

Richard Fitter
Office of Rail Regulation

Sent by e-mail

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Dear Richard

CONSULTATION ON FINANCIAL ISSUES FOR NETWORK RAIL IN CP5

Many thanks for the opportunity to comment on the issues raised in this consultation. I have outlined some general points below, with answers to your specific questions contained within the annex attached to this letter.

The Minister for Housing and Transport (now the Minister for Transport and Veterans) outlined his priorities for Scotland's railways in his statement to the Scottish Parliament in June this year. The statement highlighted the contribution of rail to Scotland's success – supporting economic growth, strengthening connections between communities, forming a key part of a fully integrated transport system and providing sustainable alternatives to road and air travel. This is why the statement also included a commitment to record levels of investment, which was reflected in the HLOS also published in June.

Railways across GB are in a period of considerable reform with among other things Network Rail decentralisation, the emergence of alliancing arrangements and the creation of the Rail Delivery Group (RDG). We are undoubtedly at a critical juncture in the shaping of the future of rail services and the Scottish Ministers are doing all that they can with the resources and powers that they have to help the railway in Scotland achieve its full potential. It is therefore critical that the ORR can support this through a financial framework for Control Period 5 that will deliver better value for money for passengers, freight users and the taxpayer, which balances short-term affordability and longer-term sustainability, which strikes the right balance of risk and critically which demonstrably has the needs of rail users at its core.

Under the terms of the the Railways Act 2005, certain powers transferred to the Scottish Ministers in respect of railways in Scotland. This was supported by the ORR in Control Period 4 through price control separation. Our collective understanding of the effects of these arrangements is now far more developed and the ORR should be more open to different, innovative arrangements for aspects of the financial framework for Scotland where this represents the best value for money option. As an absolute minimum, the ORR should be able to monitor and report on Network Rail's financial performance at a fully disaggregated Scottish level, including centralised costs. This will become of critical importance as the role of the

systems operator moves from a concept to reality over the remainder of Control Period 4 and in Control Period 5.

As outlined in our response to the objectives consultation in September last year, much of the regulatory framework for rail can be overly complex, and the financial framework is no exception to this. PR13 therefore represents an opportunity to focus on simplicity and in this context I would again refer you to the Scottish Government's principles of Better Regulation. Such an approach should help the ORR to provide assurance that the framework is fully aligned with outcomes, outputs and incentives and that the flows of public resource to Network Rail and the activity that it funds are both transparent and efficient.

I hope this response is useful and I am content for it to be placed on your website.

Yours sincerely



Steven McMahon
Head of Rail Strategy

ANNEX

CONSULTATION ON FINANCIAL ISSUES FOR NETWORK RAIL IN CP5

Responses to the specific consultation questions

Q3.1 What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB 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?

We would be fully supportive of the proposed approach, for the following reasons:

- This will help to bring certainty and stability to rail financing over Control Period 5 for Network Rail, funders and users. This is critical, particularly in the current fiscal climate.
- This has the potential to secure greater efficiency as Network Rail will need to work closely with its supply chain to effectively manage inflation risk, rather than rely on inflationary uplifts in revenue throughout the lifetime of the settlement.

We would, however, seek assurances from the ORR that such an approach to the setting of indexation will not undermine the delivery of the outputs as set out in the Scottish Ministers HLOS published in June.

We are also supportive of the deadband approach, and would expect Network Rail to manage fully any risk within these limits within the revenue requirements set for Control Period 5. Where inflation did exceed the upper limit of the deadband, we would still expect Network Rail to manage this as effectively as possible, with any increase in either RAB debt or Control Period 6 revenue requirements only incurred in exceptional circumstances.

In terms of calculating the appropriate level of indexation for Control Period 5, we would strongly recommend that the ORR refer to the Bank of England's monetary policy framework, which would be consistent with the approach taken in other areas of the use of public resources. As a minimum, we would not expect the level of indexation set to be above that used by the ORR in the financial calculations within the Advice to Ministers i.e. 2.75%. Anything higher may make the SoFA limits undeliverable.

