in relation to the intrastate railway business is maintained by a separate legal entity to the entity that operates the interstate railway and advise on the reasonableness of any management fees or other subsidisation mechanisms that may exist between these two businesses.*

Legal separation

Financial information for:

- the intrastate railway is maintained in the Genesee & Wyoming Australia Pty Ltd (GWA) statutory entity; and
- the interstate railway is maintained in the GWA (North) Pty Ltd (GWA(N)) statutory entity.

Intercompany management charges

The costs of activities relating to the interstate railway, carried out by GWA employees were attributed by GWA to GWA(N) on a cause and effect basis and recharged by a management fee between GWA and GWA(N). These costs have been accounted for and attributed to above and below rail services, by GWA(N).

Intracompany revenues

In the absence of a separate access charge to certain customers, both the interstate and intrastate railways attribute part of the revenues they receive from those third parties, to below rail services for the purposes of reporting to ESCOSA. These attributions are made on the basis of structured, customer specific charges and revenues.

Intercompany revenues

GWA(N)'s below rail revenues include an access charge paid by GWA for access to the interstate railway by a specific GWA customer. The basis of charge for that revenue is consistent with the basis of third party access charges levied by the interstate railway.

KPMG has not examined the bases on which either intracompany or intercompany charges have been set.

2. _Review and confirm the allocation of:_
   - _directly attributable costs and revenues; and_
   - _other costs_

   between above-rail and below rail businesses for each of the intrastate and interstate railway businesses.

The following tables summarise the bases of attribution of revenues and costs to below rail services for both the intrastate and interstate railways. The attributions are expressed in terms of the percentages of below rail revenues and costs that have been directly attributed, or allocated on a causal or judgmental basis.

Intrastate railway - Overall percentages of revenue and cost attributed to below rail services

	Total below rail %	Directly attributed %	Causal allocation %	Judgmental allocation %
Revenues	100%	100%	0%	0%
Operating expenses and depreciation	100%	70%	23%	7%

Interstate railway - Overall percentages of revenue and cost attributed to below rail services

	Total below rail %	Directly attributed %	Causal allocation %	Judgmental allocation %
Revenues	100%	100%	0%	0%
Operating expenses and depreciation	100%	76%	8%	16%

- "Directly attributed" means that the financial item is wholly and exclusively associated with below rail services.

- "Causal allocation" means that the financial item is shared between below and above rail services and has been allocated between the two classes of service on a cause and effect basis.
- "Judgemental allocation" means that the financial item is shared between below and above rail services and has been allocated between the two classes of service on the basis of a judgement made by GWA.

3. *Advise whether cost allocation methods (between above and below rail) are reasonable and if other more reasonable cost allocation methods could be used.*

   KPMG has used a principles-based approach by assessing whether bases of allocation meet the criteria for a reasonable basis of allocation that are provided by general principles of cost allocation that are set out at Appendix B.

   On the basis of information and explanations provided by GWA, the attributions and allocations of financial items are consistent with the cost allocation principles set out at Appendix B, with the possible exception of insurance premium costs, which have been judgmentally allocated. These costs account for 7% of below rail operating cost (including depreciation) for the intrastate railway, and 16% for the interstate railway. These amounts are broadly consistent with allocations on the basis of above and below rail asset values, which are potentially a practical proxy for a casual basis of allocation consistent with Principles 1 and 4 at Appendix B.

4. *Review and confirm the allocation of directly attributable costs and revenues between bulk freight and other businesses for the interstate railway below rail businesses.*

5. *Review and confirm the allocation of other costs between bulk freight and other businesses for the interstate railway below rail businesses.*

   Costs are attributed to the bulk freight (non-sustainable) and other businesses by a three-stage process.

   The first stage both directly attributes and allocates, costs on a calendar year basis to below rail services for the interstate railway.

   The second and third stages:

   - directly attribute and allocate below rail financial items from a calendar year to a financial year basis; and
   - allocate all below rail costs to sustainable and non-sustainable services according to three potential bases of allocation. No below rail costs are directly attributed to non-sustainable and sustainable services.

