Annex A: Network Rail's response to ORR's consultation on financial issues for Network Rail in CP5

This annex should be read in conjunction with the covering letter from Paul Plummer to Cathryn Ross on the ORR consultations on the output framework and financial framework for CP5. The covering letter contains our high-level comments on the overall frameworks. This annex responds to each of ORR's consultation questions. ORR structured its consultation around the following headings and the remainder of this annex follows the same structure:

1. Risk and uncertainty;
2. Cost of capital issues;
3. Amortisation and RAB related issues;
4. Corporation Tax; and
5. Other financial issues.

In some instances, issues raised in the consultation document do not directly relate to one of the consultation questions, we have commented on / responded to these issues under the heading Other Remarks.

So as to create a standalone response and to ease readers' understanding of Network Rail's views, we have reproduced ORR's views at the start of each section.

1. Risk and uncertainty

ORR's key messages

- ORR's proposals are consistent with its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.
- By allocating risks to Network Rail ORR believes that it gives Network Rail an incentive to efficiently manage those risks. If ORR allocates to Network Rail the risks that it is best placed to efficiently manage, it considers that this will help incentivise improvements in efficiency and value for money.
- Given the changes since PR08, most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, ORR is proposing to reduce the headroom available to Network Rail.
- ORR is proposing to set an ex-ante assumption for both general inflation and input price inflation in its determination of access charges for CP5.
- ORR is proposing not to provide Network Rail with an in-year risk buffer.

- ORR is proposing to simplify the mechanism to re-open Network Rail's access charges review.
- ORR is proposing to compensate Network Rail for changes to ORR's assumptions on the licence fee and safety levy and business rates (if Network Rail has negotiated business rates efficiently).
- ORR's current thinking is that the level of financial indebtedness in each year of CP5 should at no point exceed a limit set between 70-75%. It considers that this will have the effect of incentivising Network Rail to control its costs.

Response to consultation questions

Q3.1: What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB for inflation. In particular, that we are proposing to set an ex-ante assumption for both general inflation and input price inflation in our determination of access charges for CP5?

Given the significance of this proposal we have already written to ORR setting out our emerging view. We also sent a discussion paper by Oxera setting out its view in relation to this issue, which is appended to this response.

In our opinion, this issue solely relates to appropriately apportioning risk between Network Rail and its funders. As a matter of principle, we believe that governments are best placed to manage inflation risk and that there is already an effective incentive on the company to manage the impact of exogenous changes in inflation. Therefore, we would support a continuation of the existing approach to indexation or a more traditional RPI-X approach, reflecting the fact that inflation is mainly an uncontrollable exogenous factor.

We do, however, understand that DfT and Transport Scotland has difficulty dealing with inflation in their annual budgets because they receive a cash settlement from government. We do not, therefore, object to the proposal for practical reasons. However, we do consider that it would be more appropriate to rationalise this proposal on the basis that it provides budgetary certainty for funders, rather than cost management incentives for Network Rail. Whatever approach is adopted, unnecessary complexity should be resisted.

Lack of Regulatory Precedent

We believe that there is virtually no regulatory precedent for ORR's proposed approach to indexing our allowed revenues based on an *ex ante* inflation assumption. Typically, other regulators adopt an RPI-X approach to expressing the link between inflation and incentive targets. This reflects the fact that regulators typically consider inflation to be exogenous to regulated companies. The traditional RPI-X approach also avoids the requirement to forecast inflation

several years ahead, which would be very challenging at any time but particularly challenging in the current economic climate where inflation is volatile due to the recession, banking crisis and resultant substantial quantitative easing programme.

If this proposal were to be implemented it would increase Network Rail's risk exposure and undermine regulatory certainty. Therefore, it would be important that this was reflected in our cost of capital, the debt/RAB headroom and the approach to financial sustainability.

Lack of Incentive Properties

We strongly consider that if ORR applies an *ex ante* inflation assumption when determining our revenue requirement it would not strengthen the incentives that we face to manage our costs. Like all other regulated companies, we have a natural incentive to outperform our efficiency targets. If we are able to keep input cost changes below the UK general inflation level this will contribute to us meeting and hopefully outperforming the efficiency challenge set by ORR.

However, even if one accepts that there is an incentive effect from setting an *ex ante* inflation assumption, it would appear to really matter whether ORR's assumption turns out to be above or below outturn inflation. One could argue that if outturn inflation is lower than that assumed by ORR, it would blunt the incentive that Network Rail faces to manage input cost changes. To the extent that the opposite is the case when inflation is high, there could be unintended consequences in terms of unsustainable cost reductions since we are already incentivised to achieve sustainable efficiencies.

Impact on customers

We consider that ORR's proposal to log-up any difference between assumed and outturn inflation could create intergenerational issues whereby future customers pay higher charges to fund benefits enjoyed by current customers. This would be the case under either a RAB or opex memorandum adjustment in CP6 but would be more smoothed under a RAB approach.

As we explained in our presentation at ORR's September workshop, there is another potential consequence of ORR's indexation proposal. By the start of CP6, Network Rail's prices could potentially be some way adrift from being cost reflective. To the extent that ORR's indexation assessment is different from outturn inflation, there will be a 'gap' between prices and our cost base. At the start of CP6 this gap will need to be addressed. This could result in a potentially significant price increase or decrease for customers. This effect is over and above the effect already described whereby any under or over-recovered CP5 revenue would need to be addressed in subsequent control periods.

We note that one way of mitigating against the creation of intergenerational issues and a ‘gap’ between costs and prices would be to limit the application of ORR’s *ex ante* inflation assumption to the network grant and fixed track access charges and continue to index other charges by RPI. This would have the benefit of providing DfT and Transport Scotland with budgetary certainty whilst still maintaining the link between other access charges and our cost base. It would also reduce Network Rail’s exposure to financial risk within CP5.

Impact on debt/RAB and financial sustainability

The potential impact of ORR’s proposal is contingent on the extent to which outturn inflation diverges from ORR’s *ex ante* inflation forecast. If ORR’s assumption is perfectly aligned to outturn inflation there would be no impact on Network Rail’s finances. However, as Oxera note, under a realistic possibility that outturn inflation is 2% higher than ORR’s assessment each year, the total impact on cash flows over the period could be equivalent to as much as 3% on debt/RAB. If the 2% deviation in outturn inflation is higher than ORR’s indexation allowance, the additional debt that we would incur in order to meet this exposure would have to be serviced in future control periods, increasing our future funding requirement. We note comments by ORR at its September workshop that it would be likely to add any under-recovered revenue to CP6 allowed revenues by way of the opex memorandum account, which could reduce the net risk on the company.

Network Rail welcomes the fact that ORR recognises changing the way it indexes allowed revenues will increase our financial risk and that it would need to take account of this when determining its policies elsewhere in the financial framework, for example, the restriction on the level of financial indebtedness and the treatment of financial sustainability[1]. We respond in more detail on what we consider to be an appropriate restriction on the level of financial indebtedness in response to question 3.5, below.

