OFFICE OF RAIL REGULATION

Periodic review 2013

Financial issues for Network Rail in CP5: decisions

December 2012

Office of Rail Regulation

Contents

Abbreviation and acronyms

Abbreviation / acronym	Meaning
ACR2003	The 2003 access charges review (for CP3)
AICR	Adjusted interest cover ratio
ATOC	Association of Train Operating Companies
August 2012 consultation	Consultation on financial issues for Network Rail in CP5
BIS	The Department for Business, Innovation and Skills
BT Police	British Transport Police
BTPA	British Transport Police Authority
Capex	Capital expenditure
CLG	Company limited by guarantee
COPI	COPI is the colloquial name for the Department for Business, Innovation and Skills (BIS) Output Price Index for New Construction: All New Construction
CP3	Control Period 3 (which ran from 1 April 2004 to 31 March 2009)
CP4	Control Period 4 (1 April 2009 – 31 March 2014)
CP5	Control Period 5 (1 April 2014 to 31 March 2019)
CP6 and CP7	These are control periods 6 and 7 (assuming five year control periods)
CPI	Consumer Price Index
DfT	Department for Transport
FIM	Financial indemnity mechanism
HLOS	High-level output specification
HMT	HM Treasury
IIP	Initial industry plan (N.B. two documents were published – one for England & Wales and one for Scotland)
IOPI	Infrastructure output price index
KPI	Key performance indicator
May 2011 document	Our '2013 Periodic review: first consultation' document, published in May 2011

Abbreviation / acronym	Meaning
May 2012 document	Our 'Setting the financial and incentive framework in CP5' document published in May 2012
Network Rail	Network Rail Infrastructure Limited
ONS	Office for National Statistics
Opex	Operating expenditure
ORR	Office of Rail Regulation
PR08	The 2008 periodic review (for CP4)
PR13	The 2013 periodic review (for CP5)
PR18	The 2018 periodic review (for CP6)
RAB	Regulatory asset base
REBS	Route-level efficiency benefit sharing mechanism
RMT	National Union of Rail, Maritime and Transport Workers
RPI	Retail prices index
RPIX	RPIX is RPI excluding mortgage interest payments
RSSB	Railway safety and standards board
RVfM	The McNulty Rail Value for Money study
SBP	Network Rail's strategic business plan for CP5, due by 7 January 2013
SoFA	Statement of funds available
TfL	Transport for London
The Act	The Railways Act 1993
TOC	Train operating company
VOA	Valuation Office Agency
WACC	Weighted average cost of capital

Executive summary

Background

1. In March 2012, we formally began our 2013 periodic review of Network Rail Infrastructure Limited's (Network Rail's) access charges (PR13). As part of PR13 we will determine Network Rail's access charges, what it must deliver in return for those charges and for the money it receives from the Secretary of State (in respect of England & Wales) and Scottish Ministers (for Scotland). We will also set out the wider financial and incentive frameworks for the next control period (CP5)[1].

2. PR13 takes place at a pivotal time for the rail industry. The Rail Value for Money (RVfM) study led by Sir Roy McNulty[2], which we commissioned jointly with the Department for Transport (DfT), has highlighted the value for money challenge facing the rail industry. This challenge is felt more keenly today given the economic climate and the financial pressures on train operators, passengers, freight customers, funders (taxpayers and governments) and suppliers.

3. In our periodic review we decide what outputs Network Rail should deliver and how much revenue it needs to efficiently deliver them. This involves estimating Network Rail's income[3] from stations, property and other sources and expenditure on support, operations, maintenance, industry costs and rates, renewals, enhancements and financial costs. The estimate for financial costs includes sums for the allowed return, corporation tax and amortisation.

4. In order to recover its costs, as part of our review, we will decide what access charges we allow Network Rail to levy and how much funding it will receive directly from the governments in England & Wales and Scotland through network grants. In doing this, we will set Network Rail a challenging but achievable target for improvements in its efficiency. We will also take account of the priorities for railways and the public financial support they make available, set out by the governments in England & Wales and Scotland[4] when we 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.

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[1] Control Period 5 (CP5), which will run from 1 April 2014 to 31 March 2019.

[2] *Realising the Potential of GB Rail - Detailed Report*, Final Independent Report of the Rail Value for Money Study, May 2011, available at http://www.rail-reg.gov.uk/server/show/ConWebDoc.10401.

[3] This is called other single-till income.

[4] This reflects the separate responsibilities for setting the strategy and funding the railway across Great Britain. As required by the Railways Act 2005, the 'high level output specifications' (HLOSs) set out the outputs the governments in England & Wales and Scotland want to see delivered in CP5 and the 'statements of funds available' (SoFAs) set out the funding available to deliver the HLOSs.

5. PR13 also establishes the wider 'regulatory framework', including the financial framework for Network Rail and the incentives acting on it and on train operators (and on suppliers and rolling stock companies) to encourage them to deliver and outperform our determination, including targets for performance and the efficiency challenge we set the company. The decisions taken in a periodic review have significant implications for a wide range of stakeholders including Network Rail, train operators, passengers, freight customers, funders (taxpayers and governments) and suppliers.

6. We have already set out our high-level decisions on financial framework issues in our May 2012 document – "setting the financial and incentive framework for Network Rail in CP5"[5]. These decisions covered: our approach to the cost of capital; price control separation/disaggregation; the duration of the price control; the early start mechanism[6]; whether we should use a single-till or dual till approach[7]; the high-level approach to re-openers; and our approach to the strength and other features of our approach to the financial incentives on Network Rail's operating expenditure (opex) and capital expenditure (capex). In August 2012, we consulted on some of the more detailed issues relating to Network Rail's financial framework.

7. In this document, after taking into account consultees' views, we set out some of the more detailed decisions relating to Network Rail's financial framework, e.g. our approach to inflation risk. The decisions set out in this document are important as they can have a significant impact on Network Rail, e.g. on the level of its revenue requirement and how we treat risk. The financial consequences of our decisions will be included in our draft determination in June 2013 and final determination in October 2013.

8. In this executive summary, we outline our key decisions on issues that we raised in our August 2012 consultation on financial issues for Network Rail in CP5, these include: inflation and input prices; in-year risk buffer; re-openers; level of financial indebtedness; treatment of embedded debt; and network grants. Other issues covered in this document but not in this summary include: the treatment of traction electricity, industry costs and rates; the financial indemnity mechanism (FIM) fee; amortisation and RAB[8] roll forward; corporation tax; the financial ring-fence and outperformance.

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[5] This document is available at: http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf.

[6] The early start mechanism allows Network Rail, in certain circumstances, to request early notification in the periodic review process that we will allow activity and expenditure in the next control period to be funded through its access charges.

[7] In the single-till approach, the income that we forecast Network Rail will earn on activities such as commercial property is netted off against network costs in our price control settlement. In the dual till approach, the income from each market Network Rail operates in, would be determined through the price control settlement, as if they operated in each market as a separate company.

[8] The regulatory asset base (RAB) is our calculation of the regulatory value of Network Rail's assets.

Risk and uncertainty

9. All businesses face risk and uncertainty on their costs and revenues from the impact of external events. Regulated businesses such as Network Rail are no exception. For the PR13 regulatory framework, we have decided how these risks, e.g. inflation, are allocated between the company, customers and funders.

10. It is essential that customers and funders get the best value from the money they put into the industry. To achieve this it is important that our financial framework policies deliver an appropriate allocation of risks to Network Rail (i.e. those risks that it is best placed to manage). If it manages those risks efficiently, then it will earn an appropriate return.

11. Allocating to Network Rail the risks that it is best placed to manage should ensure that it is incentivised to secure continuous improvements in value for money and operate commercially where appropriate, e.g. in managing its financial risks. Given the changes since PR08[9], most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, the key decisions set out below reflect our overall approach to reduce the headroom (i.e. a buffer) available to Network Rail in CP5.

Inflation and input prices

12. Network Rail, like other businesses and households, faces the risk that the prices it pays for goods and services, may rise or fall. This is called inflation risk[10]. Two aspects of inflation that are relevant here are:

    (a) the general level of inflation in the economy, which is usually measured by reference to the rate of change in the average prices of a basket of goods and services that is representative of typical consumption patterns. The most common measures of inflation are the indices of retail price inflation (RPI), and consumer price inflation (CPI); and

    (b) input price inflation, which is the change in the prices of Network Rail's inputs (the goods and services it consumes). Input price inflation can be measured in absolute terms or relative to movements in more general price indices, such as RPI or CPI.

13. Given that prices do change, we must decide what approach we take to inflation in reaching our determination. In particular, we must decide how to build our assumptions on inflation into the

[9] The 2008 periodic review of Network Rail's access charges for control period 4 (CP4).

[10] The inflation that each consumer faces depends on the particular mix of goods and services it consumes. This is no different for Network Rail, as inflation can affect not only the prices it must pay for labour and materials but also the interest rates it must pay on its borrowings and the real value of its assets and liabilities.

determination, and then decide what to do when actual inflation turns out to be different to those assumptions.

14. The key objectives of our approach to the treatment of inflation risk are:

    (a) allocating inflation risk between Network Rail, customers and funders based on their ability to manage those risks;

    (b) incentivising Network Rail's efficient management of inflation risk and in particular its efficient management of input prices;

    (c) maintaining the real value of Network Rail's asset base (against which it raises finance) and therefore its financial capital, to enable it to continue to access financial markets and finance the renewal and enhancement of the network;

    (d) where possible, reducing budgetary uncertainty for the industry and funders; and

    (e) where possible, not unduly affecting the financial stability of Network Rail or the rest of the industry.

15. In our proposal in the August 2012 consultation, we set out a relatively broad brush approach to incentivising the efficient management of inflation risk, reflecting the argument that the indexation approach we took for PR08 may, in some circumstances, provide weaker incentives on Network Rail to efficiently manage the inflation risk that it faces. In particular, we addressed the two key issues of incentivising Network Rail to efficiently manage inflation and dealing with budgetary uncertainty, in the same way, i.e. by proposing to remove the automatic indexation of allowed revenue by general inflation.

16. In our August 2012 consultation, we included both a proposal[11] ("the August 2012 proposal") and an alternative to that proposal[12] ("the alternative approach"). We now consider that it is more appropriate to use the alternative approach. This is because we now consider that the use of the August 2012 proposal would mean it was likely that the communication of our key message, that we want Network Rail to efficiently manage inflation, could be ineffective.

17. In the alternative approach, we allocate input price risk to Network Rail but we do not allocate general inflation risk to Network Rail, as we do not think that general inflation risk is efficiently controllable by Network Rail[13]. Indeed, if Network Rail were to bear this risk it is likely that there

[11] This was set out in detail in the August 2012 consultation.

[12] This was not set out in detail in the August 2012 consultation.

[13] To a large extent, general inflation is an uncontrollable risk as it results from the interaction of various macro-economic forces both national and international, including the fiscal and monetary policies of governments around the world. However,

would be windfall gains and losses – the company would gain if general inflation turned out to be lower than we had expected, even though the company had played no part in general inflation being lower, and vice versa.