As part of its evaluation, the ORR may wish to consider a piece of analytical work on what would have been the experience in Control Period 3 and Control Period 4 to date had these arrangements been in place. This work would be of greatest value if it were disaggregated to Scotland.

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

We are fully supportive of this proposal. The approach to risk taken in Control Period 4 has proven to be disproportionate and therefore an unsustainable and unjustifiable use of public resource, particularly in the current fiscal climate. In addition, we are not at this point in time supportive of the introduction of unsupported debt, which further lessens the requirement for headroom in the financial settlement.

This proposal will place a requirement on Network Rail to manage risk more effectively, which in principle should lead to greater efficiency. We would be of the clear view that failure to do so –

other than unforeseen catastrophic events – will not result in either an increase in Network Rail RAB debt or Control Period 6 revenue requirements.

As with Q3.1, the ORR may wish to consider a piece of analytical work on what would have been the experience in Control Period 3 and Control Period 4 to date had these arrangements been in place. Again, this work would be of greatest value if it were disaggregated to Scotland.

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

We are broadly supportive of simplification, as this aligns with our principles of Better Regulation. However, we are also mindful that this will place a greater responsibility on the ORR in terms of applying discretion where Network Rail are of the view that there has been a material change. We would therefore seek an assurance from the ORR that it has the expertise to evaluate and make judgement in such circumstances and that the funders will be fully involved in those deliberations.

We would also be supportive of retaining the Scottish specific reopener and the level proposed i.e. 15%. We would also seek confirmation that a material change that was restricted to those areas for which the Secretary of State for Transport has competence will not automatically lead to a reopener in Scotland.

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

We are fully supportive of this proposal. It is entirely appropriate that Network Rail should be expected to manage those risks over which it has either control or high degrees of influence.

However, we would seek an assurance from the ORR that they will not allow a set of circumstances to occur whereby the effectiveness of organisations such as the RSSB is adversely affected by the behaviours of Network Rail.

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%

It is in our view a matter for the ORR, under their Section 4 duties, to give assurances on the financial sustainability of Network Rail.

The 2011 Scottish Government Infrastructure Investment Plan¹ outlined the Scottish Ministers expectation to make full and appropriate use of the Network Rail Regulatory Asset Base (RAB) to fund new rail projects. The ORR should therefore take the approach to defining the right level of financial indebtedness which can support these expectations while balancing affordability with long term sustainability.

In terms of ensuring consistency across the financial framework, there does appear to be an anomaly in the treatment of indebtedness. As part of the price control separation, there has been a notional disaggregation of the Scottish RAB and the Scottish RAB debt. However, the RAB to debt ratio, and in particular the available headroom for further investment, is managed on a GB network wide basis.

¹ Scottish Government Infrastructure Investment Plan, December 2011

While I accept that Network Rail secures finance on a corporate basis, the approach taken presents a risk that notional 'headroom' for investment in the Scotland network could be swallowed up by investments in other part of the network, thus potentially constraining the extent to which the Scottish Ministers can invest through RAB financing. We would seek discussions with the ORR on this in due course.

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

In such an event, early dialogue with funders and the industry will be required. We would also have a very clear expectation that any such event which related strictly to those areas for which the Secretary of State for Transport has competence will not automatically have an impact on the financial settlement for Scotland.

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

We do not have a strong view on the process for setting the level of FIM fee. However, we have a very clear expectation that the ORR will determine it in such a way that best represents value for money for users and funders and which pays very clear regard for the current state of the financial markets and the constraints on Scottish public finances.

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 are broadly supportive of the proposal, on the condition that the debt has been incurred and continues to be managed efficiently.

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

As per our response to 3.5, it is in our view a requirement of the ORR under their Section 4 duties to monitor, report and provide assurances on Network Rail's financial sustainability.

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?

We have previously outlined our support for the adjusted WACC approach for Control Period 5. We are also supportive of the principles of simplicity and transparency, which aligns with our principles of Better Regulation.

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?

We are broadly supportive of the approach suggested. On reactive maintenance, we are of the view that this will ensure greater transparency of costs. On the suggested approach to amortisation, this will enable users, funders and the industry to benefit from both embedded and future efficiencies.