Deadband

We believe that ORR’s proposal to place a deadband around its *ex ante* inflation assumption (beyond which ORR would assess if the variances were material enough to re-open the price control) is too complex. It also appears inconsistent with ORR’s proposal for fewer re-openers. Instead, we consider that if ORR decided to make an *ex ante* inflation assumption, a better approach would be for ORR to incorporate sufficient debt/RAB headroom in the periodic review settlement and commit to an automatic adjustment in CP6. This approach would provide greater regulatory certainty. We consider that there should be no deadband based on the difference between outturn inflation and ORR’s *ex ante* inflation assumption.

[1] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.22

As stated above, this could still potentially blunt Network Rail's efficiency incentives within CP5 and create intergenerational inequities. However, it would avoid unnecessary complexity and other potentially unintended or perverse consequences.

Efficiency adjustment

We note that ORR states that any difference between its assumed level of inflation (including input price inflation) and actual inflation (including input price inflation), that it thinks is efficient, could be logged up to CP6[2]. It is not clear to us from the consultation document how ORR would assess whether the variance between actual inflation and its *ex ante* assessment is efficient. We consider that separately identifying the impact of actual inflation from the many other factors that affect costs would be extremely difficult to carry out objectively. Moreover, it places ORR in the position of having to second guess detailed management decisions and trade-offs. We believe that because inflation is beyond our control (but we are already incentivised to manage the impact of inflation on our costs), any variance between assumed and actual inflation should not be subject to an *ex post* efficiency assessment. We believe that a better approach would be to have a simple, automatic mechanism for logging up/down variances. This would avoid introducing further complexity and uncertainty into the regulatory regime, remove the subjectivity associated with an *ex post* efficiency assessment and the associated transaction costs.

ORR's September Workshop

At ORR's recent industry workshop on its Financial Issues consultation, some stakeholders commented that in unregulated sectors companies would seek to reduce their costs rather than pass on their input inflation into prices that they charge their customers. This clearly cannot always be the case otherwise there would be no inflation in the UK. In addition, we would point out that the way in which companies cut costs is often to reduce their outputs. For example, if a retail chain experienced increased input costs it may decide to close some of its stores. Network Rail is constrained by its regulatory commitments to fixed outputs. We cannot reduce the number of trains that run on our network or close stations or branch lines as a way of reducing our costs. If we are able to achieve real efficiencies we should do so regardless of whether inflation happens to be above or below some forecast at an arbitrary point in time.

We also note that passenger train operators are themselves protected from the effects of inflation in the way that their annual fare adjustments are agreed as part of their franchise contracts. Annual regulated fare changes are linked to RPI.

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[2] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.19 (c)

Treatment for the RAB

We welcome ORR's proposal to continue to adjust Network Rail's RAB by actual movements in general inflation in order to avoid eroding the real value of the regulatory asset base.

Indexation of Renewals

As set out in our response to ORR's May 2011 consultation, we acknowledge the theoretical rationale for using IOPI to index our renewal costs. In practice, however, we have found it to be volatile, difficult to forecast and an inaccurate reflection of our costs, which has resulted in planning uncertainty. We consider a better approach would be to index our costs using RPI. We believe that this would result in greater planning certainty, which is very important for the business. However, if that RPI indexation were to be based on an *ex ante* assumption we would need to revisit whether some form of input price protection is required.

Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?

In our response to ORR's consultation on incentives we stated that we strongly considered that we would need some form of risk buffer in CP5 to help us manage the business risks that we face. However, we also stated that we were open to considering different types of risk buffer such as a balance sheet risk buffer. We noted that in the absence of a risk buffer we would not be able to adopt a whole-life approach and longer term costs would almost certainly increase.

Whilst we consider that there are good reasons for retaining an in-year risk buffer, for example, for financial sustainability reasons. We note that, at present, government finances are highly constrained and, therefore, not providing Network Rail with an in-year risk buffer will be attractive to funders because, in the short term, it would result in a lower funding requirement.

We are content to manage any adverse risks 'crystallising' using a balance sheet risk buffer rather than an in-year P&L risk buffer. However, it is vital that we are provided with sufficient balance sheet headroom to borrow additional funds should business risks materialise. The absence of an in-year risk buffer and sufficient balance sheet headroom would increase the likelihood of ORR having to re-open its determination in order to address any unexpected 'cost shocks'. We consider that it would be more appropriate for Network Rail to manage any 'cost shocks' through a suitable risk buffer, rather than ORR addressing them through re-opening its determination. If ORR had to re-open its determination in this situation it would undermine the need for Network Rail to be focussed on addressing the commercial issues.

Early this summer we shared with ORR analysis of our CP5 risk exposure[3] and the additional balance sheet headroom required to manage our business risks. The analysis indicated that any debt/RAB limit should be set at least 2-3 percentage points higher than that implied by Network Rail hitting its CP5 financial performance targets on average. We consider this to be a minimum based on specific identifiable risks under normal circumstances. This analysis did not consider the additional risk that would be imported if ORR adopted an *ex ante* inflation approach, as it now proposes. We discuss what we consider to be an appropriate restriction on the financial indebtedness, taking into account the accumulative risks that we face, in response to question 3.5, below.

P&L Sustainability

It also appears to us that that this proposal, like most of ORR's other proposals, centre on the financing effects on Network Rail. To some extent this is understandable as the ability to raise finance is a very important issue for companies. However, in order to maintain the credibility of the regulatory regime and for investors in Network Rail's debt to have confidence in the company, there is a need to be mindful of the P&L impact of ORR's policies. Whilst Network Rail is currently somewhat sheltered from the full vagaries of the financial markets by the government backed indemnity, the company retains the long-term ambition of raising risk capital unsupported by this indemnity. We understand that ORR supports the company's ambitions in this respect.

In order to be in a position to generate interest in raising unsupported debt, Network Rail will need to demonstrate that it is a credible entity that it is capable of generating sustainable profits and cash flow.

Seen in the round, ORR's current package of proposals would be likely to leave Network Rail, on central PR13 projections, generating little or no cash flow from operating activities during CP5. ORR's proposals would also leave the company's P&L with very little headroom to absorb the impact of cost variability and we would contend that any investors in Network Rail could consider it to be insufficiently profitable to justify investing in the company. We consider that investors in Network Rail would demand a profitability cushion. In addition, Network Rail is to be exposed to significant levels of incremental risk at least in part beyond its control, which could result in losses within the P&L and negative operating cash flows.

Irrespective of whether Network Rail seeks to raise unsupported debt in CP5, we consider that the company's profitability needs to be sustainable and provide sufficient headroom to absorb potential adverse outcomes. ORR has stated that it does not consider that Network Rail should have an in-year P&L risk buffer in CP5, but should instead borrow more money if risks crystallise during the control period. Stakeholders should be clear that if this situation comes about Network

[3] CP5 risk buffer analysis paper

Rail could make substantial and sustained P&L losses during CP5. We consider that this could seriously undermine the credibility of the company and of the regulatory regime for CP5 and beyond.

For the avoidance of doubt, we consider that if Network Rail were to raise unsupported debt in CP5 it would require an in-year P&L risk buffer in order to satisfy the cash flow coverage ratios required by rating agencies. We note that although ORR links the proposed removal of the in-year risk buffer to the fact that Network Rail is unlikely to issue unsupported debt in CP5, it is not clear what ORR would do as and when unsupported debt / risk capital is introduced.

