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Dear Richard,

Financial issues for Network Rail in CP5

This letter sets out TfL's response to the consultation. TfL is content for this response to be published.

As a major funder of rail services and infrastructure in London and the South East, TfL has a particular interest in Network Rail's financial framework. TfL's London Overground concession already operates on Network Rail's routes but early in CP5, TfL operations will expand with the start of pre-Crossrail services on the Great Eastern and Great Western Main Lines in preparation for full Crossrail services towards the end of the Control Period. In addition, the Mayor has set out aspirations for TfL to manage inner suburban rail services in north east and south east London in his response to the government's Rail Decentralisation consultation. TfL is thus anticipating an increased role in national rail during CP5 which means that the issues addressed in this consultation will be of greater importance to TfL.

TfL is a significant sponsor of rail infrastructure projects on the national network with recent projects completed including NLRIP and the East London line extensions. Under the current Investment Framework, the definition of government sponsored schemes appears to be restricted to DfT and Transport Scotland sponsored schemes. This is clearly inappropriate and it is important that the definition of government in this context is clarified to include schemes sponsored by TfL to ensure they receive the correct regulatory treatment.

As discussed at the recent ORR workshop, decisions on individual financial issues need to be taken as part of a consistent overall approach to deliver the required financial framework for Network Rail.

Yours sincerely

Carol Smales

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?

TfL considers that the case is not fully made for using an ex-ante assumption for access charges for CP5 followed by an ex-post adjustment at the start of CP6 as an incentive for Network Rail to manage inflation risk. In practical terms this would be more complicated than the arrangements in PR08. Network Rail has identified a number of drawbacks to the proposal including the issue of "intergenerational transfers" between control periods which will need to be addressed. We consider that the merits of the ORR proposal are insufficiently well articulated, and as there would be an ex-post adjustment in CP6 to take account of differences between the actual and assumed inflation rate, remain to be convinced of the case for the potential incentivisation of Network Rail by exposure to inflation, under the proposal.

TfL has previously questioned whether it is always appropriate to adjust Network Rail's income by RPI or whether an index that more closely links to Network Rail's cost and revenue bases would be more appropriate. Both at PR08 and in earlier consultations in PR13, TfL suggested possible use of CPI as the reference rate. We understand that ORR has decided that RPI is an appropriate basis on which to compensate Network Rail for inflation risk. However we advocate building in an efficiency margin either as RPI-X or, as was touched upon at the workshop, use of a sub-multiple of RPI (e.g. 0.75 times RPI). That would mitigate inflation risk while providing a true incentive to effectively manage inflation risk as far as is possible by Network Rail through a positive feedback loop. ORR has indicated that a study will be undertaken to consider to what extent inflation is manageable by Network Rail. This study could be used as a vehicle to evaluate the appropriate percentage of RPI that should be applied.

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

TfL supports the proposal not to provide Network Rail with an in year risk buffer going forward. This support is given in the context of Network Rail being unlikely to raise unsupported debt within CP5.

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?

As is set out in the consultation document, re-opening a settlement should occur only in exceptional circumstances and not as a result of normal fluctuations in costs and revenues. We support a global re-opener for material change in Network Rail's circumstances or in the relevant financial markets in place of specific reopeners but suggest that it should be defined in such a way as to provide only for such exceptional circumstances. TfL would in principle therefore welcome such a simplification of the approach to re-openers and would expect ORR to issue clear guidance on the circumstances when and how the global re-opener would be triggered and the conditions that would apply.

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

Network Rail should be exposed to cost risk for some industry costs where it has control over these costs. TfL supports the proposal to expose Network Rail to some of the costs associated with transmission losses. Where Network Rail has an industry leadership role and can influence costs of bodies such as RSSB and BTP, it should also bear a proportionate share of risk. Network Rail has no influence over ORR fees or cumulo rates and should not bear the cost risk.

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?

TfL considers that it is appropriate for Network Rail's level of financial indebtedness to continue to be limited. This provides an important incentive effect, pushing Network Rail to control its costs within the control period and to ensure its debt is maintained at a sustainable level. TfL would agree that the appropriate range for such a limit should be between 70% and 75% expressed as a percentage of debt to RAB. It is likely that within this range, the most appropriate level would be at the lower end, at or close to 70%. This is lower than in 2012-2013, but the overall size of the RAB and debt is anticipated to be significantly higher over CP5.

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

The method of handling future industry reforms would depend on the extent of the changes taking place. For example a complete unwinding of the WACC is not likely to be triggered by the formation of an alliance or a concession. TfL supports ORR's proposal to evaluate the consequences with stakeholders of logging up or down the effect of the change on Network Rail and adjusting

Network Rail's revenue and if appropriate its RAB for CP6 to take account of any change in the geographical area covered by Network Rail's business.

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?

Setting the FIM fee based on current short-run credit enhancement is not appropriate when seen in the context of the whole duration of the control period, as this would burden Network Rail unnecessarily in the longer term and thus move away from a fee that is consistent with market conditions. A long run approach to the calculation of the implied credit enhancement seems more reasonable in current market conditions. However, as there is likely to be market variability of the value of the credit enhancement provided by the FIM fee over the duration of any control period, it may be appropriate for ORR to consider how a variable FIM fee could be applied in future control periods.