We would however seek absolute assurance from the ORR that the intended approach will not increase overall revenue requirements for Control Period 5.

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?

We are broadly supportive of the proposal for indexing renewals.

It is our view that monitoring, reporting and providing assurance on Network Rail efficiency is a matter for the ORR under their Section 4 duties.

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

The split of RAB debt for Scotland is notional, based on the size of the Scottish network. While Scottish Ministers provide funding to finance that debt, the overall FIM guarantee is provided by HM Treasury. Therefore the treatment of legacy debt is solely a matter for the UK Government: the Scottish Ministers have no locus in this matter.

However, you may find the following points useful in your deliberations:

- The McNulty study highlights the extent of historical overspending and retiming of revenue grants - around 30% of total RAB debt – and clearly this is limiting the tangible effects of greater industry efficiency and its plans for reform.
- Financing the legacy debt reduces the capability of the Scottish Ministers to invest in improvements to Scotland's railways: either infrastructure or train services.
- Whilst ensuring the safety of the Scottish network is of upmost priority, there is a question as to the extent to which the portion of the legacy debt that the Scottish Ministers finance has directly benefitted the network in Scotland. We would therefore welcome further advice and analysis from the ORR on the level of current Scottish RAB debt which has occurred as a direct result of investment by the Scottish Ministers.

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

We would be broadly supportive of the proposal as it is both simple and transparent, which aligns with our principles of Better Regulation. However, the ORR should ensure that where charges are incurred in Scotland or E & W that these are correctly apportioned.

Q5.5 What are your views on the options we set out for our approach to corporation tax in CP5?

We would expect the ORR to take the approach which represents the best value for money for rail users and taxpayers. Of the two options presented, option B appears to be the simpler, which aligns with our principles of Better Regulation.

Q7.1 What are your views on our proposals 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 fully support the proposal that part of Network Rail's revenue requirements are met through network grant. This represents the best use of public resource, and our preference would be to continue to route the majority of Network Rail funding in this way.

While the ORR has said on numerous occasions that there is potential for additional efficiency in routing funding through track access charges, it has consistently failed to produce evidence to support this. Recent economic events have clearly demonstrated that flexibility in the deployment of public resources is critical in terms of ensuring maximum value for the use of those funds. That is why we are of the strong view that, while we support providing certainty in network grant as far as is possible, flexibility is critical if the Scottish Ministers and other funders are to respond to changing circumstances over the life of the Control Period.

The views of the Scottish Ministers on this issue are clearly laid out in their Guidance to the ORR. If the ORR is minded to set the network grant on an ex-ante basis and not permit any flexibility within Control Period 5 then we would expect a full written explanation on why they have chosen not to act in accordance with the Guidance.

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

We are, in principle, supportive of non Control Period activity in circumstances where this is to the direct benefit of passengers, freight users and the taxpayer. Which activities Network Rail are allowed to carry out is a matter for the ORR under the terms of their Section 4 duties.

The ORR must provide assurance that such activity will not call on any revenue or resource provided for through the SoFA nor will it in anyway impinge upon or hinder the delivery of HLOS specified outcomes.

Q7.3 What are your views on increasing the strengths of the incentives in 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?

There is insufficient detail within the consultation document to provide a definitive view on this. However, we would make the following general points:

- There is a considerable question as to the effectiveness of the Control Period 4 incentive regime and the ways in which Network Rail has responded to this, and therefore a strengthening of what we currently have would not immediately appear to be the most appropriate approach.
- Any changes in the strength of incentives should be about making real differences to the experience of the passenger and freight user and must continue to represent maximum value for money for taxpayers: it should not be simply about encouraging Network Rail to do the 'day job' a bit better.
- We fully expect that there will be a very strong incentive dynamic in the establishment of a deeper Alliance in Scotland and the establishment of the Regional Efficiency Benefits Scheme in Control Period 5. Before any new, additional regulatory arrangements were put in place, we would need to see an explicit, evidence based link between the initiatives and the outcomes e.g. a sizeable reduction in costs, a significant increase in performance, passenger/freight satisfaction. This must be disaggregated at Scotland level.
- We would not support a change in the system which led to any overall increase in public subsidy requirements.