We believe that it is also important to be transparent about the fact that although not providing Network Rail with an in-year risk buffer will result in a lower funding requirement in the short term, any additional funds borrowed to meet adverse risks materialising will have to be financed in future control periods. This will increase the overall level of future funding. However, we recognise that this is at least partially offset by the proposed approach to amortisation.

Contingency

ORR states that it will review the appropriate amount of contingency that it should include in its estimates of enhancement costs and that it is investigating the extent to which Network Rail includes contingency in maintenance and renewals unit costs in its business planning[4]. For enhancements, our spot estimates of early GRIP stage projects are uplifted to reflect the expected increases in anticipated final costs throughout the life cycle of projects (for example increases in scope). Our approach is consistent with DfT's Webtag requirements. For projects in later stages of development, the anticipated final costs contain quantitative risk assessments designed to increase the accuracy of our project cost forecasting. For maintenance and renewal our forecasts are based on expected costs and we do not include any additional overlay for contingency or risk. It is essential that sufficient contingency is included in project costs and that the approach to the financial framework reinforces the criticality of this issue.

Q3.3: What are your views on our proposal to simplify the mechanism to re-open Network Rail's access charges review by removing some of the specific re-openers?

Network Rail supports the inclusion of re-openers in the access charges review as a means of managing material unforeseen risks materialising. Furthermore, it is content with ORR's proposal to simplify the mechanism to re-open the review by removing some of the specific re-openers. Network Rail notes, however, that ORR's proposal to reduce the number of re-openers increases its exposure to

[4] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.35

financial risk, which should be reflected in its cost of capital. Furthermore, Network Rail considers that the exclusion of the AICR re-opener should at least be capable of being reversed, during the control period, if Network Rail seeks to issue unsupported debt. In this context we suggest that there is merit in reforming this provision since there is no material downside in doing so.

Scottish re-opener

Network Rail is content with ORR's proposal to retain a specific re-opener for expenditure in Scotland, recognising that an issue that might be material in Scotland may not be material for Network Rail as a whole.

Simplicity

As stated above, we believe that ORR's proposal to include a deadband around its *ex ante* inflation forecast is likely to be too complex and is also inconsistent with this proposal to simplify re-opener mechanisms. In order to provide certainty for the industry and facilitate Network Rail adopting a whole-life approach to managing longer term costs we would reiterate the importance of providing us with sufficient balance sheet headroom to manage business risks. We consider that, in the first instance, this headroom should be used to manage any unforeseen business risks that materialise, not a re-opener.

Reversibility

Rather than incorporating a specific re-opener in relation to industry reform we consider that ORR's unconventional regulatory approaches (such as adjusted WACC and *ex ante* inflation assessments) should be readily reversible in the event that reforms such as unsupported debt or concessions are taken forward. Furthermore, we believe that on exiting CP5, Network Rail's regulatory framework should return to the conventional model.

Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?

Traction electricity

In respect of traction electricity ORR states that:

- It will expose Network Rail to some of the costs associated with transmission losses, reflecting its ability to control these costs[5];
- It will determine an efficient level of costs and set an *ex-ante* allowance with the risk of the outturn, on those aspects of the cost such as

[5] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.54

transmission losses that are controllable by Network Rail, being different taken by Network Rail[6];

- Metered train operators will be billed on the basis of consumption, with a mark-up based on a challenging but achievable level of losses[7];

- It will allocate the year-end volume wash-up between unmetered services and Network Rail, to reflect its respective ability to manage the risk[8];

- Network Rail's own use of traction electricity will be treated as a controllable cost[9]; and

- It will include costs sufficiently controllable by Network Rail in efficiency and performance assessments in CP5[10]

Network Rail is broadly content with ORR's proposals in respect of the framework of incentives for traction electricity costs and charges in CP5.

Network Rail is currently consulting on the actual level of AC losses[11], and plans to consult on DC losses later this year. In principle, ORR's proposal to allow Network Rail to recover a challenging but achievable level of losses is reasonable. We are keen to work closely with ORR to determine how this may be set, using evidence-based targets.

Network Rail and the industry will require more detail in respect of ORR's proposals to adjust the way in which volume wash-up risk should be allocated in CP5 in order to be able to consider ORR's proposals appropriately.

Network Rail supports the proposal for its own use of traction electricity to be treated as a controllable cost.

BT Police and RSSB costs

In respect of BT Police and RSSB costs, ORR proposes determining an efficient level for Network Rail's share of these costs and setting an *ex ante* allowance with Network Rail being exposed to the risk of the outturn being different[12]. This is consistent with the current approach.

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[6] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[7] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[8] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[9] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.56
[10] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.57
[11] This consultation closes on 12 October 2012, and is available to download here: http://www.networkrail.co.uk/PeriodicReview2013.aspx
[12] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.58

ORR also states that one way of increasing the incentive on Network Rail would be to expose it to the whole costs of BT Police and RSSB, rather than just its share of these costs. This would be achieved by 'gearing' Network Rail's exposure to these costs, whereby if outturn costs were different to ORR's allowance, Network Rail would be exposed to 100% of the difference.

Network Rail does not consider that it was appropriate for ORR to expose it to variances in BT Police and RSSB costs in CP4 and, therefore, strongly believes that it should not be exposed to variances in these costs in CP5. We do not consider that because we have one director on the respective boards that we are able to exercise influence to an extent that these costs should be included in any efficiency or performance assessment in CP5. Our limited ability to influence these costs means that ORR's decision to expose us to them has negligible incentive properties and increases our exposure to what is largely an uncontrollable cost.

We consider that these costs are very different from controllable support costs and thus should be treated differently. We strongly consider that a better and more equitable approach would be to treat them in the same way that ORR proposes treating the ORR licence fee and safety levy. Network Rail would still use its influence over the level of costs and it would still need to manage the financial consequences of any variations.

Given we do not consider that we have sufficient influence such that we should be exposed to variances in BT Police and RSSB costs, we strongly consider that we should not be exposed to the total of these costs rather than our own share. Increasing the incentive strength in respect of cost categories that we have a very limited ability to influence would only serve to further increase our risk exposure, resulting in higher/lower windfall gains/losses.

We also note that the Network Rail director on the BT Police and RSSB boards has a legal obligation to these organisations when he works in these capacities. This duty would conflict with ORR's view that they should use their influence to Network Rail's advantage. Clearly we would exert our influence as a customer and to improve efficiency but that is a different matter which should not be confused with governance roles.

In summary, we consider that continuing to expose Network Rail to its share (or a higher share) of BT Police and RSSB costs represents an inequitable transfer of risk to Network Rail that could reduce financial sustainability. We also consider that ORR's policy should be reflected in our cost of capital.

Licence Fee and Safety Levy

Network Rail supports ORR's proposal not to expose it to variances in the ORR licence fee and safety levy[13]. ORR correctly identifies that these costs are not controllable by Network Rail and thus any variance between forecast and outturn costs should be logged up/down in the next control period. As stated above, we believe that BT Police and RSSB costs should be treated in the same way. We also consider that the costs of the independent reporters should be treated in the same way as the licence fee and safety levy.

Business Rates

Network Rail supports ORR's proposal not to expose it to variations in business rates, subject to Network Rail being able to show that it has negotiated efficiently with the Valuation Office Agency (VOA)[14]. However, this should not put ORR in a position of having to second guess management decisions and trade-offs.

