PR13 workshop on financial issues for Network Rail in CP5

5 September 2012

Welcome and introduction

Cathryn Ross

Introduction
Purpose

- This is a technical area of PR13 and our decisions on these detailed financial issues can have significant impacts on Network Rail's finances
- This workshop will help to inform consultation responses, which are due by 26 September 2012
- It is useful to have a direct conversation with industry on these areas to help inform our decisions
- We are only covering the key issues from the consultation in today's workshop…

…so please speak to Carl Hetherington and his team if you have any further questions on today's discussion or on topics not covered today

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Introduction
Background

- As part of PR13, we will determine Network Rail's access charges, what it must deliver in return for those charges and the money it receives from governments
- PR13 will also establish the financial framework for Network Rail to encourage it (and others) to deliver and outperform our determination
- The decisions taken in a periodic review have significant implications for a wide range of stakeholders
- In May 2012 we set out our high-level decisions on the financial framework for CP5, e.g. the duration of the price control
- Our latest consultation on financial issues covers some of the more detailed issues relating to Network Rail's financial framework
- We will set out our decisions on these issues by the end of 2012

Introduction
Risk and uncertainty

- All businesses face risk and uncertainty on their costs and revenues from the impact of external events - Network Rail is no exception
- For PR13, we need to decide how these risks are allocated between the company, customers and funders
- In the current economic climate it is as important as ever that customers and funders get the greatest value for money – this highlights the importance of our financial framework and in particular that we allocate risks appropriately
- Given the changes since PR08, most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, we are proposing to reduce the headroom (i.e. a buffer) available to Network Rail

Agenda

13:15	**Registration and lunch**
13.45	Welcome and introduction
13.50	Indexation and input prices
14.45	In-year risk buffer
15.00	Level of financial indebtedness
15.15	Embedded debt
15.30	Wrap-up discussion
15.50	**Break**
16.00	Industry costs
16.15	Incentives to outperform determination
16.30	Corporation tax, network grant and disaggregation of financial issues
17.00	Closing remarks
17.15	**Close**

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Indexation and input prices – ORR proposal

Carl Hetherington

Indexation and input prices – ORR proposal
Background

- Network Rail, like other businesses and households, faces the risk that prices may rise or fall
- For Network Rail in CP4:
  - We compensate for general inflation - determination in real terms and we adjust access charges
  - Our efficiency assumptions included our view of input prices
  - RAB is adjusted each year for movements in inflation
- Two key potential issues:
  - DfT and Transport Scotland issue SoFAs in nominal terms – automatically adjusting for actual inflation increases budgetary uncertainty
  - An automatic adjustment may provide weaker incentives on Network Rail to manage inflation