6. *Advise whether cost allocation methods (between bulk freight and other) are reasonable and if other more reasonable cost allocation methods could be used.*

   On the basis that no interstate railway below rail costs are incurred wholly and exclusively to provide either non-sustainable or sustainable services, it is reasonable that no interstate railway below rail costs are directly attributed to services and that all interstate below rail costs are subject to allocation.

GWA has proposed three potential methods for allocating interstate railway below rail costs to bulk freight services and other services. The three methods are distinguished by the degree to which they reflect a causal relationship between service provision and incurring cost. The three methods comprise allocations on the basis of:

1. revenues;
2. thousands of gross tonne kilometres (KGTK); and
3. cost drivers specific to each category of cost, principally but not wholly, comprising a 50% weighting given to KGTK and a 50% weighting given to either train movements or train kilometres.

Method 1 does not have a casual basis and hence does not fulfil the criteria for a reasonable basis of allocation used by this report.

Both Methods 2 and 3 provide measures of causality. Method 3 refines Method 2, by introducing a broader range of cost drivers aligned with different cost categories. Because of this, it is potentially more accurate than the broader brush approach of Method 2.

Method 3 is potentially capable of further refinement by using a broader range of cost category specific cost drivers/allocators. However, the effort and practical considerations of implementing a more detailed method may not be justified by a useful increase in accuracy for the purposes of assessing revenue adequacy and hence may not be preferable to Methods 2 and 3.

7. *Discuss with management the extent to which the allocation methodologies reviewed above were different in any of the 11 years until 30 June 2014.*

Allocations between above and below rail services

GWA has explained that:

- it has developed Regulatory Accounting Models to carry out these allocations for 2013 and 2014, for each railway;
- the Regulatory Accounting Models implement allocation approaches that had been applied in prior years but implemented by other means; and
- due to Genesee & Wyoming's purchase of the assets of FreightLink in 2010 there has been a loss of corporate knowledge originating prior to the purchase date. Accordingly, the current management of GWA does not know when the current allocation approaches were first implemented.

However, a member of the GWA team orally represented to KPMG that on the basis of personal experience of working on the above and below rail allocations, the current allocation approach has been in place since 2006-07.

Allocations between sustainable and non-sustainable interstate below rail services

GWA's professional advisers orally represented to KPMG that a consistent allocation approach had been taken to attributing costs throughout the interstate railway review period to 30 June 2013.

1 Background

At the time this report was completed, the Essential Services Commission of South Australia (ESCOSA) was undertaking two rail-related reviews:

- a review of revenues for the first 10 years of operation of the Tarcoola to Darwin railway (the interstate railway); and
- the SA Intrastate rail review (the intrastate railway).

Each railway provides both rail infrastructure (below rail services) and above rail services. The access regime for reach railway requires ESCOSA to review below rail services.

The Access Provider (Genesee & Wyoming) operates and owns both railways. There is a risk that revenues and costs may be allocated such that the below rail business effectively subsidises above-rail business.

In relation to the interstate railway review, below rail operations are required to be separated into those subject to sustainable competition and those that are not. The Commission has made a draft determination[1] that the bulk freight business is the only below rail business on the interstate railway that is not subject to sustainable competition. Accordingly, the costs and revenues of the below rail interstate railway business are required to be attributed to between bulk freight and other (intermodal freight and passenger) businesses.

1.1 Purpose

The sole purpose of this report is to provide ESCOSA with factual findings concerning financial attributions and allocations made by GWA:

- between above and below rail services for both the intrastate and interstate railways; and
- of below rail financial items, between sustainable and non-sustainable services, for the interstate railway

to assist ESCOSA undertake its interstate and intrastate railway reviews.

1.2 Scope

The scope of work carried out by KPMG comprised the completion of procedures to enable it to report factual findings in response to seven questions which ESCOSA instructed KPMG to address in its terms of reference and which are set out in this report's Summary.