We consider that ORR's current approach to assessing Network Rail's efficiency in the 2010 negotiation has the following major issues:

- The assessment of efficiency has lasted too long and thus, there should be a timetable for the resolution of the efficiency assessment in CP5 and a definition of what efficient negotiation looks like.

- In the current assessment of efficiency ORR appears to be defining efficiency as: *"Network Rail must demonstrate after the event that there was nothing it could have done that could conceivably have resulted in a better outcome"*. We have two points with regards to this:

    - This process requires us to demonstrate an efficient process occurred. External experts noting that the result of the negotiation was significantly better than a standard application of the valuation officer's approach has not been sufficient to satisfy ORR.

    - This definition of efficiency effectively equates to requiring perfection. We consider that it is possible to be a highly skilled negotiator and negotiate efficiently with the VOA without reaching perfection.

To mitigate these issues in CP5 we believe any *ex post* assessment of negotiation efficiency should be undertaken by an independent third party (e.g. an independent reporter) and that the primary focus should be on our processes.

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[13] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.62
[14] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.64

Q3.5: What are your views on our current thinking that the maximum level of financial indebtedness that Network Rail can incur should at no point exceed a limit set between 70-75% in CP5?

If ORR implements its proposal not to provide Network Rail with an in-year P&L risk buffer it would make setting the maximum level of financial indebtedness (balance sheet risk buffer) even more significant. In addition, as ORR recognises, its proposal to index allowed revenues based on an *ex ante* inflation assumption will increase Network Rail's financial risk and this would also need to be taken into account when setting the maximum level of financial indebtedness and Network Rail's cost of capital for CP5.

Our current view is that it is too early to assess the appropriate limits of Network Rail's level of financial indebtedness for CP5. This can only be considered when we have a greater understanding of ORR's approach to financial sustainability, and the approach to efficiency and investment costs which need to be considered following the submission of our Strategic Business Plan in January 2013. Prior to this, we cannot indicate whether the range proposed by ORR will be sufficient.

We have, however, performed some initial analysis in relation to this issue. As noted, above, we have already provided ORR with analysis in relation to the balance sheet headroom that we would require to manage business risk and unexpected fluctuations in cash flow in CP5 in the absence of an in-year P&L risk buffer. This analysis indicated that if a balance sheet risk buffer approach is to be pursued in CP5; the debt/RAB limit should be set at least 2-3 percentage points higher than the limit implied by Network Rail hitting its CP5 financial performance targets on average. We consider this to be a minimum based on specific identifiable risks under normal circumstances. We will update this analysis in our SBP.

This analysis did not consider the significant uncertainty associated with enhancements. However, we note that the substantial uncertainty associated with early-stage HLOS schemes, which amount to c. £4bn, reinforces the need for a reasonable amount of balance sheet headroom. The analysis also did not consider the impact of ORR's new proposal to index allowed revenues based on an *ex ante* inflation assumption because ORR only made this proposal clear in August 2012. These indicate a number of potential reasons why the level of financial headroom needs to be higher than that which would arise from the removal of the P&L risk buffer alone.

Considering ORR's proposals more generally, including the proposals not to provide Network Rail with an in-year P&L risk buffer and apply an *ex ante* inflation assumption in the round, our initial view is that the debt/RAB limit should be set at least 5-6% higher than the limit implied by Network Rail hitting its CP5 financial performance targets on average. We will revaluate this view following

confirmation of ORR's decisions on risk and uncertainty and in the context of ORR's approach to efficiency and investment, and would not expect ORR to come to a firm view until these issues have been subject to consultation. We note that several regulated utilities in the water sector have a debt/RAB ratio in excess of 75%.

Innovation

If we are not provided with sufficient balance sheet headroom it could result in the company adopting a more conservative approach to innovation and thus result in fewer initiatives to improve efficiency. Network Rail welcomes the innovation funding provided for in the HLOS / SOFAs and considers that much more needs to be done in this area to provide for a sustainable level of research and development expenditure in the railway. We, therefore, intend to develop proposals in conjunction with RDG to address this issue.

2. Cost of capital issues

ORR's key messages

- ORR considers that its proposals will help to deliver its key transformational goals, especially having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money and improving transparency.
- ORR decided in its May 2012 document, that the cost of capital that it allows Network Rail will reflect the risk profile of the company. However, ORR have decided that it will only allow Network Rail to recover ORR's forecast of its efficient financing costs in charges levied reflecting that it does not pay dividends and is financed by government backed debt.
- If there were a significant change in the industry affecting Network Rail (e.g. if the company were to let a concession), ORR would evaluate the consequences with Network Rail, DfT, Transport Scotland and other stakeholders and if the changes are not material ORR considers it could log up/down the effect of the initiative on Network Rail and adjust Network Rail's allowed revenue, and if appropriate, its RAB for CP6. If the initiative has a material effect on Network Rail then ORR could re-open the price control.
- ORR is proposing to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail benefits from.
- ORR is proposing to take account of the impact of embedded debt in its forecast of efficient financing costs.
- ORR will identify the risks that Network Rail faces as part of its report on Network Rail's cost of capital for its draft determinations.

- ORR intends to roll forward the debt assumption used in CP4 for efficient movements in debt.
- ORR will assess financial sustainability 'in-the-round' and has set out its initial view of the financial indicators that it will use in PR13.

Response to consultation questions

Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?

We welcome the statement from ORR that, as a general principle, it supports preserving the option of introducing risk capital into Network Rail[15]. In considering how we will finance our activities, Network Rail continues to be positive about the benefits of introducing risk capital and considers that it should be regulated in a way that preserves the options for changes to its financial structure.

Reversibility

ORR notes that in an extreme case, where all of Network Rail's business was sold to another party, which is conventionally funded by unsupported debt and equity, then it would unwind the effects of the adjusted WACC approach[16]. Network Rail welcomes this statement and considers that ORR's adjusted WACC approach should be readily reversible back to the more conventional full WACC. In addition to the extreme case highlighted by ORR, we consider that this reversal will be necessary if Network Rail were to issue unsupported debt or concession part of its infrastructure in CP5.

We believe that the approach to unwinding the adjusted WACC should be mechanistic and set-out as part of ORR's CP5 determination. This would provide certainty and avoid undue complexity. We would welcome further discussion with ORR in relation to this issue.

Alternative Approach

ORR considers an alternative approach where, if the industry reform is not material, it could log up/down the effect of the change on Network Rail and adjust Network Rail's allowed revenue, and if appropriate, its RAB for CP6[17]. If the initiative has a material effect on Network Rail, ORR states that it could re-open the price control. Network Rail does not support this alternative approach due to its complexity and the uncertainty it would create for both Network Rail and potential investors.

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[15] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.8
[16] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.13
[17] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.14

Q4.2: What are your views on our proposal to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail is provided with?

Network Rail is content with ORR's proposal to set the FIM fee based on a long-run view of the credit enhancement that Network Rail is provided with. We consider that the FIM fee should be based on the long-run average maturity of debt issued.

The range, 78 to 129 basis points, which ORR assumed in its Advice to Ministers document in relation to the FIM fee, appears reasonable.

As set out in our response to ORR's consultation on incentives, we consider that there would be merit in the FIM fee (and the equity surplus under the adjusted WACC approach) being paid direct to HM Treasury, rather than the DfT. This would avoid potentially unduly influencing DfT policies due to it being in receipt of these sums.