Indexation and input prices – ORR proposal
Proposal

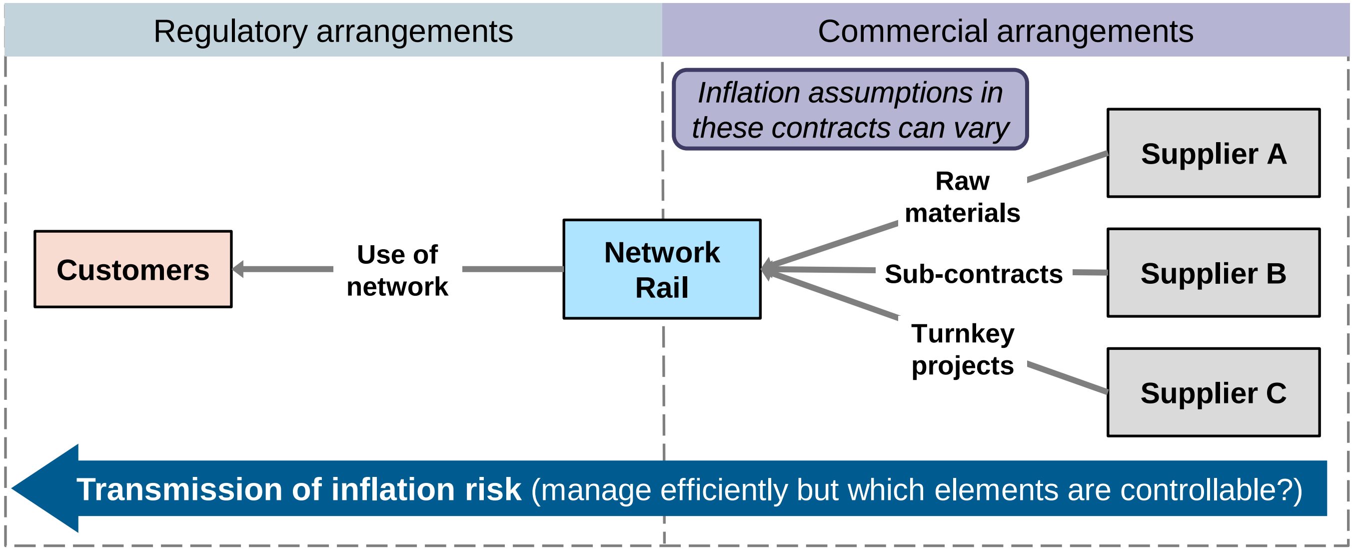
- For CP5, we are proposing:
  - To make an upfront forward looking assumption for both general inflation and input price inflation in our determination for CP5, e.g. x% per annum
  - A ‘deadband’ around our forecast for each year of CP5, within which we will not adjust Network Rail’s revenue in the year concerned or re-open the price control
  - We will adjust Network Rail’s revenue in CP6 for the difference between our ex-ante assumption and actual inflation
  - We will not adjust Network Rail’s renewals expenditure for movements in IOPI, or other inflation indices
  - To continue to uplift Network Rail’s RAB by the actual movements in general inflation

Indexation and input prices – ORR proposal

Key issues (1)

- We recognise some of the practical difficulties with an ex-ante (upfront) approach
  - More complicated than an automatic adjustment approach
  - Incentive effects of ex-ante approach are difficult to evaluate once there is a difference between actual inflation and our forecast
- Will increase Network Rail's financial risk – we will take account of this change elsewhere in the financial framework
- Should change the way Network Rail interacts with the supply market
- We will commission a study to consider the inflation risk that is controllable by Network Rail and assess how it manages inflation risk
- An alternative to our proposed approach would be to continue to index allowed revenue each year for movements in RPI unless our study determines that there is an issue, then we would adjust our efficiency assumptions

Indexation and input prices – ORR proposal
Key issues (2)



- We have to assess the effect of inflation on Network Rail
- We don't want to re-open the price control unless circumstances are exceptional
- Deadbands can still allow for material changes that could result in windfall gains and losses
- Either leave ex-ante, adjust or review ex-post:
  - Ex-ante: windfall gains/losses – is this feasible?
  - Automatic adjustment: does this provide the correct incentives?
  - Ex-post: difficult but necessary anyway – given that we have to assess input prices as part of next periodic review and for assessing efficiency

Indexation and input prices
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?

Indexation and input prices – Network Rail's view

Peter Swattridge

ORR's Indexation Proposals

Peter Swattridge
Date 05.09.12

ORR's Indexation Proposals

Important that there is clarity about what is being proposed, and the rationale for it.