18. So, we will incentivise Network Rail to efficiently manage inflation risk, by including, as part of PR13 (i.e. before CP5 starts), an upfront ex-ante forward looking[14] assumption for both general inflation and input price inflation[15] in our determination of access charges for CP5. Any variances between our efficiency assumptions (including input price inflation) and the actual efficiency achieved by Network Rail (including input price inflation) will be borne by Network Rail, and this strong incentive will provide a clear message that it is critically important that Network Rail efficiently manages inflation.

19. In PR13, we are keen to improve the incentives on Network Rail to efficiently manage inflation risk and in particular we are challenging Network Rail to efficiently manage its input costs by including an input price assumption in our efficiency challenge. This means Network Rail will gain if it delivers on that challenge and lose if it does not deliver the challenge. The next critical element of our challenge to Network Rail on the efficient management of its costs will come in our assessment of its strategic business plan and through a study of its management of inflation risk.

20. We are about to commission a study to identify how efficiently Network Rail manages inflation risk[16]. Following this study, if we think that Network Rail does not efficiently manage inflation then we will further adjust our efficiency assumptions in addition to our input price inflation assumptions, e.g. increase or decrease them. This will incentivise Network Rail to efficiently manage inflation. To be consistent with the allocation of input price risk to Network Rail, we have also decided that we will not adjust Network Rail's renewals expenditure for movements in a specific inflation index.

21. As we do not think that general inflation risk is efficiently controllable by Network Rail, we have decided not to expose Network Rail to variances in general inflation between our assumptions and the actual outturns by continuing to[17]:

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each consumer can affect the particular inflation which it faces by the choices it makes in the selection of goods and services to buy and the way in which it buys them. To this extent, the impact of inflation can be managed.

[14] This means that we will forecast our view of both general and input price inflation for CP5 and not just assume that the current level of general and input price inflation continues for CP5.

[15] Including input price inflation in our efficiency assumption has a similar effect, in terms of efficiency, as adjusting our inflation assumptions for an estimate of input price inflation.

[16] As it is important that Network Rail manages inflation risk as efficiently as possible and that the inflation risk that Network Rail faces and the extent to which that risk is controllable are identified, we are about to commission a study to identify how efficiently Network Rail manages inflation risk.

[17] This means that Network Rail will neither gain nor lose from the effects of general inflation.

(a) index allowed revenue by general inflation (i.e. RPI), which will provide stability for the industry through CP5. This is the most straightforward way of not exposing Network Rail to variances in general inflation risk, for the costs that are funded through allowed revenue; and

(b) adjust Network Rail's RAB by the actual movements in general inflation (i.e. RPI). This is because otherwise the real value of its asset base (against which it raises finance) and therefore its financial capital would be eroded, which could ultimately reduce the company's ability to access financial markets, and finance the renewal and enhancement of the network.

22. Table 1 below summarises how we dealt with inflation and input prices in PR08 and how we have decided to deal with it in PR13.

Table 1: Summary of our approach to inflation risk

Issue	PR13	PR08
Include an ex-ante forward looking assumption of RPI in our determinations	Yes	Yes
Include our estimate of input price inflation in our efficiency assumptions	Yes	Yes
We will carry out an inflation management study, to inform our challenge of Network Rail's costs	Yes	No
Adjust our assumptions of Network Rail's renewals expenditure for movements in a specific inflation index	No	Yes
Variances between our input price assumptions and actual input prices will be borne by Network Rail	Yes	Yes
Adjust our assumptions for renewals and enhancements expenditure each year for actual movements in RPI	Yes	Yes
Automatically adjust Network Rail's allowed revenue for actual movements in RPI	Yes	Yes
Adjust Network Rail's opening RAB each year by actual movements in RPI	Yes	Yes

In-year risk buffer

23. In PR08, we established an 'in-year risk buffer' for Network Rail. This was the amount we thought that it needed to enable it to manage business risk and normal fluctuations in cash flow. In PR08, the in-year risk buffer was £219m for England & Wales and £27m for Scotland per annum (in 2011-12 prices)[18].

24. We have decided not to provide Network Rail with an in-year risk buffer in CP5. This is because we consider that, for a number of reasons, the benefits of an in-year risk buffer may not be achieved in practice and circumstances have changed since PR08, e.g. it is not likely that Network Rail will issue unsupported debt in CP5. Also, as in control period 4 (CP4), Network Rail's balance

[18] This was £185m for England & Wales and £23m for Scotland in 2006-07 prices (2006-07 was the PR08 price base).

sheet buffer[19] (at 31 March 2012, for Great Britain, it is around £5bn in 2011-12 prices) can also be used to manage risk.

Re-openers

25. The revenue that we allow Network Rail in CP5 should be sufficient for it to deliver the required outputs if it operates economically and efficiently, taking into account normal fluctuations in costs and revenues. However, providing Network Rail with a surplus within allowed revenues, i.e. an in-year risk buffer, or a balance sheet buffer that is sufficient for it to manage all possible risk, is unlikely to represent value for money, as Network Rail is unlikely to be best placed to manage all risks. Therefore, we need to consider other ways of dealing with exceptional risks, that are material.

26. Re-openers are mechanisms that can be used to re-open the price control in certain situations to allow changes to be made to the revenues that Network Rail is allowed to recover[20], for example, where material events have happened that are beyond reasonable management control or could not have reasonably been foreseen. Hence, the financial consequences of some elements of the risks that Network Rail faces are transferred to customers and funders.

27. We decided in our May 2012 document, that we would continue to use re-openers as part of our approach to risk and uncertainty and we have now decided to use the following re-openers in PR13:

    (a) if there is a material change in the circumstances of Network Rail or in relevant financial markets. This re-opener applies to events in England & Wales and Scotland; and

    (b) for Scotland, if Network Rail's expenditure[21] in Scotland is forecast to be more than 15% higher than our determination for Scotland over a forward looking period of three years.

Level of financial indebtedness

28. The restriction on Network Rail's level of financial indebtedness has an important effect as it incentivises Network Rail to control its costs. This is because, unless we have consented otherwise, Network Rail could be in breach of its network licence if it does not use reasonable

[19] The balance sheet buffer is the difference, at a point in time, between Network Rail's actual level of financial indebtedness and the level of financial indebtedness allowed by its network licence. In its network licence the restriction on its level of financial indebtedness is presented as a percentage (i.e. debt/RAB).

[20] In our May 2011 consultation, we asked whether we should continue to use re-openers to manage risk and uncertainty. Most respondents that commented on re-openers agreed that we should continue to use them and the approach is used by other regulators.

[21] Expenditure includes support, operations, maintenance, industry cost and rates, other single-till income, renewals and enhancement expenditure, and interest costs and corporation tax payable.

endeavours to ensure that its total financial indebtedness does not exceed limits specified in that licence.

29. Given that Network Rail has not issued unsupported debt in CP4[22], we retained the licence condition that restricts the level of its financial indebtedness (although we did review the condition and made some changes to it, in particular tightening the limits). This restriction is set as a limit on Network Rail's debt/RAB ratio, which is 75% in 2012-13[23].

30. We have decided to retain the licence condition restricting the level of Network Rail's financial indebtedness, and consistent with our aim of improving the disaggregation of Network Rail's price control, we will include separate terms in Network Rail's licence for England & Wales and Scotland.

31. We will consult on the specific levels of Network Rail's maximum level of financial indebtedness in each year of CP5, by 12 July 2013, as the levels need to reflect the entire PR13 package. Our 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%.

Cost of capital

32. In our May 2012 document, we said that we will use the adjusted weighted average cost of capital (WACC) approach[24] to calculate Network Rail's allowed return for PR13. We have reviewed the other financial framework issues in light of this decision.

33. Network Rail is best placed to efficiently manage its financing costs as it understands its risks and how to finance those risks better than customers and funders do. Network Rail's financing costs in CP5 will be partly based on financial instruments that it has already taken out, i.e. part of its interest costs in CP5 are already fixed. These costs are referred to as embedded debt costs.

34. We have reduced the headroom available to Network Rail, e.g. we are using the adjusted WACC approach to determine Network Rail's allowed return (which means that the net revenue requirement funds efficient financing costs) and we have decided not to provide Network Rail with an in-year risk buffer, so we have decided to take embedded debt costs into account in CP5.

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[22] In our PR08 determination, we assumed that Network Rail would start to issue unsupported debt from the beginning of CP4.

[23] For 2009-10 and 2010-11 the limit was 70.0%. For 2011-12 the limit was 72.5% and for 2012-13 and 2013-14 the limit is 75%.

[24] This approach identifies the full cost of capital for Network Rail but recognises that Network Rail's debt is government backed and it does not pay dividends. Therefore, we adjust the cost of capital by deducting the equity surplus (i.e. the potential dividend payment) and on a net basis we fund our forecast of Network Rail's efficient financing costs.

35. However, it is important that Network Rail efficiently manages its financing costs, so we will only fund embedded debt costs in our PR13 determination for CP5, where they can be shown to have been incurred efficiently. This will help to ensure that Network Rail faces the financial consequences of its actions in the period before our final determination, i.e. it cannot take out debt and just assume that we will allow the costs associated with it.

Network grants

36. Our preferred method of funding Network Rail is for all of its income to come from train operators and other customers. This is in line with our preference for cost-reflective charges, which will in turn send signals for the efficient usage and provision of the network. It would also help avoid blurring the roles and responsibilities of Network Rail and the governments. The provision of network grants by the governments can make them look too close to Network Rail, which is not consistent with the more commercial relationships we would like to see drive behaviour in the industry, e.g. we think that it is important to strengthen the customer relationship between Network Rail and train operators. However, we see these changes happening over time and do not want to destabilise the industry.

37. It is also particularly important to improve the transparency of industry cash flows. This is because there is a real focus on whole-industry performance, and one of the effects of paying network grants straight to Network Rail, is that it makes Network Rail appear to be the loss making part of the industry.

38. We also recognise that, at the moment, 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 due to the governments' accounting rules and the processes the governments use to record expenditure.

39. In determining our PR13 policies, we need to take into account all of our statutory duties. In relation to this issue we consider that our duty to have regard to the funds available to the Secretary of State and our duty that requires us, in summary, to have regard to the expenditure that is to be incurred by Scottish Ministers are particularly relevant. Taking this into account, we have decided to allow part of Network Rail's income to be provided directly from the governments through network grants, which will be set ex-ante for each year of CP5.

40. Given the importance of driving more commercial relationships in the industry, we are keen to see the level of network grants decline in CP5. We would also expect, everything else being equal, that the efficiencies that Network Rail has delivered in CP4 and that we will challenge it to achieve in CP5, would reduce the level of the network grants in CP5. However, a significant proportion (c.

70%) of Network Rail's revenue requirement funds past investment, so the effect of efficiency savings in CP5 on Network Rail's revenue requirement is not as significant as that of some financial issues, such as the efficiency of Network Rail's financing costs and our approach to amortisation.