Q4.3: What are your views on our proposal to take account of the cost of embedded debt in our forecast of efficient financing costs?

We welcome the fact that ORR recognises that Network Rail is best placed to manage its financing costs because it understands the risks and how to finance those risks better than other stakeholders[18]. We also welcome the fact that ORR proposes to fully take into account the cost of embedded debt[19]. We consider that if ORR did not fully take into account our embedded debt costs it would unfairly penalise us for reasonable historic financing decisions. We note, however, that ORR states that it will only allow embedded debt costs to be included in its PR13 determination for CP5, where they can be shown to have been incurred efficiently[20]. It is not clear to us how we can demonstrate that these financing costs have been incurred efficiently. We would welcome ORR setting out how it would make such an assessment.

Network Rail is content with ORR's suggestion[21] that it is not necessary to consider other ways of reducing the interest rate risk that Network Rail faces, for example through indexing movements in the risk free rate, due to complexity that this would introduce.

[18] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.20
[19] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.23
[20] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 32
[21] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.25

Q4.4: What are your views on how we are proposing to assess financial sustainability?

ORR notes that when considering the long-term financial sustainability of Network Rail one should consider the following questions, in particular[22]:

- Is the level of debt appropriate for a company such as Network Rail?
- Can the debt be re-financed when appropriate and serviced efficiently?

We consider that Network Rail's CP5 forecast debt levels are entirely appropriate and sustainable as long as the regulatory regime remains consistent and robust. The regulatory asset base effectively provides for our revenues to be set such that our sunk costs can be recovered from remaining access charges.

We consider that our investment costs should be considered over a suitable long-run period in order to ensure that they are financeable over the useful life of the network's assets.

However, whilst total debt levels may be sustainable relative to the RAB we would want to be assured that we would be in a position to efficiently service our debt from current earnings in CP5. ORR recognised in CP4 the importance of maintaining interest cover ratios (e.g. AICR) as well as balance sheet ratios, and whilst the debt/RAB headroom and FIM may provide financial headroom within CP5, we consider that it is important that ORR continue to take account of ongoing service cover ratios as well as balance sheet ratios to ensure that Network Rail remains financially sustainable for the longer-term beyond CP5.

We note that ORR's policy decisions (e.g. to apply an adjusted WACC) and proposals (e.g. removing the in-year P&L risk buffer) would result in higher absolute debt levels and a less favourable debt/RAB ratio than if there was a continuation of the CP4 approach in CP5. In addition, ORR's proposal to apply an *ex ante* inflation assumption increases Network Rail's financial risk and could result in higher financing costs and / or difficulties if Network Rail were to attempt to issue unsupported debt. It is also important to note that although ORR's policy decisions/proposals result in a lower funding requirement in the short term, the total amount of money required by Network Rail in CP5 will remain unchanged and it will, therefore, have to borrow additional funds to meet this requirement, increasing the overall level of funding in future control periods.

Currently Network Rail can refinance its debt as and when appropriate, however, if there was a downgrade in the UK's credit rating then ORR's approach could impact on the cost of refinancing. In addition, if Network Rail's profitability is adversely impacted by ORR's CP5 determination then its cost of borrowing could

[22] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.53 (b)

potentially increase as investors could potentially deem the company to be more reliant on government backing.

Financial Indicators

Network Rail is content with ORR's initial view[23] that the financial indicators used in PR08 remain suitable for PR13. Assessing our gearing based on the debt/RAB ratio is consistent and comparable with other regulated utilities. We also consider that the other coverage ratios highlighted by ORR remain important in ensuring longer-term financial sustainability, and await ORR's detailed proposals as to how the different ratios will be assessed.

P&L Sustainability

As stated above, it appears that most of ORR's proposals centre on the financing effects on Network Rail and to some extent this is understandable as the ability to raise finance is a very important issue for companies. However, in order to maintain the credibility of the regulatory regime and for investors in Network Rail's debt to have confidence in the company, there is a need to be mindful of the P&L impact of ORR's policies. Whilst Network Rail is currently somewhat sheltered from the full vagaries of the financial markets by the government backed indemnity, the company retains the long-term ambition of raising risk capital unsupported by this indemnity. We understand that ORR supports the company's ambitions in this respect.

In order to be in a position to generate interest in raising unsupported debt, Network Rail will need to demonstrate that it is a credible entity that it is capable of generating sustainable profits and cash flow.

Seen in the round, ORR's current package of proposals would be likely to leave Network Rail, on central PR13 projections, generating little or no cash flow from operating activities during CP5. ORR's proposals would also leave the company's P&L with very little headroom to absorb the impact of cost variability and we would contend that any investors in Network Rail could consider it to be insufficiently profitable to justify investing in the company. We consider that investors in Network Rail would demand a profitability cushion. In addition, Network Rail is to be exposed to significant levels of incremental risk at least in part beyond its control, which could result in losses within the P&L and negative operating cash flows.

Irrespective of whether Network Rail seeks to raise unsupported debt in CP5, we consider that the company's profitability needs to be sustainable and provide sufficient headroom to absorb potential adverse outcomes. ORR has stated that it does not consider that Network Rail should have an in-year P&L risk buffer in CP5, but should instead borrow more money if risks crystallise during the control

[23] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.58

period. Stakeholders should be clear that if this situation comes about Network Rail could make substantial and sustained P&L losses during CP5. We consider that this could seriously undermine the credibility of the company and of the regulatory regime for CP5 and beyond.

For the avoidance of doubt, we consider that if Network Rail were to raise unsupported debt in CP5 it would require an in-year P&L risk buffer in order to satisfy the cash flow coverage ratios required by rating agencies.

Q4.5: What are your views on our proposal to keep the introduction of the adjusted WACC approach as simple and transparent as possible by calculating efficient financing costs on a cash basis and by taking the normal regulatory approach to indexing the whole of the RAB?

ORR discusses two different approaches to implementing the adjusted WACC approach in its 'purest' form.

The first suggests that ORR could not index the part of the RAB that is associated with nominal debt. We consider that this would have the effect of permanently reducing the enterprise value of the company. We consider that this would not only be inconsistent with regulatory precedent but would also extend the adjusted WACC approach beyond CP5. Our understanding is that ORR's intention is to adopt the adjusted WACC approach for CP5 only in recognition of exceptionally constrained government finances.

The second ORR approach would be to only fund Network Rail's cash interest costs excluding the inflation component of financing costs on nominal debt. As ORR highlights itself, if it implements this approach there could be significant financial sustainability issues that would need addressing in some other way.

We, therefore, agree with ORR's proposal to calculate efficient financing costs on a cash basis and take the normal regulatory approach to indexing the whole of the RAB. Unless there is strong reason for doing otherwise Network Rail should continue to be regulated in the same way as any other normal company.

However, we do not agree with ORR's characterisation of indexing our nominal debt as *"compensating [the company] twice".* ORR's decision to not provide us with the funding associated with the equity component of our cost of capital means that we will be funded significantly less than would be the case under the conventional regulatory approach. Given the extent to which the adjusted WACC approach reduces the company's funding, it seems inappropriate to characterise this approach as 'over compensation'.