<u>In CP4:</u>

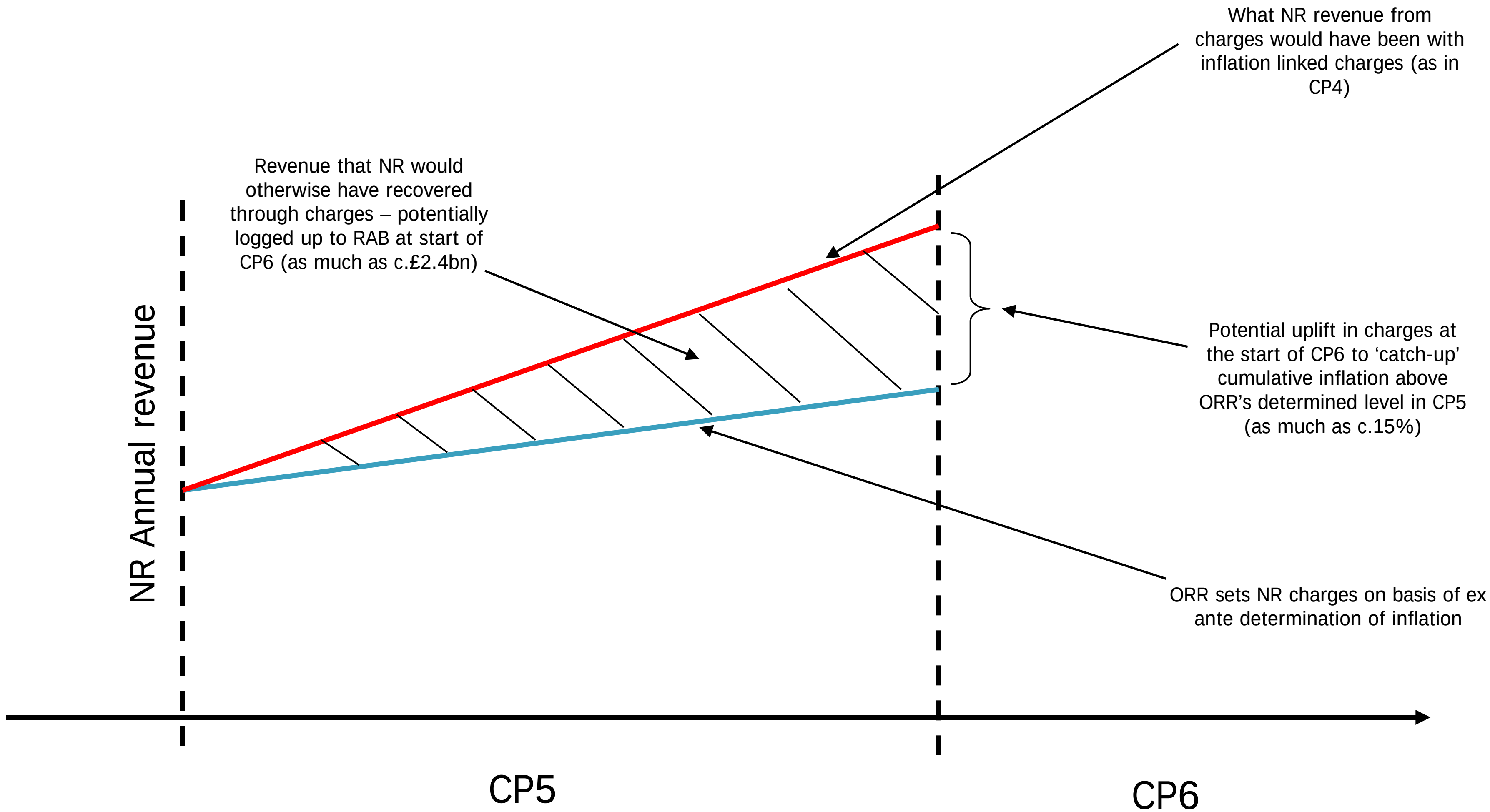
- ORR determination was in real prices (before inflation)
- Determined charges are uplifted annually by actual inflation

<u>Our understanding of ORR's approach is:</u>

- ORR considers that this will create a new incentive on NR to keep its cost increases below inflation
- It would 'set' a fixed ex ante indexation e.g. 3%
- Charges would be uplifted by the ORR determined 'indexation' each year instead of by actual inflation
- If ORR's determined indexation is lower than actual inflation (subject to some ORR tests) would be logged up to the RAB from start of CP6
- From CP6, NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5
- Possible 'deadband' re-opener

Pictoral representation of the Proposal

(assuming inflation ends up being higher than ORR's determination)



Issues - 1

- <u>ORR considers that this will create a new incentive on NR to keep its cost increases below inflation</u>
- We do not accept that there will be significant incentive effects from this policy. NR has a natural incentive to keep its costs as low as possible.
- All other regulators express their incentive targets as RPI-X targets, as they consider inflation to be exogenous to regulated companies.
- If one did consider there to be incentive effects from an ex ante indexation it would seem to really matter whether ORR's chosen indexation level turned out to be above or below outturn inflation.