41. It is also important that the method we use to determine the level of the network grants in CP5 is transparent and understandable. For example, it is clearer if network grants fund specific costs, such as the financing costs of enhancements. This was not the case in CP4. Calculating the network grants in this way, would allow funders to clearly see how future efficiencies affect the level of network grants[25]. Therefore, we are considering taking a different approach to setting the level of network grants from the one we adopted in PR08.

42. To provide further transparency, we will also set out clearly in our determination what the appropriate level of fixed track access charges for each franchised passenger train operator would be in the absence of direct network grant payments. We will also show this by operating route. In this way, it will be clearer where the network grant subsidy goes, and – through our work in setting and monitoring outputs and key performance indicators (KPIs) – what taxpayers are getting for their money.

Next steps

43. This document marks an important step in establishing the financial framework for CP5. The financial consequences of the decisions we have made in this document will be included in our draft determination in June 2013 and final determination in October 2013.

[25] In CP4, the link between how the network grants were calculated and what they fund is not transparent.

1. Introduction

Purpose of this document

1.1 This document sets out our decisions on the detailed issues relating to the financial framework that will apply to Network Rail Infrastructure Limited (Network Rail) in CP5. This is an important step in the 2013 periodic review of Network Rail's access charges (PR13), which will set Network Rail's outputs, access charges and the wider regulatory and incentive framework for control period 5 (CP5) – this will run from 1 April 2014 to 31 March 2019.

1.2 We have already made high-level decisions on the financial framework, and issues that it was useful for us to resolve for our advice to ministers[26], in our May 2012 document – "setting the financial and incentive framework for Network Rail in CP5"[27]. The May 2012 document gave clarity, as far as possible, to Network Rail, train operators (passengers and freight), government, taxpayers and other stakeholders involved in the periodic review so that they could take into account the decisions and approach we are taking on certain issues and note where we will be undertaking further work. It also assisted Network Rail in developing its strategic business plan[28] (SBP). The May 2012 document also provided further explanation for our approach to the PR13 financial framework that we took in our advice to ministers, which was published in March 2012[29].

1.3 The August 2012 consultation – "consultation on financial issues for Network Rail in CP5"[30] consulted on the detailed issues relating to the financial framework that will apply to Network Rail in CP5. The consultation covered our approach to:

(a) risk and uncertainty (including inflation and input prices);

(b) cost of capital;

(c) amortisation and regulatory asset base (RAB) related issues;

(d) corporation tax; and

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[26] In our advice to ministers, we provided an update of our thinking on some of the key financial framework policies and then, where appropriate, we concluded on them in our May 2012 document.

[27] This document is available at: http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf.

[28] Network Rail's strategic business plan for CP5.

[29] Our advice to ministers was published as separate documents for England & Wales and for Scotland and began the 'formal review' phase of PR13; provided advice to the Secretary of State for Transport and Scottish Ministers on the possible range for Network Rail's revenue requirement in England & Wales and Scotland for CP5, this was intended to assist the Secretary of State and Scottish Ministers in developing their HLOSs and SoFAs for CP5; and provided advice on how the outputs in the HLOSs could be structured. See chapter 4 of each of *Advice to the Secretary of State for Transport on Network Rail's costs and outputs in CP5*, March 2012, and *Advice to Scottish Ministers on Network Rail's costs and outputs in CP5*, March 2012, both available at http://www.rail-reg.gov.uk/pr13/publications/index.php.

[30] This document is available at: http://www.rail-reg.gov.uk/pr13/consultations/financial-issues.php.

(e) other financial issues, such as, network grant, financial ring-fence and outperformance.

Structure of this document

1.4 This document is structured as follows:

(a) Chapter 2 sets out the background to this document and PR13;

(b) Chapter 3 sets out our decisions on risk and uncertainty issues;

(c) Chapter 4 sets out our decisions on inflation and input prices;

(d) Chapter 5 sets out our decisions on cost of capital issues;

(e) Chapter 6 sets out our decisions on amortisation and RAB related issues;

(f) Chapter 7 sets out our decisions on corporation tax issues; and

(g) Chapter 8 sets out our decisions on other financial issues.

2. Background

Purpose

2.1 The purpose of this chapter is to provide some background to this document, including:

(a) an overview of PR13; and

(b) our objective for PR13.

PR13 – overview

2.2 In March 2012, we formally began PR13. Through our review we will determine Network Rail's access charges, what it must deliver in return for those charges (paid by passenger train and freight operators) and for the money it receives from the Secretary of State (in respect of England & Wales) and Scottish Ministers (for Scotland). We will also set out the wider financial and incentive frameworks for CP5.

2.3 PR13 takes place at a pivotal time for the rail industry. The Rail Value for Money (RVfM) study led by Sir Roy McNulty[31], which we commissioned jointly with Department of Transport (DfT), has highlighted the value for money challenge facing the rail industry. This challenge is felt more keenly today given the economic climate and the financial pressures on train operators, passengers, freight customers, funders (taxpayers and governments) and suppliers.

2.4 In our periodic review we decide what outputs Network Rail should deliver and how much revenue it needs to efficiently deliver them. This involves estimating Network Rail's income[32] from property, stations and other sources and expenditure on support, operations, industry costs and rates, renewals, enhancements and financial costs. The estimate for financial costs includes sums for the allowed return, corporation tax and amortisation.

2.5 In order to recover its costs, as part of our review, we will decide what access charges we allow Network Rail to levy and how much funding it will receive directly from the governments in England & Wales and Scotland through network grants. In doing this, we will set Network Rail a challenging but achievable target for improvements in its efficiency.

2.6 We will also take account of the governments' priorities for railways and the public financial support they make available. The governments in England & Wales and Scotland set this out in their 'high level output specifications' (HLOSs), which set out the outputs the governments in

[31] *Realising the Potential of GB Rail - Detailed Report*, Final Independent Report of the Rail Value for Money Study, May 2011, available at http://www.rail-reg.gov.uk/server/show/ConWebDoc.10401.

[32] This is called other single-till income.

England & Wales and Scotland want to see delivered in CP5 and the 'statements of funds available' (SoFAs), which set out the funding available to deliver the HLOSs.

2.7 PR13 also establishes the wider 'regulatory framework', including the financial framework for Network Rail and the incentives acting on it and on train operators (passenger and freight), and on suppliers and rolling stock companies, to encourage them to deliver and outperform our determination, including targets for performance and the efficiency challenge we set the company. A periodic review is one of our core functions and is a major programme of work for the whole industry. The decisions taken in a periodic review have significant implications for Network Rail, train operators, passengers, freight customers, funders (taxpayers and governments) and suppliers.

2.8 We have already set out our high-level decisions on financial framework issues in our May 2012 document. These decisions were:

(a) our approach to the cost of capital;

(b) the approach to price control separation/disaggregation we are taking in CP5;

(c) the duration of the price control;

(d) the early start mechanism[33];

(e) whether we should use a single-till or dual till approach[34];

(f) the high-level approach to the mechanisms to re-open Network Rail's access charges review ('re-openers'); and

(g) our approach to the financial incentives on Network Rail's operating expenditure (opex) and capital expenditure (capex), e.g. the strength of the incentives.

2.9 In this document we set out our decisions on some of the more detailed issues relating to Network Rail's financial framework, e.g. our approach to inflation risk. The decisions in this document are important as they can have a significant impact on Network Rail, e.g. on the level of its revenue requirement and how we treat risk. These decisions follow on from our August 2012 consultation on 'detailed financial issues' for Network Rail in CP5. The consultation period closed on 26 September 2012 and we have now reviewed the consultation responses and where

[33] The early start mechanism allows Network Rail, in certain circumstances, to request early notification in the periodic review process that we will allow activity and expenditure in the next control period to be funded through its access charges.

[34] In the single-till approach, the income that we forecast Network Rail will earn on activities such as commercial property is netted off against network costs in our price control settlement. In the dual till approach, the income from each market Network Rail operates in, would be determined through the price control settlement, as if it operated in each market as a separate company.

appropriate comment on them in this document[35]. The financial consequences of the decisions will be included in our draft determination in June 2013 and final determination in October 2013.

2.10 Reflecting the separate responsibilities of governments for setting the strategy and funding of the railway across Great Britain, we 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.

Our objective for PR13

2.11 Our objective for PR13, as set out in our May 2012 document is – to protect the interests of customers and taxpayers by:

"ensuring our determination enables Network Rail and its industry partners to deliver or exceed all the specified outcome and output requirements safely and sustainably at the most efficient levels possible comparable with the best railways in the world by the end of the control period."

2.12 A key aim of any regulatory price control is to ensure that the regulated company (in this case, Network Rail) is as efficient as possible given the obligations on the company and the wider circumstances. In the context of the railway, this means maximising value for passengers, taxpayers, customers and society. To achieve this, industry reform will be crucial. In our advice to ministers documents we said that we saw PR13 as an important facilitator and driver of industry reform – in particular through our key transformational goals:

(a) a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money;

(b) 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;

(c) alignment of incentives – 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; and

[35] The consultation responses are available at: http://www.rail-reg.gov.uk/pr13/consultations/financial-issues.php.

(d) greater contestability – ensuring that there is more effective use of market mechanisms through the value chain, including in the provision of infrastructure services where appropriate, delivering further efficiencies.

2.13 Our decisions set out in this document are consistent with our 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.

2.14 We have made the decisions set out in this document by having regard to all our statutory duties including:

(a) acting in a manner that will not render it unduly difficult for Network Rail to finance its activities;

(b) having regard to the funds available to the Secretary of State;

(c) promoting efficiency and economy on the part of persons providing railway services;

(d) having regard to the interests, in securing value for money, of the users or potential users of railway services, of persons providing railway services, of persons who make available the resources and funds and of the general public;

(e) enabling persons providing railway services to plan the future of their business with a reasonable degree of assurance; and

(f) our duty which, in summary, requires that we have regard to the expenditure that is to be incurred by Scottish Ministers.

3. Risk and uncertainty

Key messages from this chapter

- By allocating risks to Network Rail, we give it an incentive to efficiently manage those risks. If we allocate to Network Rail the risks that it is best placed to manage, this will help incentivise it to deliver continuous improvements in value for money and operate commercially where appropriate.
- Given the changes since PR08, most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, we have decided to reduce the headroom available to Network Rail.
- We have decided not to provide Network Rail with an in-year risk buffer in CP5.
- We have decided to simplify the mechanisms to re-open Network Rail's access charges review.
- We have decided not to expose Network Rail to variances in the costs of the licence fee and safety levy, and business rates (if Network Rail has negotiated business rates efficiently), between our PR13 assumptions and the actual outturns.
- We have decided to retain the licence condition restricting the level of Network Rail's indebtedness, and consistent with our aim of improving the disaggregation of Network Rail's price control, we will include separate terms in Network Rail's licence for England & Wales and Scotland. Our 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%. This will have the effect of incentivising Network Rail to control its costs.

Introduction and context

3.1 All businesses face risk and uncertainty on their costs and revenues from the effect of exogenous (external) events. Regulated businesses such as Network Rail are no exception. For the PR13 regulatory framework, we have decided how these risks, e.g. inflation, are allocated between the company, customers and funders.