Other remarks

Treatment in CP6

We consider that as part of its final determination ORR should provide a firm commitment or presumption that it would fund Network Rail based on the conventional full WACC in CP6, rather than an adjusted WACC. This would provide early certainty in relation to the level of our future funding and represent a commitment to a more financially sustainable approach

As stated above, Network Rail welcomes the fact that ORR recognises[24] that if its entire business was sold to another party that is conventionally funded by unsupported debt and equity, then it would be appropriate to unwind the effects of the adjusted WACC approach.

Non-HLOS investment schemes

We welcome the statement[25] from ORR that the full cost of capital will continue to be used in the investment framework for calculating the financing costs of non-HLOS investment schemes.

Semi-annual approach

ORR considers that it should continue using the semi-annual approach to calculate Network Rail's forecast of efficient financing costs, as it appropriately adjusts for the timing of cash flows[26]. ORR also states that for its draft and final determinations it will look closely at Network Rail's phasing of its cash flows in its SBP and it will not simply assume that Network Rail's cash flows should be spread evenly through the five-year control period or spread evenly during a year. Hence, although ORR is proposing to retain the semi-annual approach, it may amend the calculation if it considers that the phasing of cash flows materially affects its forecast of efficient financing costs[27].

Network Rail is content with ORR's proposal to retain and potentially amend the semi-annual approach to calculating efficient financing costs but would not want to introduce undue complexity into the forecasting process.

Split Cost of Capital

ORR states that any advantage that a split cost of capital could offer in terms of preventing arbitrage of the WACC (effectively by increasing gearing while continuing to earn a cost of capital that reflects a split between debt and equity)

[24] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.13
[25] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.7(a)
[26] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.39
[27] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.40

is not relevant at the moment for Network Rail[28]. Network Rail considers that although there could have been a way of creating a concept of 'historic assets' and 'new assets', with different risk levels for each, on balance, a split cost of capital approach would be too complicated. For the longer term, Network Rail remains of the view that it maybe appropriate to consider a RAB buy-back which could have a similar impact to a split cost of capital.

3. Amortisation and RAB related issues

ORR's key messages

- ORR considers that its proposals will help to deliver its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.
- ORR is consulting on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation.
- ORR is proposing to largely keep the overall approach to the RAB roll-forward the same as in PR08 but believes that there are some issues that it needs to consider such as: it is minded not to index renewals for changes in input prices and it is considering how to take account of the difficulty that it has experienced in CP4 in confirming that renewals underspends have been efficient.
- ORR states that the investment framework will continue to fund investments that customers and funders want Network Rail to undertake outside of the periodic review process.
- ORR states that as it decided in PR08, it will only allow capex to be added to the RAB and is proposing to keep using the opex memorandum account.

Response to consultation questions

Q5.1: What are your views on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation?

Reactive maintenance

ORR is considering whether reactive maintenance costs should be remunerated in the year concerned (i.e. for the purpose of calculating the revenue requirement treating them in the same way as operating and other maintenance costs). It

[28] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.27

considers that this would improve transparency as Network Rail currently accounts for reactive maintenance costs as operating costs in its statutory accounts and capital expenditure (renewals) in its regulatory accounts (to be consistent with ORR's PR08 determination). This means that at the moment Network Rail needs to provide a reconciliation of maintenance and renewals costs between its statutory and regulatory accounts[29].

Network Rail considers that it is not appropriate, at this stage, to remunerate reactive maintenance costs in the year concerned for the following reasons:

- we are continuing to improve our understanding of civils assets and the optimum asset policies. It is, therefore, possible that there could be a significant increase in preventative maintenance which would impact our funding requirement in CP5;

- it is likely that there will continue to be differences between financial and regulatory accounts and, therefore, making an adjustment in respect of reactive maintenance is unlikely to result in alignment; and

- the regulatory treatment reflects how we currently manage civils expenditure.

Amortisation

ORR states that given the adjusted WACC approach and the associated adjustment to amortisation for financial sustainability reasons, Network Rail's revenue requirement is unlikely to be affected by the way it calculates average long-run renewals. However, ORR considers that it is still important to make an appropriate calculation of long-run renewals as it wants to present charges before and after the adjusted WACC approach[30]. ORR believes that the main issues it needs to consider when calculating average long-run steady state renewals are[31]:

- whether the amortisation charge should take account of the scope for future efficiency improvement after CP5; and

- the period of time that should be used as a proxy for the long-run period (ORR proposes a 30-year period from 2014/15).

Network Rail agrees that the calculation of long-run steady state renewals continues to be important. It also agrees that it is important to present charges before and after the adjusted WACC adjustments. We consider that this will provide transparency in respect of our overall revenue requirement, including the

[29] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 517
[30] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.19
[31] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.20

funding associated with the equity element of our WACC. Only presenting access charges net of the adjusted WACC adjustment would understate our revenue requirement and not fully reflect the risks that we face as a business. Being transparent will also make it easier to understand the longer-term framework when the adjusted WACC approach ceases to apply. However, it is not clear to us that the unadjusted charges should necessarily be based on a different approach to amortisation.

Network Rail agrees that it is appropriate to take into account future scope and frontier shift efficiency in the amortisation calculation, but notes the challenges associated with estimating efficiency improvements. Furthermore, we consider that the more costs that are not funded during the control period in which they fall due, the more debt that we will have to incur to meet this financial exposure. This additional borrowing will reduce financial sustainability and result in higher charges in future control periods, potentially causing intergenerational issues.

We note that in PR08, and for the IIP, the amortisation calculation was based on a 35-year period. Our initial analysis indicates that the difference between basing the amortisation calculation on a 30-year period rather than a 35-year one is negligible. However, we would welcome further discussion with ORR in relation to why it is proposing to amend the calculation.

Network Rail supports an amortisation adjustment in CP5 to improve the company's financial sustainability. The level of the adjustment will depend on other financial assumptions in ORR's determination and we will continue to engage with ORR in relation to this issue.

Q5.2: What are your views on our proposal not to index renewals for changes in input prices and how should we take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient?

As noted in our response to Q3.1, above, while we acknowledge the theoretical rationale for using IOPI, in practice we have found it to be volatile, difficult to forecast and an inaccurate reflection of changes in our costs, which has resulted in planning uncertainty. We consider a better approach would be to index our costs using RPI. We believe that this would result in greater planning certainty, which is very important for the business. However, if that RPI indexation were to be based on an *ex ante* assumption we would need to revisit whether some form of input price protection is required.

We note that there is currently a broader discussion ongoing with ORR in relation to measuring financial performance in CP5. We consider that, in order to avoid some of the difficulties experienced in CP4, it is important that any new approach in CP5 is simple to understand and explain. There are a range of factors that have an impact on measuring financial performance and we do not consider that

it is sensible to isolate just one of these, input prices. However, we believe that the approach to assessing the efficiency of renewals underspend could be improved by distinguishing between ‘investment’ (non-railway infrastructure such as IT systems) and ‘renewals’ (railway infrastructure such as track renewals).

Q5.3: What are your views about legacy debt and RAB?

Network Rail supports ORR’s view that there could be a value for money case for a ‘RAB clean-up’ where government would pay down the part of Network Rail’s debt which relates to historic non-capex additions to the RAB. In turn, ORR would make a corresponding RAB adjustment reducing the future funding requirement. We are, however, mindful of the fact that this is ultimately a decision for government and that its finances are highly constrained at present.