Issues - 2

- <u>ORR ‘sets’ a fixed ex ante indexation e.g. 3%</u>

This is a very hard thing to do, up to 6 to 7 years ahead. Inflation is particularly volatile/uncertain at the moment because of the recession, banking crisis and resultant QE.

Issues - 3

- Charges would be uplifted by the ORR determined 'indexation' each year instead

The 'significance' of this policy would be very dependent on the level of indexation that ORR sets. If it ends up being very similar to outturn inflation, then there would be a limited impact on NR's finances.

If the ORR indexation is (say) 3% lower than outturn levels, there would be significant additional funding exposure for NR (c.£2.5bn) which will need funding in future control periods.

If the ORR indexation is (say) 3% higher than outturn levels, there would be significant additional revenue will have accrued to NR from current customers, to the benefit of future customers.

Issues - 4

- If ORR's determined indexation is lower than actual inflation (subject to some ORR tests) would be logged up to the RAB from start of CP6

  This could create additional debt which will then need to be funded in the future. This could make the industry less financially sustainable in the future.

  Future customers will be paying higher charges at the expense of CP5 customers.

  (The opposite could also be true, of course)

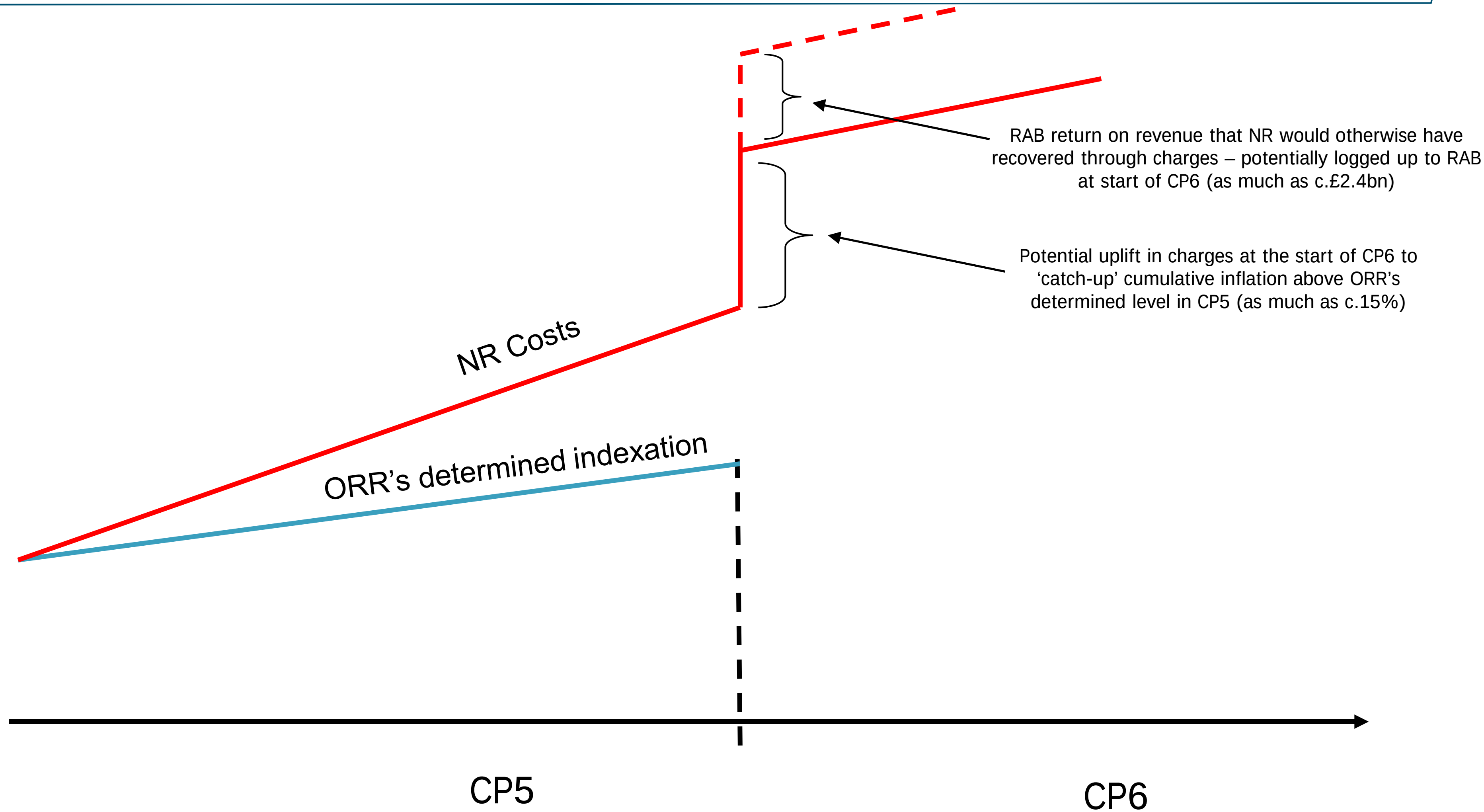
Issues - 5

- From CP6 NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5

This could create a price 'spike' in CP6 when past inflation is factored into CP6 prices. (see next slide)

The opposite could also be true, of course.

…from CP6 NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5



Summary of Issues - 1

- Weak / no additional incentive properties
- Potentially even more complex regime (especially with possibility of ‘deadband’ reopeners)
- Potential extra NR debt (or over-recovery) of between £400m and £2.4bn
- Inter-generational issues for any CP6 adjustments
- Price spike / dip at the start of CP6
- Timing is tricky (inflation is particularly uncertain at the moment)

Summary of Issues - 2

IN ADDITION:

- Makes the business more uncertain to people we borrow from (could affect our borrowing rates)
- No regulatory precedent (could affect our borrowing rates)

Our Emerging View