3.2 It is essential that customers and funders get the best value from the money they put into the industry. To achieve this it is important that our financial framework policies deliver an appropriate allocation of risks to Network Rail (i.e. those risks that it is best placed to manage). If it manages those risks efficiently, then it will earn an appropriate return.

3.3 Our objectives in designing our approach to risk and uncertainty include the need to:

(a) allocate to Network Rail the risks that it is best placed to manage. If it efficiently manages the risks we have allocated to it, Network Rail will earn the appropriate return;

(b) incentivise Network Rail to secure continuous improvements in value for money; and

(c) enable Network Rail to accommodate fluctuations in cash flow.

3.4 This chapter sets out the decisions that we have made in relation to our treatment of risk and uncertainty. This includes:

(a) the in-year risk buffer;

(b) the mechanisms to re-open Network Rail's access charges review ('re-openers');

(c) which cost changes we will compensate Network Rail for, e.g. changes in the licence fee and safety levy; and

(d) the maximum level of financial indebtedness that Network Rail can incur.

High-level approach to the treatment of risk and uncertainty

3.5 Allocating to Network Rail the risks that it is best placed to manage should ensure that it is incentivised to secure continuous improvements in value for money and operate commercially where appropriate, e.g. in managing its financial risks. Given the changes since PR08[36], most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, the key decisions set out below reflect our overall approach to reduce the headroom (i.e. a buffer) available to Network Rail in CP5.

3.6 In determining Network Rail's outputs and access charges for CP5, there are risks that its actual costs of delivering the required outputs (or revenues it will earn) will be different to those we assume in making our determination. We need to take account of these risks and uncertainties in establishing the overall package for CP5 and consider the balance of risk exposure between Network Rail and customers and funders.

3.7 We consulted on our high level approach to risk and uncertainty in our May 2011 consultation, e.g. whether we should continue to use mechanisms to re-open Network Rail's access charges review ('re-openers'). Generally, the majority of respondents agreed that the high-level approach to risk and uncertainty used in PR08 was appropriate, e.g. that we should use re-openers to assist in allocating the financial consequences of risk to whoever is best placed to manage that risk. In this document, we have set out our decisions on how these risks, e.g. inflation, are allocated between the company, customers and funders.

3.8 We discuss the approach to inflation and input prices in chapter 4.

In-year risk buffer

[36] The 2008 periodic review of Network Rail's access charges for control period 4 (CP4).

Background

3.9 In PR08, we established an 'in-year risk buffer' for Network Rail. This was the amount we thought that it needed to enable it to manage business risk and normal fluctuations in cash flow. In PR08, the in-year risk buffer was £219m for England & Wales and £27m for Scotland per annum (in 2011-12 prices)[37].

3.10 In PR08, we thought that the main advantage of an in-year risk buffer is that it enables Network Rail to manage business risk and normal fluctuations in cash flow, i.e. we provided it with headroom. Arguably, it may also allow Network Rail to be more innovative and to take some risks when developing ways of improving efficiency. This could allow Network Rail to undertake an initiative and if it went wrong it would still have sufficient resources to continue to deliver our determination. It may also help reputational incentives for it to still be able to, overall, present a positive picture, even if an efficiency initiative had failed, i.e. it might still make a profit in its statutory accounts.

August 2012 Proposal

3.11 In our August 2012 consultation we proposed that we would not provide Network Rail with an in-year risk buffer in CP5. This is because we considered that there are a number of reasons why the benefits of an in-year risk buffer may not be achieved in practice and circumstances have changed since control period 4 (CP4). These include:

(a) given it is not likely that Network Rail will issue unsupported debt in CP4 or CP5 and as it has the Financial Indemnity Mechanism[38] (FIM), it will be able to continue to deliver our determination irrespective of whether an efficiency initiative has failed;

(b) not issuing unsupported debt in CP5 will, everything else being equal, mean that we expect the consequences of Network Rail experiencing an unexpected increase in costs will be less severe than we thought in PR08. This is because as Network Rail is still using the FIM, it should still be able to access financial markets on reasonable terms. Therefore, the benefit an in-year risk buffer provides in relation to this issue is not significant;

(c) in a determination, our base case assumption is that Network Rail performs in line with our determination and does not require the use of the in-year risk buffer. Therefore, in PR08 we assumed that the annual in-year risk buffer in CP4 is used to reduce debt and is not used to fund inefficiencies. If we provide Network Rail with an in-year risk buffer for CP5, it is likely that we would take the same approach. Therefore, this money in practice

[37] This was £185m for England & Wales and £23m for Scotland in 2006-07 prices (2006-07 was the PR08 price base).

[38] This guarantee enhances Network Rail's credit, allowing it to raise debt at gilt rates (i.e. UK Government interest rates) plus a relatively small margin.

just increases the balance sheet buffer[39], which means that the real issue is whether the size of the balance sheet buffer is appropriate;

(d) in PR08, when we assessed Network Rail's financial sustainability, the adjusted interest cover ratio (AICR) was a very important financial indicator for us to consider. This was because of its use by credit rating agencies to assess the financial position of a company. Without an in-year risk buffer, Network Rail's AICR would have been significantly lower. This could have made it more difficult for Network Rail to issue unsupported debt in CP4. However, in CP5 we do not expect Network Rail to issue unsupported debt. Therefore, it is not necessary to provide Network Rail with an in-year risk buffer for financial sustainability reasons;

(e) providing funding for Network Rail in advance of it being needed could be perceived as being an unnecessary cost at a time of constrained funding and could weaken incentives. This is particularly the case now that we have confirmed in our May 2012 document that we will be using the adjusted WACC approach to determine Network Rail's allowed return and that we do not expect Network Rail to issue unsupported debt in CP5; and

(f) as well Network Rail's statutory accounts, we also require Network Rail to prepare regulatory accounts and we report on its efficiency in our annual assessment. Therefore, the overspend (everything else being equal) caused by the failure of an efficiency initiative would still be included in our efficiency monitoring in our annual assessment, as our reporting needs to be balanced. Therefore, the financial consequences of the failure of an efficiency initiative would still be clear.

Consultation responses

3.12 The majority of respondents agreed with our proposal not to provide Network Rail with an in-year risk buffer.

3.13 Network Rail strongly considered that it would need some form of risk buffer in CP5 to help it manage the business risks that it faces and considered that there are good reasons to retain the in-year risk buffer, for example, the effect on financial sustainability. However, it acknowledges the current constraint on public funds and is, as a result, content to manage risk via the balance sheet buffer as long as the balance sheet buffer is set at a level that provides it with sufficient headroom. Network Rail is also concerned about the impact that not having an in-year risk buffer could have on its reporting in its statutory financial statements and its ability to issue unsupported debt in the future.

[39] The balance sheet buffer is the difference, at a point in time, between Network Rail's actual level of financial indebtedness and the level of financial indebtedness allowed by its network licence. In its network licence the restriction on its level of debt is presented as a percentage (i.e. debt/RAB).

3.14 DfT and Transport Scotland agreed with our proposal.

3.15 Train operators agreed with our proposal, provided that Network Rail has sufficient overall headroom to respond to reasonably foreseeable shocks. However, the National Union of Rail, Maritime and Transport Workers (RMT) believes that the in-year risk buffer should be retained.

Our comments on the consultation responses

3.16 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) given how Network Rail is financed, the accounting profits it reports in its statutory accounts are not as important as ensuring the cash funding position is appropriate in accordance with our duties and our PR13 objectives; and

(b) we agree that it is important to retain the flexibility to change Network Rail's financing structure. As we discuss in chapter 5, if a situation arises in CP5 that requires a different approach we could deal with that situation. It is very important to communicate our approach effectively to financial markets and credit rating agencies, so they have a good understanding of our approach and of how changes to Network Rail's financial structure could be accommodated within it. We will therefore explain our approach to the credit rating agencies shortly.

Decisions

3.17 In terms of how Network Rail manages risk, Network Rail's balance sheet buffer (at 31 March 2012, for Great Britain, it is around £5bn in 2011-12 prices) is more important than its in-year risk buffer (for 2011-12, for Great Britain, it is £250m per annum in 2011-12 prices[40]). Network Rail's balance sheet buffer is fully available for it to use to manage risk, and hence fund unexpected increases in costs. This should allow it to deliver its required outputs and will also allow Network Rail to be more innovative and to take some risks when developing ways of improving efficiency[41]. Therefore, for this reason and those discussed above, we have decided not to provide Network Rail with an in-year risk buffer in CP5.

3.18 Not providing Network Rail with an in-year risk buffer, everything else being equal, could affect the financial sustainability of Network Rail and this is a factor we will take account of when we consider financial sustainability in our draft determination and final determination.

[40] This is £208m per annum for Great Britain in 2006-07 prices.

[41] If Network Rail is using its balance sheet buffer to fund unexpected increases in costs, depending on the reason for the higher costs, we may also be taking enforcement action against it, e.g. if there had been problems delivering an enhancement project.

3.19 If we thought that it was likely that Network Rail would issue risk capital (either debt or equity) in control period 6 (CP6), then we would consider whether we should provide Network Rail with an in-year risk buffer in CP6.

3.20 In PR08, in addition to the in-year risk buffer we included an allowance for contingency in our estimates of the cost of Network Rail's enhancements. As we develop our cost estimates for our draft and final determinations we will review the appropriate amount of contingency that we may include in our estimates of enhancement costs and we are investigating the extent to which Network Rail includes contingency in maintenance and renewals unit costs in its business planning. We are also considering whether we should use the balance sheet buffer to cover enhancement risk instead of making a specific adjustment for contingency, as that would be a simpler and more transparent approach.

3.21 We will ensure that if we do make an allowance for contingency it is transparent and consistent with our overall approach to risk and uncertainty and we are not double-counting, e.g. if we did include contingency then we would be likely to retain the enhancement deadband discussed in chapter 6.

Re-openers

Background

3.22 The revenue that we allow Network Rail in CP5 should be sufficient for it to deliver the required outputs if it operates economically and efficiently, taking into account normal fluctuations in costs and revenues. However, providing Network Rail with a surplus within allowed revenues, i.e. an in-year risk buffer, or a balance sheet buffer that is sufficient for it to manage all possible risk, is unlikely to represent value for money, as Network Rail is unlikely to be best placed to manage all risks. Therefore, we need to consider other ways of dealing with exceptional risks, that are material.

3.23 Re-openers are mechanisms that can be used to re-open the price control in certain situations to allow changes to be made to the revenues that Network Rail is allowed to recover, for example, where material events have happened that are beyond reasonable management control or could not have reasonably been foreseen. Hence, the financial consequences of some elements of the risks that Network Rail faces are transferred to Network Rail's funders and customers.

3.24 However, re-openers are just one of the tools that we use to allocate the financial consequences of risk to whoever is best placed to manage that risk and in doing so provide the basis for the cost of managing that risk to be efficient. In choosing whether to use a re-opener, we must balance this benefit with the uncertainty that re-openers can create for customers and funders.