To address these questions, KPMG:

- met with officers of GWA and received copies of models and other information and explanations concerning the attributions of financial items between above and below

[1] ESCOSA, Tarcoola-Darwin Railway: 10-Year Review of Revenues, Draft Report, May 2015.

rail services for both railways, and between sustainable and non-sustainable below rail services for the interstate railway, for the year ended 31st December 2014.;

- documented:
  - the methods used by the GWA models to attribute or allocate each reported category of revenue and expense for GWA and GWA(N) between above and below rail services; and
  - an analysis of the intercompany management charge made by GWA to GWA(N) based on information and explanations received from GWA;
- reconciled the total revenue and costs attributed or allocated to above and below rail services for GWA and GWA(N) to the audited statutory financial statements of each entity for the year ended 31st December 2014;
- addressed ESCOSA's request to report on whether the attributions and allocations are reasonable and whether more reasonable methods could be used, by reporting on whether the attributions and allocations are consistent with a framework of good practice principles. The principles relevant to the allocations considered by the report, are set out at Appendix B;
- met with GWA's professional advisers, to understand the approaches advanced by GWA for the allocation of interstate railway below rail cost between sustainable and non-sustainable services; and
- compared GWA's proposed allocators between sustainable and non-sustainable below rail services, to the good practice principles of cost allocation set out at Appendix B.

Appendix A: Glossary

Allocation	The attribution of a cost or financial item that is shared by two or more services, between those services.
Attributable or Attribution	The association of a cost or financial item with one or more services. If a cost or financial item is associated with: • a single service, it is directly attributable; or • more than one service, the attribution is carried out by means of an allocation.
Below rail services	The provision of railway infrastructure
Causal allocation	An allocation made on the basis of a cause and effect relationship between services and a cost. A direct attribution is a causal allocation associated with a single service only.
Direct Attribution	A cost or financial item is directly attributable to a service if it is wholly and exclusively associated with that service.
ESCOSA or the Commission	Essential Services Commission of South Australia
GWA	Genesee & Wyoming Australia Pty Ltd
GWA(N) or GWAN	GWA (North) Pty Ltd
Interstate railway	The Tarcoola to Darwin railway
Intrastate railway	The South Australian rail network owned and operated by GWA
KGTK	Thousands of gross tonne kilometres

Appendix B: Cost allocation principles

This appendix sets out and briefly explains the rationale for the principles which have been used by this report to assess the reasonableness of the attribution of financial items between above and below rail services and between sustainable and non-sustainable services.

Principle 1: Allocators should reflect a cause and effect relationship whenever practicable

This is necessary to provide a rational, transparent and replicable basis for selection for an allocation.

A cause and effect relationship also allows efficient costs to be allocated on a basis that maintains the nexus between the efficient cost and the factors that cause that efficient cost to arise.

In some instances, it may not be practicable to precisely identify and measure causal allocators of cost. In such cases, it may be necessary to substitute a close approximation to an ideal causal allocator, to provide allocations that do not differ materially from a causal allocation. Regulatory frameworks including the National Electricity Rules for example[2], recognise this. This matter is dealt with by Principle 4 below.

Principle 2: Allocations of cost between services need to be on mutually consistent bases

This is an arithmetic requirement. If different allocators are used to allocate a single category of cost to different services then it will not be possible to demonstrate that:

- a shared cost has been allocated completely and that the allocated costs in total do not exceed the shared cost; and
- the resulting allocations of cost represent allocations of efficient cost.

Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated

This basic arithmetic check complements Principle 2. It is necessary to demonstrate that:

- cost has been neither created nor lost as a result of the allocation; and
- the resulting allocations fairly reflect the causal relationship between each service and the total shared cost.

[2] For example, see Australian Energy Markets Commission, National Electricity Rules, Clause 16.5.2

Principle 4: Cost allocators need to be practical

This principle is referred to in the summary of Principle 1. A cost allocation that cannot be practically implemented and replicated is unlikely to be acceptable. In practical terms, appropriate judgements may need to be made to assess and trade off the identification and measurement of precise cause and effect relationships, with potentially less precise surrogates that may be better capable of implementation.