- We do not accept the incentive argument
- We have a natural incentive to keep our costs down
- We consider that HMG is best placed to manage inflation risk
- We consider that this is all about apportioning risk between NR and our funders
- We understand that DfT finds it difficult to budget with exposure to inflation

Our Emerging View

HOWEVER, BEING PRAGMATIC…

- If this policy is implemented we would need more financial headroom to absorb possible risks of inflation being higher than ORR's determination of it
- We would also need to be careful about the impact on our P&L
- Any variation in determined and outturn inflation should be automatically adjusted for, at the start of CP6
- The deadband re-opener idea is likely to be too complex
- All variations from *ex ante* assumption should be added to RAB to avoid unnecessary complexity which will add no value and could have perverse effects

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Indexation and input prices – a view from industry

Nigel Jones

Periodic Review 13 – CP 5 Financial Issues for Network Rail

The indexation of Network Rail's allowed revenue – a view from Industry

Nigel Jones

September 5th 2012

Indexation of Network Rail’s allowed revenue

- How does revenue from customers change year on year – what indices are used ?
- What indices are currently used on inter-industry contracts ?
- What behaviours are ORR seeking to drive ?
- What characteristics do TOCs and FOCs want from Network Rail’s revenue structure ?

Indexation and passenger sector revenue

- Regulated fares are subject to an RPI + formula:
    - Post privatisation : RPI
    - 1999 – 2004 : RPI -1%
    - 2004 – 2012 : RPI +1%
    - 2013 – 2014 : RPI + 3%
    - RPI + 1% thereafter
- Unregulated fares not subject to any formula

Indexation and freight sector revenue

- Customer sales contracts with a term of more than one year may have a price variation clause linked to an index.

- Customers try to opt for indices other than RPI that will deliver them benefit.

- Customers frequently negotiate reductions from a full index level as part of commercial agreements – eg 50% of RPI.

- Notwithstanding contractual agreements, many customers will use market conditions to force counterparties to accept lower price increases, standstills or reductions.

