John Thomas
Director of Regulatory Economics
Telephone 020 7282 2025
Fax 020 7282 2044
E-mail john.thomas@orr.gsi.gov.uk

29 September 2006

Ron Henderson
Group Finance Director
Network Rail Infrastructure Limited
40 Melton Street
London
NW1 2EE

Dear Ron

Approach to the amortisation of Network Rail's Regulatory Asset Base

Introduction

1. In December 2005, we published our initial assessment of Network Rail's CP4 net revenue requirement. That document also included a consultation on the financial framework for the Periodic Review 2008 (PR08) and invited initial views on a number of strategic and technical issues[1].

2. This letter concludes on the principles we should apply for the amortisation of Network Rail’s RAB in Control Period 4 (CP4). This is an important issue because amortisation is one of the elements of Network Rail’s allowed revenue and averages approximately £1.4 billion[2] per annum over Control Period 3 (CP3). Paragraph 4 below explains how we calculate Network Rail’s allowed revenue in more detail.

3. This is one of two letters being published today in relation to the financial framework. The other letter deals with the approach to risk and uncertainty.

Background

4. We, like other utility regulators, use the building block approach to determine Network Rail’s allowed revenue. This means in assessing Network Rail’s net

---

[1] We subsequently published a consultation document on the high-level issues surrounding the incentive framework in July 2006.
[2] In 2002/03 prices.

revenue requirement the total amount of money that Network Rail should receive in income is calculated as the sum of forecast expenditure on operating and maintaining the network, plus an allowance for amortisation of investment (both renewals and enhancements) and an overall return on the RAB, less other income received through the single till.

5. The December 2005 initial assessment document explained the approach we took to amortising the RAB at ACR2003. In assessing the rules that we put in place for amortising the RAB as part of ACR2003, we said that we would have regard to the following criteria:

   (a) the net annual adjustment to the RAB (i.e. annual capital expenditure less amortisation) ought to reflect the amount of investment which actually improves the underlying condition of the network rather than simply maintaining steady state;

   (b) any increase in Network Rail's debt must be financeable and sustainable; and

   (c) Network Rail must be able to raise the required amount of additional debt from lenders in a timely manner.

6. The overall amortisation principle identified for ACR2003 was that the total allowance for amortisation in any year should be broadly equivalent to the level of investment expenditure that is required in order to maintain the overall capability, age, condition, and serviceability of the network in steady state. This means that in principle, if there is no enhancement to the asset base (it is neither improving or declining), the allowance for amortisation would be set equal to the level of investment expenditure.

7. Our December 2005 initial assessment document said that defining steady state in terms of long-run annual average investment expenditure might create adverse financial sustainability issues as Network Rail may still be dealing with a peak in renewals expenditure for some asset categories. Therefore, we said that we would need to consider carefully whether financial sustainability reasons might lead us to conclude that amortisation should be set more in line with the investment expenditure required in Control Period 4 (CP4) to maintain the network in steady state.

8. In order to implement the above amortisation principle the following rules were used in ACR2003:

   (a) new renewals and enhancement expenditure incurred after 1 April 2004 is depreciated on a straight line basis over 30 years, a period that is approximately the average life of the assets; and

(b) past investment is depreciated on a reducing balance basis at a rate of 7% per annum in order to achieve a total amortisation allowance broadly equivalent to investment expenditure required to maintain the network in steady state.

9. Under this approach Network Rail received a total amortisation allowance of, on average, approximately £1.4 billion per annum[3] in CP3. This meant that Network Rail, over the course of CP3, was expected to finance through borrowing around £7 billion of its renewals and enhancement expenditure (or half of its total £14 billion capital programme).

10. The December 2005 document also explained that, under current forecasts, the allowance for amortisation using the ACR2003 rules is likely to be considerably lower than the expected level of capital expenditure throughout CP4. Network Rail's Initial Strategic Business Plan also assumes that the amortisation allowance would be lower than capital expenditure in CP4.

Discussion

11. As we said in the December 2005 initial assessment document our starting point for setting the annual allowance for amortisation in CP4 is that in principle it should be set equal to the long-run annual average capital expenditure required to maintain the network in steady state. This would ensure that access charges and Government grants over time reflected appropriately the level of assets consumed by current and future users and funders of the railway. This was largely supported by the responses to the December 2005 document (see Appendix A).