3.25 In PR08, we included the following re-openers in passenger access contracts:

(a) if there is a material change in the circumstances of Network Rail or in relevant financial markets;

(b) if Network Rail's AICR is forecast to be equal to, or below, the value of 1.4 on average over a forward looking period of three years;

(c) if Network Rail is forecasting that within the next 18 months it cannot finance itself efficiently; and

(d) for Scotland, if Network Rail's expenditure[42] in Scotland is forecast to be more than 15% higher than our determination for Scotland over a forward looking period of three years.

3.26 In our May 2012 document, we said that providing Network Rail with a surplus within its allowed revenue that is sufficient to compensate it for all possible risk is unlikely to represent value for money as Network Rail is unlikely to be best placed to manage all risks.

3.27 We also said that we will use re-openers as part of the package of measures to efficiently manage risk and that we will use them where they represent value for money. That is, we will consider the use of a re-opener where Network Rail is unlikely to be best placed to manage the relevant risks. In choosing to use a re-opener, we will balance this benefit with the uncertainty that re-openers can create for customers and funders.

3.28 An enduring settlement across the control period is very important both for the incentives that Network Rail faces and to provide certainty to the industry and its investors. So, in our view, it is likely that re-openers will only be sparingly used as they are generally intended to cover exceptional events that have a material effect on Network Rail.

August 2012 proposal

3.29 In our August 2012 consultation, we said that when developing an approach to re-openers we need to consider whether a global re-opener (e.g. a material change in circumstances type of re-opener) is best (as by definition a global re-opener covers all potential risks) or whether additionally including more specific re-openers can add value by providing additional clarity about the treatment of some risks. Our preference is to use a global re-opener, and only include specific re-openers where we are satisfied that the risk is not one that Network Rail would be best placed to manage and would not be covered by the global re-opener, or there are other advantages of including a specific re-opener, e.g. it may improve transparency.

3.30 We proposed the following re-openers for PR13 in our August 2012 consultation:

(a) if there is a material change in the circumstances of Network Rail or in relevant financial markets; and

[42] Expenditure includes operating, maintenance, renewals and enhancement expenditure, and interest costs and corporation tax payable.

(b) for Scotland, if Network Rail's expenditure[43] in Scotland is forecast to be more than 15% higher than our determination for Scotland over a forward looking period of three years.

3.31 We also considered whether the potential changes that could arise from the industry structural reform review would need a specific re-opener, e.g. a concession, and whether there is a need for any other specific re-openers.

Consultation responses

3.32 The majority of respondents agreed with our August 2012 proposal, which they saw as a welcome simplification. Some respondents wanted us to issue clear guidance on the circumstances when and how the global re-opener would be triggered and the conditions that would apply for a global re-opener and, for example, for ORR to specify events that are excluded from the scope of such a mechanism.

3.33 Network Rail was supportive of our proposal on re-openers but noted that its exposure to financial risk should be reflected in its cost of capital.

3.34 DfT agreed with our proposal. Transport Scotland was broadly supportive of simplification, as this aligns with the principles of better regulation. However, it was also mindful that this will place a greater responsibility on the ORR in terms of applying discretion where Network Rail is of the view that there has been a material change. Transport Scotland sought an assurance from the ORR that it has the expertise to evaluate and make judgements in such circumstances and that the funders will be fully involved in those deliberations.

3.35 Transport Scotland also supported retaining the Scottish specific re-opener and the level proposed i.e. 15%. But it sought confirmation that a material change that was restricted to those areas for which the Secretary of State for Transport is responsible, will not automatically lead to a re-opener in Scotland.

3.36 Train operators generally agreed with our proposal. However, FirstGroup added that it would also expect there to be specific exclusions from a global re-opener and that it should be acknowledged ex-ante that Network Rail will not be bailed out where their actions have caused or exacerbated the factors that caused the event. In relation to Scotland, FirstGroup also said that "materiality" should be clarified as being material to Scottish Ministers.

Our comments on the consultation responses

3.37 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

[43] Expenditure includes operating, maintenance, renewals and enhancement expenditure, and interest costs and corporation tax payable.

(a) re-openers are generally intended to cover exceptional events that have a material effect on Network Rail;

(b) Network Rail thinks that our proposed changes increase its exposure to financial risks. In our view having a number of re-openers that serve similar purposes does not reduce its exposure to risk. Therefore, removing some re-openers that are no longer necessary does not increase Network Rail's exposure to risk;

(c) we can confirm that we have the expertise to evaluate whether a change in circumstances is material;

(d) we can confirm that a material change in relation to England & Wales, will not automatically lead to a re-opener in Scotland;

(e) in deciding whether a price control should be re-opened, we will involve stakeholders to the extent that we think it is appropriate;

(f) there are no exclusions from the scope of the material change in circumstances re-opener. However, just because an event is deemed material or is a change in circumstances it does not mean that we will re-open Network Rail's price control as that decision is at our discretion[44]. Also, if we do re-open the price control it does not mean that we will fully reimburse Network Rail for the cost of the event and our decision will take into account how it has managed the event; and

(g) we think that having a quantified re-opener for Scotland is more transparent for stakeholders and funders in Scotland.

Decisions

3.38 For PR13, given that it is not likely that Network Rail will issue unsupported debt in CP5 we have decided not to retain the AICR re-opener in CP5, as it was introduced to facilitate the issuance of unsupported debt by Network Rail. For similar reasons, in CP5 we are not retaining the re-opener based on Network Rail forecasting its financial position over the next 18 months.

3.39 If we thought that it was likely that Network Rail would issue risk capital (either debt or equity) in CP6, then we would consider whether these two re-openers or other similar re-openers should be used as part of our risk and uncertainty framework in CP6.

3.40 Network Rail is funded separately for its activities in England & Wales and Scotland and its activities in Scotland are approximately 10% of its total activities in Great Britain. Hence, an issue that might be material in Scotland may not be material in England & Wales or for Network Rail as

[44] In taking this decision we would have regard to our section 4 duties.

a whole[45]. In PR08, it was thought that having a quantified re-opener for Scotland was more transparent for stakeholders and funders in Scotland and in our view this reasoning still applies today. For these reasons, we have therefore decided to retain a specific re-opener for expenditure[46] in Scotland and we will retain the same trigger level as in PR08 (i.e. 15% of expenditure) as that is still an appropriate level.

3.41 Therefore, we will include the following re-openers in PR13:

(a) if there is a material change in the circumstances of Network Rail or in relevant financial markets. This re-opener applies to events in England & Wales and Scotland; and

(b) for Scotland only, if Network Rail's expenditure in Scotland is forecast to be more than 15% higher than our determination for Scotland over a forward looking period of three years.

3.42 We also do not think that the potential changes that could arise from industry structural reform need a specific re-opener, e.g. for a concession, as the material change in the circumstances of Network Rail or in relevant financial markets re-opener is sufficient and adding other re-openers to our risk and uncertainty framework would unnecessarily complicate the regulatory framework.

3.43 The Office of National Statistics (ONS) is considering changing the definition of RPI[47]. We will continue closely monitoring this issue and decide whether there needs to be a specific re-opener for this issue in our draft determination. Our initial view is that we do not think that a specific re-opener for CP5 is necessary, as the issue is covered by the material change in circumstances re-opener. We will decide on this issue in our draft determination.

Traction electricity, industry costs and rates

Background

3.44 The key issue for us in determining the treatment of traction electricity costs (£211m for Great Britain in 2011-12), industry costs and rates is ensuring that these costs are efficiently managed and if it efficiently manages the risks we have allocated to it, Network Rail will earn the appropriate return.

3.45 Industry costs and rates includes:

[45] It is unlikely, but an issue that leads to the re-opening of the price control in England & Wales may not lead to a re-opening of the price control in Scotland.

[46] Expenditure includes support, operations, industry cost and rates and other single till income, maintenance, renewals and enhancement expenditure, and interest costs and corporation tax payable.

[47] The consultation document is available at: http://www.ons.gov.uk/ons/about-ons/user-engagement/consultations-and-surveys/archived-consultations/2012/national-statistician-s-consultation-on-options-for-improving-the-retail-prices-index/options-for-improving-rpi-consultation-document.pdf.

(a) British Transport Police (BT Police) costs[48] (£72m for Great Britain in 2011-12[49]);

(b) the Rail Safety and Standards Board (RSSB) levy (£9m for Great Britain in 2011-12[50]);

(c) the ORR's licence fee and the safety levy (£20m for Great Britain in 2011-12); and

(d) business rates[51] (£108m for Great Britain in 2011-12).

August 2012 Proposal

3.46 In our May 2012 document, we confirmed that for support costs Network Rail will continue to be wholly exposed to the difference between the assumption in our determination and the outturn cost. However, some costs are not as subject to Network Rail's control as support costs, so that Network Rail may not be as well placed to efficiently manage risks around those costs. So, for some of those costs we are proposing to use a different approach that reimburses Network Rail for differences between our assumptions and the actual outturns. We set out below our decisions on the treatment of the costs of traction electricity, industry costs and rates[52].

Traction electricity

3.47 In our May 2012 document, we decided on the framework of incentives for traction electricity charges in CP5, which should drive the efficient management of these costs by both Network Rail and train operators. As part of that framework, we have decided to expose Network Rail to some of the costs associated with transmission losses, reflecting their ability to control these costs.

3.48 We said that metered train operators will be billed on the basis of consumption, with a mark-up based on a challenging but achievable level of losses and the year-end volume wash-up will be allocated between unmetered services and Network Rail, to reflect its ability to manage the risk. Network Rail will therefore be increasingly exposed to the risk of underperformance (downside) and outperformance (upside) in electricity supply tariff areas where there is a greater percentage of metered services.

3.49 In our August 2012 consultation, we proposed that Network Rail's own use of traction electricity (such as power supplies for signals and stations) is treated as a controllable cost, as it has control over these costs. We also proposed that the elements of traction electricity costs that we deem not to be sufficiently controllable by Network Rail will be passed through to train operators

[48] British Transport Police is the police force for the GB railways tasked with policing the track and providing services to rail operators, staff and passengers. It is an executive non-departmental public body of the DfT and, split into 7 geographical regions, the force is comprised of 2,835 police officers and 1,455 support staff.

[49] Network Rail's share of these costs, which is 28% in 2011-12.

[50] Network Rail's share of these costs, which is 28% in 2011-12.

[51] When we say business rates, we are referring to cumulo rates.

[52] In PR08, even though we treated some of these costs in a similar way to support costs we continued to call this group of costs "non-controllable" to be transparent, as at the start of PR08 they were called "non-controllable costs".

through the four-weekly billing process and their allocation of the yearly volume wash-up (at the moment this is all traction electricity costs except for Network Rail's own use and transmission losses). We also proposed to include the costs that we think are sufficiently controllable by Network Rail in any efficiency or performance assessment in CP5.

BT Police

3.50 In our August 2012 consultation, we proposed that in PR13 we would determine an efficient level for Network Rail's share of BT Police costs and set an ex-ante allowance with the risk of the outturn being different taken by Network Rail. This approach means that Network Rail has an opportunity to outperform our assumption. We also proposed to include these costs in any efficiency or performance assessment in CP5.