- In some sectors – eg intermodal – annual price negotiations are the norm. Prices frequently reduce in line with market conditions.

Indexation and rail industry contracts

• Freight Track Access	Average RPI over 12 months as CP4 efficiencies counted up front
•Passenger Track Access – fixed - variable	RPI change since Nov 2008 RPI
• Connection Agreements	RPI minus, in line with NR CP4 gross efficiency target (2012 – RPI -5.2%)
• Station Access	RPI
• Facility Access	by agreement
• Depot Access	Average RPI over 12 months

Factors for consideration

- The industry has many different variations of indices currently, even if many have a version of RPI as a base.
    - Does this matter ?
    - Does this complexity increase transaction costs ?
- Should there be any relationship or synergy between indices for industry revenue/inter industry agreements and indices for NR costs ?
- What behaviours are ORR seeking to drive ?
- Where will CP5 efficiencies be counted?
- What do TOCs & FOCs want ?

Simplicity? Certainty? Transparency?

No surprises?

Indexation and input prices

Key discussion points

Indexation and input prices
Key discussion points

- How does Network Rail's treatment of inflation compare to other organisations and customers perceptions?
  - For example, how inflation affects households budgets, e.g. car insurance
- To what extent would our proposed approach change Network Rail's incentives?
- Trade-off between complexity and uncertainty, and the effect on incentive properties on Network Rail…

  …but we can't ignore input prices, both in setting the determination and assessing Network Rail's efficiency – inevitably this will be complex
- Future considerations

In-year risk buffer

Carl Hetherington

In-year risk buffer
Background and proposal

- Established an ‘in-year risk buffer’ for Network Rail in CP4 as part of PR08
  - Provided Network Rail with a cost of capital that allowed for a surplus over and above its expected financing costs, e.g. provides it with headroom
  - Compensated it for the risks we allocated to it and enabled it to manage business risk and normal fluctuations in cash flow
  - CP4 in-year risk buffer is £219m for England & Wales and £27m for Scotland per annum (in 2011-12 prices)
- **We are proposing not to provide Network Rail with an in-year risk buffer in CP5**

In-year risk buffer
Key issues (1)

- Circumstances have changed since PR08:
  - Network Rail has not issued unsupported debt in CP4 and is unlikely to in CP5
  - Network Rail still uses the FIM which allows it to access financial markets on reasonable terms, even after an unexpected increase in costs (which we assumed would not be the case)
  - So we need to consider whether Network Rail needs a surplus over costs
- Risk buffer in practice increases balance sheet buffer – **real issue is whether the size of the balance sheet buffer is appropriate**
  - Network Rail's balance sheet buffer (£5bn for GB) is more important than its in-year risk buffer (£250m per year) and is fully available for it to use to manage risk and fund unexpected increases in costs – should allow it to deliver its required outputs, to be more innovative and to take some risks when developing ways of improving efficiency
  - Not providing Network Rail with an in-year risk buffer, everything else being equal, could affect the financial sustainability of Network Rail – we will take this into account when considering financial sustainability in our determinations

In-year risk buffer
Key issues (2)

- AICR was important in PR08 (used by credit rating agencies) due to expected issuance of unsupported debt by Network Rail – not an issue for CP5
- Could be perceived as an unnecessary cost at a time of constrained funding and could weaken incentives
- Financial consequences of an efficiency initiative going wrong would still be clear without a risk buffer

In-year risk buffer

Consultation questions

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

Level of financial indebtedness

Carl Hetherington

Level of financial indebtedness
Background and proposal

- Restrictions on Network Rail's level of financial indebtedness has an important incentive effect – incentivises Network Rail to control its costs
- If it exceeds limits specified in its network licence, then it could be in breach of that licence (its actual debt/RAB ratio cannot exceed 75% in 2012-13)
- Difference between limit on financial indebtedness and its actual debt/RAB ratio provides Network Rail with a balance sheet buffer
- **Our current thinking is that the level of Network Rail's financial indebtedness in each year of CP5 should at no point exceed a limit set between 70-75%**
- We will continue to work on this and provide an update in our draft and final determinations

Level of financial indebtedness
Consultations questions

- 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?