Q5.4: What are your views on our proposal to keep using the opex memorandum account?

Network Rail supports retaining the opex memorandum account in CP5 in order to avoid distorting the value of the RAB.

ORR is proposing to release its forecast of the value of the opex memorandum account at 31 March 2014, evenly over CP5, in order to smooth the effect on charges. ORR also considers that any difference between the forecast position at 31 March 2014 and the outturn on this account should be adjusted for in CP6, in the same way that other variances between the outturn position in 2013/14 and its PR13 assumption will be adjusted for[32]. Network Rail is content with ORR’s proposed treatment of the opex memorandum account but notes that the capitalised financing cost is not taken into account.

Other remarks

Network Rail considers that the current RAB roll-forward process is complex and not well understood and thus we support simplifying it in CP5, where possible. We have commented on the specific areas identified by ORR for potential refinement, below[33]:

- Network Rail supports ORR’s proposal[34], where possible, to treat enhancement overspends in England & Wales and Scotland consistently.

- Network Rail supports the consistent treatment of renewals and enhancements and, therefore, considers that the enhancements deadband should be removed. This would mean that we are exposed to 25% of any enhancements overspend (that is not manifestly inefficient)

[32] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.38
[33] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35
[34] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35(c)

but do not bear the first £50m of enhancements overspend. However, we recognise that there are inherent differences between these two cost categories, for example, costing enhancements is intrinsically more uncertain. We also note that, in practice, projects often comprise both renewals and enhancements and we deliver these projects as a single programme.

- Network Rail does not consider that the RAB policy should distinguish between unit cost and scope variances because this introduces unnecessary complexity and places undue focus on the respective aspects of the variances when it is the aggregate number that is most relevant. We believe that the RAB roll-forward mechanism should be simple and symmetric whilst being clear on the treatment of incremental activity. Consistent with this, we do not consider that it is appropriate to have an asymmetric mechanism for logging up/down renewals (currently the inclusion of renewals overspend in the RAB is subject to an *ex post* efficiency assessment by ORR, unlike renewals underspend). We believe that a better approach would be to remove the *ex post* efficiency assessment and have a simple automatic mechanism for logging up / down renewals. This would be more equitable, reduce complexity and remove the transaction costs associated with the *ex post* efficiency assessment.

- Network Rail supports ORR's proposal[35] to improve transparency by setting out in its determination criteria for when a failure to deliver outputs or maintain the serviceability and sustainability of the network would require a RAB adjustment. The RAB should represent the value that has been achieved by the company in delivering outputs. If outputs have not been delivered the RAB should reflect that. This should also be reflected in REBS.

- We do not, however, consider it appropriate to make an adjustment to reported efficiency in relation to any failure to deliver outputs or maintain the serviceability and sustainability of the network. We consider that as long as efficiency has been appropriately calculated it will exclude any missed outputs as it is part of a balanced scorecard, including outputs.

- We also consider that in CP5 a more balanced approach should be taken than is currently the case in assessing the extent to which Network Rail has achieved its targets. We think that it cannot be right that if the company has met, say 19 out of 20 of its targets, and achieved significant efficiency that it should be deemed to have 'failed'. A balance scorecard approach would allow trade-offs to be made. Absent such trade-offs, it

[35] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35(e)

could be necessary to ‘spend’ significant sums to achieve the last output, where such expenditure could well be very poor value for money.

- Network Rail agrees that, at present, there is lack of clarity in respect of how ORR would adjust for a failure to deliver outputs or maintain the serviceability and sustainability of the network. Hence, we would support the development of further guidance in relation to how any adjustment would be quantified and the potential scale of the adjustment.

4. Corporation tax

ORR’s key messages

- ORR’s decision on the treatment of Network Rail’s corporation tax costs is unlikely to have significant financial implications for Network Rail in CP5 (as a result of its brought forward corporation tax losses and the effect of the adjusted WACC approach). But it is still important that ORR set out clearly its approach to corporation tax as the effect on corporation tax of income and expenditure decisions in CP5 will affect future control periods and can be material.
- In PR08, ORR determined the overall incentive strengths on income and expenditure on a net of tax basis and it is now consulting on whether it should retain that approach or whether another approach would be more appropriate.

Response to consultation questions

Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?

ORR considers that there are two main options for how it rolls-forward corporation tax balances from CP5 into CP6[36]:

- Take the PR08 approach which is the same approach as ORR used to roll-forward corporation tax balances from CP4 to CP5 and is consistent with its overall approach to risk and incentives, as it thinks it is appropriate that Network Rail is exposed to the net of tax effect of an underspend/overspend in income and expenditure; or

- Take a simpler approach to the roll-forward of corporation tax balances and just use its forecast of Network Rail’s efficient CP5 opening balances as the basis of its calculation of Network Rail’s efficient corporation tax payments in CP5, given that Network Rail is not forecasting to make

[36] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 6.17/6.18

significant corporation tax payments in CP5 and may not be affected by corporation tax incentives.

Network Rail generally favours taking a simpler approach to the roll-forward of corporation tax balances, where possible, but it is not clear that this is delivered by either of ORR's proposals. Before this process is determined the calculation of the regulatory estimates of tax opening balances and annual costs should be reviewed in some detail to ensure that, within reason, the calculation is as representative of tax legislation as is possible. Any differences arising solely from modelling assumptions which are incorrect or over-simplified should be identified and clarified.

Corporation tax is highly complex and technical and Network Rail considers that there would be considerable merit in simplifying the regulatory treatment of its corporation tax. We also believe that PR13 provides a suitable opportunity for such simplification. For example, ORR considers that in CP3 it 'pre-funded' Network Rail for c. £1.3bn of future corporation tax. Whilst we disagree with ORR on this point[37], if ORR confirms its previous decision we believe that the best way forward would be to wrap up all such issues into a one-off RAB adjustment at the start of CP5. This would create a more transparent and easier to understand tax position for the future.

In its consultation document, ORR makes a number of very detailed statements regarding Network Rail's corporation tax. Because of the very specialist nature of corporation tax, we intend to engage with ORR separately in relation to these issues.

5. Other financial issues

ORR's key messages

- ORR is proposing to allow part of Network Rail's income to be provided directly by the governments through network grants, which will be set ex-ante for each year of CP5, as it did in CP4.
- ORR will review the activities that Network Rail may be allowed to carry out in addition to its core business and consult on the options for its financial ring-fence in its draft determinations and conclude in its final determinations. This will help ORR to deliver its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.

[37] We wrote earlier this year setting out the reasons why we consider that ORR is mistaken with regards to its view that Network Rail has been pre-funded for future corporation tax liabilities. Our letter included a paper written by Oxera, which sets out its views on the matter.

- In its May 2012 document, ORR proposed that it will disaggregate the effect of the PR13 financial framework, (e.g. it will set out indicative interest costs for the operating routes). This is consistent with its key transformational goals, especially a more disaggregated approach – increasing transparency and access to information, facilitating greater localism, and supporting more disaggregation in the industry (for example through Network Rail devolution) will provide for a more comparative approach to regulation and a better understanding of costs, revenues and subsidy across the sector.