3.51 The total cost in 2011-12 of BT Police is £265m[53]. This is significant in terms of the industry's overall costs. Therefore, from a whole industry perspective it is important that these costs are efficiently managed.

RSSB costs

3.52 In our August 2012 consultation, we proposed that in PR13 we would determine an efficient level for Network Rail's share of RSSB costs and set an ex-ante allowance with the risk of the outturn being different taken by Network Rail. We also proposed to include these costs in any efficiency or performance assessment in CP5[54].

Licence fee and safety levy

3.53 In our August 2012 consultation, we explained that we did not think that the licence fee and safety levy were sufficiently controllable by Network Rail for us to expose it to variances in these costs, as we control these costs and ensure they are at an efficient level.

3.54 As such, we proposed to log up/down any variances in these costs between the assumptions in our determination and the outturns. As these costs are not sufficiently controllable by Network Rail, we said that we were minded to exclude this cost from any efficiency or performance assessment in CP5.

Business rates

3.55 Business rates are controllable when Network Rail is negotiating the valuation of its network with the Valuation Office Agency (VOA). The next valuation of Network Rail's network will be completed after our final determination, so we will not know the cost of Network Rail's business rates in CP5 when we make that determination.

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[53] Network Rail pays 28% of BT Police costs (£72m in 2011-12).

[54] The RSSB has undertaken a strategic review as a result of findings in the McNulty Report, which recommended an increase in RSSB's size, to incorporate a system agency function. This may increase RSSB's costs, so we will consider these issues for our draft determinations. In a recent consultation, RSSB said that it is too soon to anticipate any restructuring costs consequent upon the strategic review. The consultation is available at: http://www.rssb.co.uk/AboutUs/Documents/RSSB%20Consultation%20Final.pdf.

3.56 Therefore, we proposed that we would assume an ex-ante forecast in Network Rail's CP5 allowed revenue and as long as Network Rail can show that it has negotiated efficiently with the VOA, e.g. if it has raised the right issues, we will log up/down any variations from the level we assumed in our determination and adjust Network Rail's allowed revenues in CP6. This is the same approach as in PR08. If we determine that it has negotiated these costs efficiently, then we proposed that we would exclude these costs from any efficiency or performance assessment in CP5, otherwise we will include them.

Consultation responses

Traction electricity

3.57 Most respondents, including DfT and Transport Scotland, supported our proposal to treat Network Rail's transmission losses as controllable and pass the risk for the remainder of traction electricity costs to the train operators (apart from electricity used for Network Rail's own use).

3.58 Network Rail agreed that its own traction electricity usage should be treated as a controllable cost and agreed that our proposal to allow it to recover a 'challenging but achievable level of losses' is reasonable, and that it would like to work closely with us to establish evidence based targets. In addition, Network Rail said that it and the industry will require more detail in respect of ORR's proposals to adjust the way in which the volume wash-up risk should be allocated in CP5 in order to be able to consider ORR's proposals appropriately.

3.59 The train operators agreed with our proposal on traction electricity. FirstGroup noted the need to ensure that maintenance regimes are targeting reducing electricity losses and warned of the increased importance of improvement in this area, given the increase in electrification projects.

BT Police and RSSB costs

3.60 The majority of respondents, supported the proposal that Network Rail, given its size and ability to influence decisions, should take industry leadership and accept exposure to at least its share of BT Police and RSSB costs.

3.61 Network Rail does not consider that it should be exposed to variances in these costs because it thinks that having one director on these boards does not mean it can exercise enough influence over these costs. Furthermore, Network Rail noted that its representative on the British Transport Police Authority (BTPA) and RSSB has a legal obligation to the BTPA and RSSB, which Network Rail thinks would conflict with its view that the ORR thinks that Network Rail should use its influence to Network Rail's advantage. However, Network Rail says it would exert its influence as a customer and to improve efficiency.

3.62 DfT agreed with our proposal. Transport Scotland agreed with our proposal subject to us ensuring that Network Rail does not adversely reduce the effectiveness of the services provided by these organisations.

3.63 Train operators accepted our proposal. FirstGroup and East Midland Trains highlighted the requirement for Network Rail to be incentivised as an industry leader to be efficient.

Licence fee and safety levy

3.64 All respondents were supportive of our proposal not to expose Network Rail to variances in the cost of the licence fee and safety levy, as this is not sufficiently controllable by Network Rail.

Business rates

3.65 All respondents were supportive of our August 2012 proposal. However, Network Rail said that the ORR should not be in the position of having to second guess management decisions and trade-offs. It highlighted that there were issues with Network Rail's efficiency negotiations in 2010, as our assessment lasted too long. Therefore, there should be a clear timetable and the definition of efficiency was too onerous.

Our comments on the consultation responses

3.66 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we understand that the Network Rail representative on the BTPA and RSSB has legal duties to those organisations. We do not think Network Rail should use its influence inappropriately for its own advantage but that it can act to improve the efficiency of these costs. This is because, it is a normal part of a director's role to run an organisation as efficiently as possible and part of the BT Police's mission statement is to "endeavour to provide value for money in everything we do". Also, Network Rail says that it would exert its influence as a customer and to improve efficiency; and

(b) the key criteria, in simple terms, that Network Rail will need to meet to show it has negotiated business rates efficiently, are set out below in our decision on business rates.

Decisions

Traction electricity

3.67 We have decided that we will assess traction electricity costs and determine an efficient level of cost and set an ex-ante allowance with the risk of the outturn, on those aspects of the cost (such as transmission losses that are controllable by Network Rail), being different, taken by Network Rail, as it has control over these costs. We have also decided that Network Rail's own use of traction electricity (such as power supplies for signals and stations) is treated as a controllable cost, as it has control over these costs.

3.68 We have decided that the elements of traction electricity costs that we deem not to be sufficiently controllable by Network Rail (at the moment this is all traction electricity costs except for Network Rail's own use and transmission losses) will be passed through to train operators. We expect this to be implemented in CP5, as in CP4, through the four-weekly billing process and the allocation

of the yearly volume wash-up (for services that are not metered) and yearly price/cost wash-up (for all services). We will consult on our proposals regarding treatment of the traction electricity costs that we consider sufficiently controllable by Network Rail, specifically related to transmission losses, shortly.

3.69 We have also decided to include the costs that we think are sufficiently controllable by Network Rail in any efficiency or performance assessment in CP5, e.g. in Network Rail's regulatory accounts and our annual assessment of Network Rail's finance and efficiency.

BT Police

3.70 Network Rail is a member of the BTPA and one of its directors is also a representative on the board of the BTPA. It is the largest funder of BT Police and can exercise industry leadership. We think that it has sufficient influence over these costs for us to treat them in the same way as support costs. We have therefore decided to determine an efficient level for Network Rail's share of these costs and set an ex-ante allowance with the risk of the outturn being different taken by Network Rail. This treatment is exactly the same treatment as for support costs, which is important as some of the benefits that are provided by BT Police (such as reductions in delay minutes) relate to cost and performance issues that Network Rail is incentivised to deliver. Therefore, we have also decided to include these costs in any efficiency or performance assessment in CP5, e.g. in Network Rail's regulatory accounts and our annual assessment of Network Rail's finance and efficiency.

RSSB costs

3.71 Network Rail is a member of the RSSB, and two of its directors are also on the RSSB Board, it is the largest funder of RSSB and can exercise industry leadership. We think that it has sufficient influence over these costs for us to treat them in the same way as support costs. We have therefore decided to determine an efficient level for Network Rail's share of these costs and set an ex-ante allowance with the risk of the outturn being different taken by Network Rail. This treatment is exactly the same treatment as for support costs, so we have decided to include these costs in any efficiency or performance assessment in CP5, e.g. in Network Rail's regulatory accounts and our annual assessment of Network Rail's finance and efficiency.

Licence fee and safety levy

3.72 We do not think that the licence fee and safety levy is sufficiently controllable by Network Rail for us to expose it to variances in the costs, as we control these costs and ensure they are at an efficient level. Therefore, we have decided to log up/down any variances in these costs between the assumptions in our determination and the outturns. As these costs are not sufficiently controllable by Network Rail, we have decided to exclude them from any efficiency or performance assessment in CP5, e.g. in Network Rail's regulatory accounts and our annual assessment of Network Rail's finance and efficiency.

Business rates

3.73 Business rates are controllable when Network Rail is negotiating the valuation of its network with the VOA. The next valuation of Network Rail's network will be completed after our final determination[55], so we will not know the cost of Network Rail's business rates in CP5 when we make that determination.

3.74 Therefore, we have decided to assume an ex-ante forecast in Network Rail's CP5 allowed revenue and as long as Network Rail can show that it has negotiated efficiently with the VOA, e.g. it has raised the right issues, at the right time and in the right way we will log up/down any variations from the level we assumed in our determination and adjust Network Rail's allowed revenues in CP6.

3.75 If we determine that it has negotiated these costs efficiently, then we have decided to exclude these costs from any efficiency or performance assessment in CP5, e.g. in Network Rail's regulatory accounts and our annual assessment of Network Rail's finance and efficiency, otherwise we will include them. Due to the uncertainty over the next valuation of Network Rail's network, we cannot, at the moment, say when we will complete our assessment of the efficiency of Network Rail's negotiations for its next valuation. But as soon as we can, we will set out the timetable for our assessment.

Level of financial indebtedness

Background

3.76 The restriction on Network Rail's level of financial indebtedness has an important effect as it incentivises Network Rail to control its costs. This is because, unless we have consented otherwise, Network Rail could be in breach of its network licence if it does not use reasonable endeavours to ensure that its total financial indebtedness does not exceed the limits specified in that licence. Also, the difference between its limit on financial indebtedness and its actual debt/RAB ratio provides Network Rail with a balance sheet buffer that is fully available for it to use to manage risk and hence fund unexpected increases in costs, which should allow it to deliver its required outputs.

3.77 Given that Network Rail has not issued unsupported debt in CP4[56], we retained the licence condition that restricts the level of Network Rail's financial indebtedness (although we did review

[55] The UK government has announced plans to postpone the 2015 business rates revaluation until 2017 in England. Legislation will be required to do this, which as far as we know is expected to receive Royal Assent by April 2013. If passed, the revised valuation date will be 1 April 2015 and the effective date will be 1 April 2017. It is predicted that the same changes will be made in Scotland and Wales.

[56] In our PR08 determination, we assumed that Network Rail would start to issue unsupported debt from the beginning of CP4.

the condition and made some changes to it, in particular tightening the limits)[57]. This restriction is set as a limit on Network Rail's debt/RAB ratio, which is 75% in 2012-13[58].

3.78 In order to calculate our proposed levels for the restriction of Network Rail's financial indebtedness, we set out in our August 2012 consultation how we could test the robustness of Network Rail's financial position in the face of cost and revenue uncertainty.

3.79 Based on our indicative analysis we explained that our thinking, in August 2012, was that the level of financial indebtedness in each year of CP5 should at no point exceed a limit set between 70-75% of Network Rail's RAB.