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?

Of the three options presented, TfL considers that it is appropriate to take embedded debt costs fully into account in CP5. While in general TfL supports Network Rail's ongoing requirement to demonstrate that costs are efficiently incurred, in the case of pre-existing debt, it is difficult to envisage how existing debt could become more or less efficient before the PR13 determination. It seems reasonable that efficiency measures should be applied going forwards, however retrospective application of efficiency tests where debt costs are already locked in seems inappropriate.

TfL is content with ORR's proposal not to index the risk free rate.

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

ORR's proposals in relation to assessment of financial sustainability of Network Rail seem to be appropriate and TfL has no additional comment.

TfL welcomes the introduction of the adjusted WACC approach, and agrees with ORR's aspiration to maintain transparency and simplicity of approach. We welcome, in the calculation of Network Rail's efficient cost of finance, the recognition that Network Rail does not pay dividends and is financed by government backed debt through the application of the FIM fee.

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?

In principle TfL supports the introduction of the adjusted WACC approach being kept as simple and transparent as possible. However we are unconvinced that this automatically requires the entire RAB to be uplifted by RPI. We consider that only a proportion of the RAB should be subject to indexation reflecting the index linked debt (one of the options identified) or that the entire RAB be subject to a submultiple of RPI. An approach whereby Network Rail benefits from an automatic uplift of say 0.5xRPI would still be simple to administer and also provide appropriate incentives.

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?

TfL considers that it is appropriate for reactive maintenance to be treated as opex and not as capital investment allowing greater transparency and consistency between statutory and regulatory accounts.

TfL is supportive of the inclusion of future efficiency savings in the calculation of the cost of long run renewals and hence the amortisation charge. Future efficiency savings should be achievable through advances in technology and continuous improvement in asset management techniques. It is appropriate that these savings are included in the estimate of Network Rail's future renewals costs.

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?

Potentially as important as the calculation of predicted long term renewals cost is the treatment of underspend against predicted renewals. TfL believes that any underspend against the amortisation charge should be considered as output not delivered unless adequately demonstrated otherwise by Network Rail. This would place the onus on Network Rail to justify that underspend arises from planned renewals delivered efficiently, whether through reduced volumes or reduced unit costs.

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

TfL recognises the case advanced in the consultation document that the financing of around £15bn non-capex RAB additions from prior Control Periods potentially has an adverse effect on the sustainable funding of the railway going forward.

More generally, indexation and large capital investment programmes are increasing the RAB relative to the size of Network Rail's core business and the sustainability of the RAB should be kept under review.

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

TfL is strongly in favour of maintaining the opex memorandum account as a means to prevent distortion of the RAB through inclusion of non capex items and maintaining transparency.

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

While using the PR08 approach would provide greater consistency with ORR's approach to incentives, TfL considers that it is reasonable to adopt the simpler alternative approach proposed, given that Network Rail is not forecasting to make significant corporation tax payments in CP5 and may not be affected by corporation tax incentives.

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?

TfL is content that part of Network Rail's income continues to be provided directly by the government through network grants. To the extent that grants continue to be provided by government it is appropriate that the level of grant is set ex-ante for each year of the control period providing certainty of funding to Network Rail along with simplicity of application. We note there is the possibility that higher access charges for Train Operating Companies (with a corresponding reduction in network grant) could ultimately result in higher overall costs to government, through margins on a higher TOC cost base.

In general, TfL favours greater transparency of Network Rail's income and costs. For this reason TfL would welcome greater depth of disaggregation of the price control. TfL understands that implementation of disaggregation of Network Rail's price controls has been under consideration for some time , and would therefore welcome not only a greater depth of disaggregation but also a greater pace of change in delivery of such disaggregation.

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

National Rail's focus should be on stewardship of the national rail network pursuant to the terms of its network licence. TfL suggests that activities outside those required for efficiently providing the appropriate network for its users and funders should be limited, unless well justified in support of those core activities. However a greater level of understanding of the nature of the other activities Network Rail may seek to be allowed to carry out would allow a more informed/detailed assessment of their propriety.

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?

We welcome discussion of the issue of how normal efficiency savings are distinguished from outperformance, a subject that has been important in our discussions with Network Rail in relation to the Crossrail project. ORR raises a number of specific issues relating to strengthening incentives on Network Rail to produce genuine game changing efficiency savings. TfL would welcome effective incentivisation of Network Rail to produce these results. Such a regime would need to be developed to a greater level of detail to enable stakeholders to comment on the practical application such a regime.

In relation to symmetry of incentives we note that issues of symmetry and linearity are sometimes conflated. It is perfectly possible for a regime to be non-linear while remaining symmetric or for symmetry to be designed around an offset reference point. While symmetry is not essential, in TfL's experience some degree of reciprocity is essential. TfL also supports simplicity of comprehension and ease of calculation in the design of incentives. If the incentive cannot be readily understood, its effectiveness will be reduced and the cost of implementation may outweigh the benefits derived.