Embedded debt

Carl Hetherington

Embedded debt
Background

- Network Rail is best placed to efficiently manage its financing costs, as it understands its risks and how to finance those risks better than its customers and funders
- Part of Network Rail's financing costs for CP5 are already fixed - partly based on financial instruments that it has already taken out
- We are now considering the most appropriate way of treating these costs in CP5, given that we are using the adjusted WACC approach and proposing not to provide Network Rail with an in-year risk buffer
- We have three options:
  - Do not take account of embedded debt costs, i.e. just take account of forward looking interest rates
  - Fully include all embedded debt costs
  - Partly include embedded debt costs

Embedded debt
Proposal and key issues

- **We are proposing to take embedded debt costs fully into account in CP5 (i.e. option b)**
- However, it is important that Network Rail efficiently manages its financing costs
- We will only allow embedded debt costs to be included in our PR13 determination where they can be shown to have been incurred efficiently…

  … which helps to ensure that Network Rail faces the financial consequences of its actions in the run up to our PR13 final determinations, e.g. it can't take out take debt and just assume that we will fund it
- As a significant proportion of financing costs are fixed and as we are proposing to take account of embedded debt costs, we do not think it is necessary to consider other ways that we could reduce the interest rate risk that Network Rail takes, e.g. by indexing movements in the risk free rate

Embedded debt
Consultation questions

- 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?

Risk and uncertainty
Wrap-up discussion

- Circumstances have changed since PR08
- We need to ensure that risks are allocated appropriately, so that Network Rail can manage its income and expenditure efficiently
- We are proposing to reduce the headroom available to Network Rail
- In making these proposed changes we are thinking about their potential impact on other areas of the financial framework

What are your views?

Industry costs

Jonathan Hulme

Industry costs
Background

- Key issue is ensuring that these costs are efficiently managed but also that Network Rail is appropriately compensated for the risk it takes (where the uncertainty surrounding these costs is material)
- Some industry costs are not as subject to Network Rail's control as other costs, so that Network Rail may not be as well placed to manage risks around those costs

Industry costs
Proposals

- We are proposing to use largely the same approach as PR08:
  - **Traction electricity:** we have decided to expose Network Rail to some of the costs associated with transmission losses, reflecting their ability to control these costs – other costs that we deem not to be sufficiently controllable will be passed through to train operators
  - **BT Police and RSSB costs:** we are proposing to determine an efficient level for Network Rail's share of these costs and set an ex-ante allowance - Network Rail's role on these boards is crucial, as it can exercise industry leadership
  - **Licence fee and safety levy:** we are proposing to log up/down any variances between our determination assumptions and the outturns, as these costs are not sufficiently controllable by Network Rail
  - **Business rates:** we are proposing to assume an ex-ante forecast and log up/down any variations from our determination, if Network Rail can show that negotiations were efficient

Industry costs
Consultation questions

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

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Incentives to outperform the determination

Cathryn Ross

Incentives to outperform the determination
Background and proposal

- In our May 2012 document, we confirmed the incentive strengths for opex and capex
- Since then we have considered whether that approach needs refining to encourage Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination
- Also, we are considering whether efficiency initiatives that are genuine ‘game changers’ should be more heavily incentivised than normal efficiency savings as they are important in identifying ways to meet the long-term efficiency challenge

Incentives to outperform the determination
Key issues

- Difficulty of distinguishing between normal efficiency savings and outperformance
- Symmetry of incentives
- We want to encourage appropriate management actions but keep the efficiency calculation as simple as possible:
  - These two objectives can conflict
  - We need to consider ways to improve incentives without overly complicating the reporting process
- Issues with distinguishing between a ‘game changer’ and a normal efficiency initiative
- We will discuss this further in our October 2012 efficiency and expenditure workshop

Incentives to outperform the determination

Consultation questions

- 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?