Consultation responses

3.80 Respondents mostly agreed with our principal of restricting Network Rail's level of financial indebtedness as they thought this would improve incentives on Network Rail. The respondents who commented on what that level should be (Go-Ahead, Transport for London (TfL) and the RMT) agreed with our thinking in August 2012 that the level of financial indebtedness in each year of CP5 should at no point exceed a limit set between 70-75% of Network Rail's RAB.

3.81 Network Rail said that if the in-year risk buffer was removed, the balance sheet buffer would increase in significance and it was too early in the periodic review to assess the level of the balance sheet buffer. However, Network Rail noted that its initial analysis, which takes into account uncertainty around enhancements and our proposals on inflation suggest that the balance sheet buffer will need to be, on average, at least 5 to 6 percentage points higher than the limit consistent with Network Rail achieving its CP5 financial performance targets. Network Rail commented that the 75% debt/ratio is exceeded by several utilities in the water sector and warned that in the case of an insufficient forecast balance sheet buffer, the company may be pushed towards adopting a more conservative approach to innovation.

3.82 DfT agreed that the restriction on Network Rail's financial indebtedness was important for restricting governments' funding risk from Network Rail. It agreed with us that the level needs to be based on quantified analysis and risk modelling.

3.83 Transport Scotland highlighted an anomaly in the treatment of financial indebtedness in PR08 in respect of Scotland. This is because, as part of the separation between England & Wales and Scotland, for price control purposes, there are notional debt and RAB numbers for Scotland. Whereas, the level of financial indebtedness licence condition is based on Great Britain. Transport Scotland felt that there was a risk that England and Wales's investments could limit the ability of Scottish Ministers to invest through the RAB.

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[57] If Network Rail issues unsupported debt in CP4, as part of the changes we would make to its price control we would remove this licence condition.

[58] At 31 March 2014 this limit is 75%.

3.84 The Association of Train Operating Companies (ATOC) said that we need to set the balance sheet buffer at a suitable level to ensure that it strengthens Network Rail's efficiency incentives, whilst ensuring Network Rail has sufficient headroom.

Our comments on the consultation responses

3.85 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we agree with respondents that:

(a) our decision on the maximum level of financial indebtedness needs to be based on quantified analysis and risk modelling and we need to have the right balance between incentivising Network Rail and providing it with sufficient headroom, particularly as we have decided to remove other buffers, e.g. the in-year risk buffer;

(b) it is too early in the PR13 process for us to decide on the maximum level of financial indebtedness as we have not yet reviewed the SBP and made our other assumptions for the draft and final determinations; and

(c) there should be a separate term in Network Rail's network licence for the level of financial indebtedness in relation to Scotland, as Network Rail's price control is disaggregated between England & Wales and Scotland. This is consistent with the approach we set out in our May 2012 document, where we said that we will look for further opportunities to disaggregate Network Rail's price control between England & Wales and Scotland.

Decisions

3.86 We have decided to retain the licence condition restricting the level of Network Rail's financial indebtedness, and consistent with our aim of improving the disaggregation of Network Rail's price control, we will include separate terms in Network Rail's network licence for England & Wales and Scotland. This will have the effect of incentivising Network Rail to control its costs.

3.87 We will consult on the specific levels of Network Rail's maximum level of financial indebtedness in each year of CP5, by 12 July 2013, as the levels need to reflect the entire PR13 package. Our 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%.

4. Inflation and input prices

Key messages from this chapter

- We are incentivising Network Rail to efficiently manage inflation risk because we think that it is critically important in delivering improved value for money. Therefore, Network Rail will be exposed to input price risk and we are about to carry out a study to identify how efficiently Network Rail manages inflation risk.
- We have decided that we will not adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index) as we think we will improve incentives by including an upfront estimate of input price inflation in our efficiency assumption.
- By deciding to continue to index access charges and network grants by general inflation (i.e. RPI), we are not exposing Network Rail to changes in costs that it cannot control, while also providing stability for the industry.
- We have decided to continue to uplift Network Rail's RAB by the actual movements in general inflation (i.e. RPI), as otherwise the real value of its asset base (against which it raises finance) and therefore its financial capital would be eroded, which could ultimately reduce the company's ability to access financial markets and finance the renewal and enhancement of the network.

Introduction

4.1 This chapter provides:

(a) background on inflation issues;

(b) a summary of our August 2012 proposal;

(c) a summary of the responses to our August 2012 proposal;

(d) our comments on the responses to our August 2012 proposal;

(e) issues with our August 2012 proposal;

(f) an explanation of our alternative approach; and

(g) a summary of our decisions on inflation and input prices.

4.2 Also, in order to make our decisions on our approach to inflation risk as clear as possible, we have provided a high-level summary in Annex A.

Background

Why is inflation important?

4.3 Network Rail, like other businesses and households, faces the risk that the prices it pays for goods and services, may rise or fall, i.e. inflation is a general risk faced by everyone. This is called inflation risk. The inflation that each consumer faces depends on the particular mix of goods and services it consumes. This is no different for Network Rail, as inflation can affect not only the prices it must pay for labour and materials but also the interest rates it must pay on its borrowings and the real value of its assets and liabilities.

4.4 The general level of inflation in the economy is usually measured by reference to the rate of change in the average prices of a basket of goods and services that is representative of typical consumption patterns. The most common measures of inflation are the indices of retail price inflation (RPI), and consumer price inflation (CPI).

4.5 The RPI is the index most commonly used at the moment to adjust payment flows to maintain their real value. For example, payments of interest and repayments of capital on certain government bonds (known as index-linked gilts) are indexed to RPI.

4.6 To the extent that a particular consumer faces higher or lower inflation, compared to RPI, because the average price of the basket of goods and services it consumes is rising or falling at a different rate compared to the RPI basket, there is a so-called relative price effect – the difference between the two reflects a change in the real cost of the goods and services consumed compared to the economy-wide average.

4.7 To a large extent, inflation is an uncontrollable risk as it results from the interaction of various macro-economic forces both national and international, including the fiscal and monetary policies of governments around the world. However, each consumer can affect the particular inflation which it faces by the choices it makes in the selection of goods and services to buy and the way in which it buys them. To this extent, the impact of inflation can be managed.

4.8 We want to incentivise Network Rail to manage the inflation it faces as efficiently as it can. At the same time, we want to ensure that the real value of Network Rail's asset base (against which it raises finance) and therefore its financial capital is maintained, to enable it to continue to access financial markets and finance the renewal and enhancement of the network.

How inflation is treated in price controls

4.9 If on average prices in the economy rise, everything else being equal, a firm in a competitive market would also be expected to pay higher prices as well for the goods and services provided by its suppliers. However, it could also expect to increase the price of its own products without affecting the volume of its sales.

4.10 When setting price controls for regulated companies in non-competitive markets. Regulators have normally indexed regulated companies charges to a basket of prices, to attempt to reflect what a competitive market would do in the face of such changes in the prices of its inputs and competing products, i.e. everything else being equal, in a competitive market a company would raise its prices. Example 1 below illustrates the issue that regulators face.

Example 1 – An inflation issue faced by a regulator

Assumptions:

- A company employees 100 people
- It has a fixed output obligation
- It pays its staff £10 per hour, which is the going rate for the job and that is the only cost of production
- Therefore, the cost of the output is £1,000 (100 x £10) and that is also the selling price
- There is a perfectly flexible labour market (easy labour mobility)
- An efficiency study has said that if the company was perfectly efficient, it would employ 80 people (i.e. it is 20% inefficient at the moment)
- There is general inflation of 50% in the economy and market labour rates also rise by 50% to £15 per hour

Implications:

- The company still needs to deliver its output
- If it does not pay its staff £15 per hour, all its employees will leave and the output cannot be produced, so in order to meet its fixed output obligation it has to raise its wages to £15 per hour
- The company successfully implements its efficiency programme to reduce costs by 20%
- Therefore, the product now costs £1,200 (80 x £15), so the company would try to increase the price of its product. Otherwise it would lose money
- But a regulated company like Network Rail cannot increase its prices without a regulatory mechanism being in place to allow it to do so. A regulator deals with this situation by allowing the regulated company to increase its prices and hence deliver its fixed output

4.11 When we calculate Network Rail's efficiency assumptions we calculate them relative to our forecast of future general inflation (i.e. RPI). General inflation reflects changes in prices after the effect of productivity changes in the economy as a whole. The productivity changes that we have assumed in our efficiency assumptions are additional to the productivity changes that we expect in the economy as a whole.

4.12 The efficiency assumptions in CP4 also included adjustments for our estimate of input price inflation[59], as in order to incentivise Network Rail to efficiently manage inflation, it is exposed to movements in input price inflation in CP4.

[59] Input price inflation is the change in the prices of Network Rail's inputs (the goods and services it consumes). Input price inflation can be measured in absolute terms or relative to movements in more general price indices, such as RPI or CPI.

4.13 In CP4, we continued not exposing Network Rail to general inflation risk, by setting the PR08 determination in real terms and indexing access charges and the network grants each year with reference to movements in the November value of RPI. This means that each of the individual elements of revenue are first calculated in a real price base (e.g. 2011-12 or 2012-13 prices as appropriate for CP5) and then changed in line with movements in November's actual RPI figure.

4.14 Also, in the CP4 RAB roll forward process we adjust:

(a) our PR08 assumptions for renewals and enhancements expenditure each year for movements in RPI;

(b) our assumption of Network Rail's renewals expenditure for movements in the infrastructure output price index (IOPI)[60]; and

(c) Network Rail's opening RAB in each year for movements in RPI.

4.15 For PR08, we used RPI as the measure of general inflation to index allowed revenue and the RAB. However, there are other general inflation measures[61] that could be used instead of RPI, for example, RPIX[62], the consumer price index[63] (CPI) and the GDP deflator[64], and we could use specific indices that include the effect of input price inflation such as IOPI or COPI[65].

4.16 These other measures of inflation may or may not provide a more accurate index of the effect of inflation on Network Rail. However, any assessment of the effect of inflation on Network Rail would also need to consider the effect of inflation on Network Rail's financing costs and at the moment most financial instruments are normally indexed by RPI. Approximately 50% of Network Rail's gross debt (£15bn) is index-linked[66] and the index used to adjust the value of that debt for inflation is RPI.

4.17 Materially, the biggest effect of inflation on Network Rail is the effect on its financing costs as illustrated in table 4.1 below.

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[60] This is in addition to the adjustment in 4.14 (a).

[61] These measures of general inflation include productivity improvements in the wider economy. Therefore, when considering our efficiency and inflation assumptions (and in particular our frontier shift efficiency assumptions) we need to take this into account. Further information can be found at http://www.ons.gov.uk/ons/rel/cpi/consumer-price-indices/may-2012/stb---consumer-price-indices---may-2012.html#tab-background-notes.

[62] RPIX is RPI excluding mortgage interest payments.

[63] The Consumer Prices Index (CPI) measure the prices of goods and services purchased for the purpose of consumption by households in the UK and is similar to RPI but excludes mortgage interest payments and other costs and is calculated differently.