Response to consultation questions

Q7.1: What are your views on our proposal to allow part of Network Rail's income to be provided directly by the governments through a network grant, which will be set ex-ante for each year of CP5?

We agree with ORR that it would be preferable if all our income came from franchised train operators and other customers. However, we are sensitive to arguments for the continuation of network grants to Network Rail. We also note that investors in Network Rail bonds appear to draw comfort from the fact that we receive a large proportion of our income in direct government funding.

Network Rail, therefore, supports ORR's proposal to allow part of its income to be provided directly by the governments through a network grant. Network Rail is also content with ORR's statement that, in order to improve transparency, it will include an *ex ante* schedule of network grants for each year of CP5 in its draft and final determinations.

We support the continuation of the provision in track access contracts that automatically increases track access charges, if the governments do not pay network grants according to a pre-determined schedule, to ensure that we recover the revenue we need to finance the business.

Q7.2: What are your views on the activities that Network Rail should be allowed to carry out?

We welcome ORR's statement that it will start to discuss with stakeholders the activities that Network Rail should be permitted to carry out under the provisions of its network licence[38]. We have recently written to ORR outlining our initial views in relation to this issue and look forward to engaging further with ORR on this important enabler[39].

[38] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.27
[39] Financial ring-fence issues paper

Network Rail considers that, consistent with its move to make more of its business contestable to third parties, it should be able to compete in new areas of business where it can offer value for money services.

At present, there are several activities not considered by ORR to be permitted business (or ancillary to it) and, therefore, Network Rail has sought consent from ORR or these have been allocated as *de minimis* (often following dialogue with ORR). We believe that the majority of these activities could be considered as permitted business or ancillary to it. For example, property activities are now a core area of our expertise, the income from which directly funds railway investment, yet our engagement in this activity is still subject to a formal consent from ORR.

To date, the financial ring-fence has not prevented us from fulfilling our purpose, role and vision. However, in advance of CP5 we would like to discuss with ORR the potential for 'reclassifying' certain activities as permitted business, not least because the *de minimis* facility (at least within the current prescribed limits) may be exhausted over the course of the next control period.

As part of the discussion paper that we recently provided to ORR we set out five potential options in relation to the ring-fence licence condition. We have not yet reached any firm conclusions about the best option and would welcome further discussion with ORR.

Q7.3: What are your views on increasing the strengths of the incentives on Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination and should we consider more heavily incentivising genuine 'game changing' initiatives

ORR identifies a number of issues in relation to outperformance in the context of 'game changes'[40]:

- How does it distinguish between normal efficiency savings and outperformance?
- Should any changes to incentives be symmetrical?
- How does it improve incentives without overly complicating the reporting process?
- How does it distinguish between a 'game changer' and a normal efficiency initiative?

[40] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.43

During CP4 Network Rail identified the fact that longer term improvements would become increasingly difficult in the present business model. As a result, we decided to devolve much more accountability to a local level, to enter into alliancing arrangements with our customers, to change the way we deliver projects and to focus much more on culture change across the company. These game changers are critical for the long term but they create challenges for the short term and the business should be encouraged to make such choices.

However, Network Rail considers that the practicalities, complexities and transaction costs that would result from more heavily incentivising ‘game changers’ would significantly outweigh any potential benefits. It is also not clear to us how ORR would separately identify ‘game changers’ from other efficiency initiatives. Furthermore, if ORR’s proposal were to be implemented it could create an undue focus on developing efficiency initiatives that are ‘game changers’ to the detriment of ‘ordinary’ initiatives. Therefore, we do not support distinguishing between efficiency initiatives.

We believe that the incentive framework should, as far as reasonably possible, be simple and symmetrical. If the incentives that we face are not symmetrical (e.g. we retain a greater proportion of out performance beyond a certain threshold) the chosen benchmark is likely to become ‘too important’. The framework should also be sufficiently flexible to evolve in light of choices such as those outlined above.

Other remarks

Disaggregation

ORR states that, subject to further consultation, it envisages being in a position to undertake financially separate price controls for CP6. Therefore, in order to facilitate this in CP5 it will[41]:

- improve transparency by providing information on revenues and costs at the operating route level;
- make its assessments that underpin its calculation of Network Rail’s revenue requirement (e.g. expenditure assessments at the operating route level where possible); and
- when it is confident that its operating route assessments are robust, consider making operating route determinations of revenues, charges and outputs (e.g. operating route variable charges).

[41] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.38

We welcome increased transparency of the performance and targets for each of our Operating Routes. However, we are concerned about ORR's discussion about the future regulation of the English & Welsh routes. We have no difficulty with revenues being set separately for each route but we cannot understand why outperformance in one route should not be traded against potential underperformance in another route. This is no different to in any other group of companies and it should facilitate efficient financing. We consider that it is a mathematical certainty that any other approach would be more expensive than is currently the case. Whilst accepting that ORR's suggestions in this area would not be implemented in CP5, we would welcome further discussion as to what ORR considers the benefits of this approach would be.

ORR also states that given that Network Rail has devolved responsibility for its operations to an operating route level it will focus its disaggregation in England & Wales on the operating route level, instead of other levels of geographical separation[42]. Network Rail welcomes ORR recognising that any other form of disaggregation would run counter to how the company is managed. However, we reiterate our view that we cannot understand why outperformance in one route should not be traded against potential underperformance in another route.

In addition, ORR states that it will assess amortisation by operating route and publish its assumptions[43]. Network Rail considers that given that there are only two government funders for CP5, amortisation should be assessed at the England & Wales and Scotland level and then apportioned to operating routes.

ORR believes separate risk and uncertainty provisions, such as re-openers by operating route, are unnecessary[44]. Network Rail agrees with ORR as long as the company is permitted to manage risk and uncertainty at a company-wide level.

ORR states that it will not make separate cost of capital assumptions and financeability adjustments by operating route[45]. Network Rail agrees with this as, consistent with managing the operating routes as a portfolio, we also raise and manage debt centrally at the NRIL level.

ORR confirms that it will determine separate outputs, access charges and regulatory frameworks for Network Rail in England & Wales and in Scotland, whilst taking account of the fact that Network Rail is a single company[46]. Network Rail is content with ORR's position in this respect. However, as set out in our response to the outputs consultation, it is critical that we have the flexibility to make sensible trade-offs in the way that we deliver required outputs and that we

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[42] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.39
[43] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (a)
[44] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (b)
[45] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (c)
[46] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 9

have the flexibility to make trade-offs between different outputs, where this is the right thing to do from the point of view of the rail user and taxpayer. Moreover, given the need to maintain alignment between Network Rail and train operator outputs and to offer better value for money, we believe that it is imperative that there is a framework that allows us to make trade-offs across the routes in relation to what we deliver in CP5. We would do this by way of publishing our CP5 delivery plan, subsequent to ORR's determination.

ORR also states that improving the interfaces between the different players in the industry, for example, by facilitating alliances, efficiency benefit sharing at the route-level and bespoke arrangements where these improve whole sector working will drive greater value for money for customers and taxpayers[47]. Network Rail welcomes ORR's position on this issue. Indeed, one of our principles for CP5 concerns partnership. We consider that Network Rail and its customers/suppliers should be empowered to enter into various forms of partnerships or alliancing arrangements, which will improve value for money without undermining network benefits or scale efficiencies.

[47] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 8(c)