12. However, as set out in the December 2005 document, we will also need to consider financial sustainability issues.

13. We consider that it is important to continue to use transparent rules for determining the level of amortisation that Network Rail should receive and that the rules for amortisation must strike the appropriate balance between current and future customers and funders of the railway. For these reasons we intend to maintain the rule that renewals and enhancement expenditure incurred after 1 April 2004 is depreciated on a straight line basis over 30 years.

14. In order to inform the amortisation allowance for PR 08 we have asked Network Rail to do an engineering-led analysis to determine a view of what is the long-run annual average capital expenditure required to maintain the network in steady state. This information will be a valuable input to our analysis.

---

[3] In 2002/03 prices.

15. The other factor to be considered when deciding on the amortisation rules is the approach to the amortisation of additions to the RAB that are not related to capital expenditure e.g. those that relate to incentive adjustments or re-profiled revenues.

16. We intend further to consider the detailed rules for calculating amortisation when we have more information about steady state expenditure and financial sustainability issues and will discuss this issue in the August 2007 regulatory letter.

17. In terms of applying the amortisation rules and determining an amortisation allowance we will also need to consider:

    (a) the roll forward of the RAB to 1 April 2009;

    (b) our view of Network Rail's projected renewals and enhancement spend in CP4 and beyond; and

    (c) our capitalisation policy.

18. For additions to the RAB that are not capital expenditure related it would seem to be appropriate to treat them in the same way that past investment before 1 April 2004 was treated in ACR2003 i.e. as the part of the RAB that, for amortisation purposes, is used to ensure that the overall amortisation allowance is broadly equivalent to steady state expenditure and is consistent with financial sustainability issues.

19. The general issues involved with financial sustainability e.g. our approach to financial indicators will be covered in a regulatory letter to be published in August 2007.

Views Invited

20. We would welcome views on the issue of how additions to the RAB that are not capital expenditure related should be treated. If you would like to discuss any of the issues in this letter, please contact Carl Hetherington (Head of Regulatory Finance) on 0207 282 2110.

21. Please can you send your views on the issues we have raised in electronic format (or if not possible, in hard-copy format) by Friday 22 December 2006 to:

Linda Smith
Office of Rail Regulation
1, Kemble Street
London WC2B 4AN
Tel: 020 7282 2
Email: Linda.Smith@orr.gsi.gov.uk

22. You should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise we would expect to make it available in our library and on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, that can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

23. We are copying this letter to other interested parties who we hope will send us their views.

24. Copies of this letter can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely

John Thomas

Appendix A

Consultation responses

We received 13 responses to the December 2005 consultation paper and three of them provided substantive comments on the approach to the amortisation of Network Rail's RAB.

In its response to the December 2005 consultation, Network Rail said that it agreed with the principles underlying the proposed approach to amortisation. In particular, that amortisation should be broadly equivalent to the capital expenditure required to maintain the network in steady state. The company considers that there is a range of potential outcomes, which are consistent with this principle.

DfT said that it also supported the amortisation principle outlined in the December 2005 document and suggested that in applying the principle ORR would need to look at Network Rail's funding in the round, taking account of long term capex projections, efficiency assumptions and Network Rail's overall financial position. The DfT would expect that using this approach over time would mean that borrowing to fund a steady state railway would not be necessary.

Merseyside said that they agreed with the fundamental principles that amortisation should be broadly equivalent to steady state capital expenditure over time and where capital expenditure on the network exceeds the amount required to maintain the network in steady state over time, this expenditure should be financed by borrowing and a proportion paid for by future generations of customers and funders. Merseyside[4] then said this meant they agreed that Network Rail's amortisation allowance for CP4 should be equal to the long run average renewals cost of the network.

Merseyside also raised the issue of how we would treat RAB adjustments, which were not related to capital expenditure requirements, when setting the amortisation profile e.g. the £3.3bn of re-profiled revenues from CP3.

[4] Merseytravel, Merseyrail Electrics 2002 Limited and Merseyrail InfraCo Limited submitted a joint response to the consultation, for simplicity we refer to this as the Merseyside response.