Corporation tax, network grant and disaggregation

Carl Hetherington and Gordon Cole

Corporation tax
Background

- Our decision in this area is unlikely to have significant financial implications for Network Rail in CP5
- Still important as decisions taken in CP5 can affect future control periods
- In PR08, we determined the overall incentive strengths on income and expenditure on a net of tax basis, i.e. if the company outperforms by, say, £100 then the company will retain an overall net benefit of £74 (this assumes a corporation tax rate of 26%)

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Corporation tax
Proposal

- We are now consulting on whether we should retain that approach or whether another approach would be more appropriate:
  a) **PR08 approach**: consistent with our overall approach to risk and incentives – we think it is appropriate that Network Rail is exposed to the net of tax effect of an underspend/overspend
  b) **Simpler approach**: use our forecast of Network Rail's efficient CP5 opening balances as the basis of our calculation of Network Rail's efficient corporation tax payments in CP5, given that Network Rail is not forecasting to make significant corporation tax payments in CP5 and may not be affected by corporation tax incentives.
- We are seeking views on these options as option a) is more consistent with our PR08 approach and our approach to incentives, whereas option b) is arguably simpler

Network grant (1)

- A proportion of Network Rail's revenue requirement has in the past been paid directly by DfT and Transport Scotland in the form of network grants
- Our preferred method of funding Network Rail is for all of its income to come from franchised train operators and other customers (this was also recommended by McNulty) because direct payments can:
  - Blur the accountabilities of Network Rail, and the accountability of it to train operators
  - Worsen the incentives on Network Rail – could appear like it is less of a commercial business, which could reduce its focus, e.g. on cost control
  - Reduces the transparency of the whole industry reporting of financial performance - this is particularly important at the moment as there is a real focus on whole-industry performance

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Network grant (2)

- We recognise that if we did not allow network grants to be paid in lieu of fixed track access charges, the funds available to the Secretary of State and Scottish Ministers could be affected
- In determining our PR13 policies, we need to take into account all of our statutory duties
- **We are 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 we did in CP4)**
- We will include an ex-ante schedule of network grants for each year of CP5 in our determinations, including:
  - Network grant payments for England & Wales and Scotland
  - Indication of fixed track access charges in the absence of direct network grant payments

Disaggregation of financial issues

- In PR08, we established separate price controls for CP4 for Network Rail's activities in both England & Wales and Scotland
- We see benefits in further disaggregating the price control, e.g. comparative regulation, better understanding and transparency of Network Rail's income and costs
- We currently envisage being in a position to undertake financially separate price controls in CP6 and will take steps to facilitate this in CP5:
  - Improve transparency by providing information on revenues and costs at the operating route level
  - Make assessments underpinning the calculation of the revenue requirement at the operating route level where possible, e.g. expenditure assessments
  - When we are confident that our operating route assessments are robust, we can consider making operating route determinations of revenues, charges and outputs, e.g. operating route variable charges

Disaggregation of financial issues

- Given that Network Rail has devolved responsibility for its operations to an operating route level we will focus our disaggregation in England & Wales on the operating route level, instead of other levels of geographical separation
- Our proposals for a more disaggregated approach to the England & Wales price control in relation to financial issues for CP5 are
  - Amortisation assessments by operating route
  - Indicative estimates of RAB and debt (and hence financing costs) will be calculated by operating route
- We will not make separate cost of capital assumptions and financeability adjustments by operating route in CP5 – premature as the revenue requirements and other key parts of our regulatory framework will not be separate, e.g. our approach to risk and uncertainty

Corporation tax, network grant and disaggregation
Consultation questions

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

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Closing remarks

Cathryn Ross

Annex

List of all consultation questions

All consultation questions (1)

- 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?
- Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?
- 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?
- Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?
- 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?

All consultation questions (2)

- Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?
- 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?
- 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?
- Q4.4: What are your views on how we are proposing to assess 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?

All consultation questions (3)

- 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?
- 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?
- Q5.3: What are your views about legacy debt and RAB?
- Q5.4: What are your views on our proposal to keep using the opex memorandum account?

All consultation questions (4)

- Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?
- 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?
- Q7.2: What are your views on the activities that Network Rail should be allowed to carry out?
- 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?