[64] The GDP deflator is a much broader price index than RPI, RPIX or CPI (which only measure consumer prices) as it reflects the prices of all domestically produced goods and services in the economy. Hence, the GDP deflator also includes the prices of investment goods, government services and exports, and subtracts the price of UK imports.

[65] COPI is the colloquial name for the Department for Business, Innovation and Skills (BIS) Output Price Index for New Construction: All New Construction and is derived from the relationship of current price and constant price construction output volume figures produced by the ONS. In other words, it represents the movement in the cost to clients of work carried out on new construction in a period.

[66] This is the level of index-linked debt at 31 March 2012. Index-linked debt is debt where the value of the debt is adjusted for movements in inflation, instead of the assumed level of inflation being included in an interest payment.

Table 4.1: Materiality of inflation on Network Rail (based on 2011-12)

In £millions	2011-12	Impact of higher inflation (e.g. 3%)	% of total expenditure
Expenditure categories			
Controllable opex	906	27	13%
Non-controllable opex	420	13	6%
Maintenance	968	29	14%
Schedule 4 & 8	172	5	2%
Renewals	2,455	74	35%
Enhancements	2,077	62	30%
Total expenditure	**6,998**	**210**	**100%**
Finance categories (as a percentage of expenditure)			
Financing costs	1,470	44	21%
Net debt (at 31 March 2012)	26,489	795	379%
RAB (at 31 March 2012)	42,371	1,271	605%

Note: Approximately 50% of Network Rail's debt is index-linked and its value changes each year for inflation. The interest payments in relation to nominal debt will also include the estimate of inflation assumed when the debt was issued.

4.18 Indexing Network Rail's allowed revenue by general inflation, as we did in PR08 and in previous access reviews, means Network Rail is not exposed to general inflation risk. However, there are two key potential issues with that approach:

(a) it is important that Network Rail manages inflation as efficiently as possible. It may be the case that not exposing Network Rail to general inflation risk, by automatically adjusting Network Rail's revenue in line with actual movements in general inflation will, in some circumstances, provide weaker incentives on Network Rail to manage the effects of inflation where it can; and

(b) DfT and Transport Scotland have issued their PR13 SoFAs in nominal terms because they budget in nominal terms. This means that if Network Rail's allowed revenue is automatically updated for actual general inflation on a yearly basis, DfT and Transport Scotland will have budgetary uncertainty, i.e. they will not know in advance how their cash flows will change.

4.19 Given that prices do change, we must decide what approach we take to inflation in reaching our determination. In particular, we must decide how to build our assumptions on inflation into the determination, and then decide what to do when actual inflation turns out to be different to those assumptions

4.20 The key objectives of our approach to the treatment of inflation risk are:

(a) allocating inflation risk between Network Rail, customers and funders based on their ability to manage those risks;

(b) incentivising Network Rail's efficient management of inflation risk and in particular its efficient management of input prices;

(c) maintaining the real value of Network Rail's asset base (against which it raises finance) and therefore its financial capital, to enable it to continue to access financial markets and finance the renewal and enhancement of the network;

(d) where possible, reducing budgetary uncertainty for the industry and funders; and

(e) where possible, not unduly affecting the financial stability of Network Rail or the rest of the industry.

4.21 In PR13, we are keen to improve the incentives on Network Rail to efficiently manage inflation risk and in particular we are challenging Network Rail to efficiently manage its input costs by including an input price assumption in our efficiency challenge. This means Network Rail will gain if they deliver on that challenge and lose if they do not deliver the challenge. The next critical element of our challenge to Network Rail on the efficient management of its costs will come in our assessment of its strategic business plan and our study on Network Rail's management of inflation risk.

August 2012 proposal on indexation and input prices

4.22 In our August 2012 consultation, we included both a proposal[67] ("the August 2012 proposal") and an alternative to that proposal[68] ("the alternative approach"). The key features of the August 2012 proposal are:

(a) we determine an ex-ante forward looking[69] assumption of inflation for PR13 (i.e. before CP5 starts), of say 3% per annum. This estimate would include both general inflation, e.g. RPI, and the effect of specific inflation faced by Network Rail (input price inflation)[70]. We proposed to include the effect of specific inflation in our inflation assumption because we are focusing on incentivising Network Rail to manage inflation efficiently, which means that we need to assess the inflation risk that it is likely to experience. In practice, it is hard

[67] This was set out in detail in the August 2012 consultation.

[68] This was not set out in detail in the August 2012 consultation.

[69] This means that we will forecast our view of both general and input price inflation for CP5 and not just assume that the current level of general and input price inflation continues for CP5.

[70] Including input price inflation in our inflation assumption has a similar effect, in terms of efficiency, as adjusting our efficiency assumptions for an estimate of input price inflation.

to split the inflation that Network Rail faces into general and input price inflation. Therefore, the important issue is to identify the total inflation risk that Network Rail faces and the extent that risk is controllable;

(b) we would continue to adjust Network Rail's RAB by the actual movements in general inflation, as otherwise the real value of its asset base and therefore its financial capital would be eroded, but we would hard-wire our inflation assumption into the determination of allowed revenue, so that if we assumed that inflation (including input price inflation) was going to be 3% per annum in CP5, allowed revenue would increase by 3% each year;

(c) we could then place a deadband around our forecast inflation assumption of, say, plus two percentage points and minus two percentage points for each year of CP5, i.e. the deadband would be from 1% to 5% (it is also possible to make the deadband asymmetric around our assumed level of inflation, e.g. the deadband could go from 2% to 5%). Within this band we would not adjust Network Rail's revenue in the year concerned and we would not re-open the price control. Any difference between our assumed level of inflation (including input price inflation) and actual inflation (including input price inflation), that we think is efficient[71], could be logged up and allowed as revenue in CP6. This would mean that there would be no yearly adjustment in CP5 but we will adjust Network Rail's revenue in CP6 for the difference in CP5. For example, if Network Rail was worse off by, say, £500m in CP5, we would increase its revenue in CP6 by £500m (if we thought that it had efficiently managed inflation)[72]; and

(d) if actual inflation was outside of the deadband, i.e. lower than 1% or higher than 5%, then in CP5 we would assess whether the variances were material enough for us to re-open Network Rail's price control within CP5 through the material change in circumstances re-opener.

4.23 In our August 2012 consultation, we recognised there were some practical difficulties with our August 2012 proposal. In particular, we recognised that it is more complicated than an automatic adjustment (indexation) approach and the incentive effects of our August 2012 proposal are difficult to evaluate, particularly if there is a difference between our inflation assumptions and the actual outturns.

4.24 We also explained in our August 2012 consultation that an alternative to our August 2012 proposal would be to continue to index allowed revenue each year for movements in RPI and if

[71] This would be done through an ex-post review of the efficiency of Network Rail's management of inflation risk.

[72] An alternative to this approach would be to fully expose Network Rail to the differences between our inflation assumptions (general and input inflation) and the actual outturns. However, given the difficulty of forecasting inflation accurately, this could produce material windfall gains or losses that could unduly distort incentives.

our study on Network Rail's management of inflation risk identifies an issue, we could adjust our efficiency assumptions, e.g. increase or decrease them.

Consultation responses

4.25 Most respondents did not support our August 2012 proposal. The main issues raised were that the proposal was too complex, unlikely to improve incentives and would increase the risk for both Network Rail and train operators.

4.26 Network Rail said that it would prefer to retain the current approach to indexation as the August 2012 proposal is virtually without regulatory precedent, that it exposes Network Rail to exogenous risks of inflation which the governments are better placed to manage, and that it does not think that it would strengthen efficiency incentives. However, Network Rail recognises the uncertainty that inflation introduces to governments' budgets.

4.27 Network Rail thinks that some aspects of our August 2012 proposal, such as the use of "deadbands" are too complex. It also considers that our proposal would increase the volatility of its accounting profits, which could impact on funding costs with knock on reputational and financial stability effects. It also thinks that the ex-post efficiency review would be difficult to conduct objectively.

4.28 Network Rail also agreed with our proposal to index the RAB by general inflation.

4.29 DfT welcomed our August 2012 proposal as it would reduce uncertainty in government budgeting and incentivise Network Rail to manage cost inflation.

4.30 Transport Scotland welcomed our August 2012 proposal on the basis that it would improve budgetary certainty. However, it would seek assurances from us that the ex-ante assessment will not undermine the delivery of the Scottish Ministers' HLOS. Transport Scotland also said that it would not expect us to use a level of indexation greater than the 2.75% that we used in our Advice to Ministers. It recommended that we set the level of indexation with reference to the Bank of England's monetary policy framework.

4.31 Go-Ahead, FirstGroup, East Midlands Trains and ATOC thought that our August 2012 proposal would increase the risk faced by Network Rail and by train operators but would not provide an additional efficiency benefit, especially given the difficulties of conducting an ex-post review.

4.32 FirstGroup highlighted that most train operators' income varies with RPI, for example, regulated fares and the payment/receipt of franchise payments from the governments. FirstGroup also said that it agrees with the use of RPI for indexing access charges.

4.33 TfL said that it thinks we should use CPI instead of the RPI for indexing allowed revenues.

Our comments on the consultation responses

4.34 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) in respect of the lack of regulatory precedent noted by some consultees, we agree that some aspects of our August 2012 proposal differ from the approaches taken by other regulators but the circumstances we face are also different from those faced by other regulators. In particular, Network Rail has weaker corporate financial incentives due to the way it is financed. Network Rail also – directly and indirectly – receives a large amount of public money, and we have a statutory duty to have regard to the funds available to the Secretary of State for Transport and our duty which, in summary, requires that we have regard to the expenditure that is to be incurred by Scottish Ministers. This means that sometimes we need to address issues in a different way to other regulators;

(b) we agree that the governments are better placed to manage the risks of general inflation than Network Rail;

(c) we still think that efficiency incentives might be strengthened by the August 2012 proposal but consider that the alternative approach discussed below, is a more effective way of presenting our message; and

(d) we agree that some aspects of the August 2012 proposal, such as deadbands and the ex-post review, are complex, and we address these issues below;

(e) our advice to ministers was provided in March 2012. This was at an early stage in the process, so it is likely that there will be a difference between some of our assumptions in our advice to ministers and our final decisions. We also said that we would update our assumptions for inflation in CP5 in our draft determination in June 2013 and in our final determination in October 2013;

(f) we will take account of the Bank of England's monetary policy framework in setting our assumptions on general inflation levels, together with other external inputs as we think appropriate. However, ultimately our inflation assumptions will reflect our view of inflation during CP5; and

(g) the use of CPI to index Network Rail's RAB would not be consistent with regulatory precedent and at the moment most financial instruments are normally indexed by RPI and approximately 50% of Network Rail's debt (£15bn) is indexed by RPI.

Issues with our August 2012 proposal

4.35 In our August 2012 consultation, we set out our proposal for the treatment of inflation risk. Since then we have thought further about the issues and considered the responses to our consultation.

4.36 The August 2012 proposal, was a relatively broad brush approach to incentivising the management of inflation risk, reflecting the argument that the automatic adjustment approach we took for PR08 may, in some circumstances, provide weaker incentives on Network Rail to efficiently manage the inflation risk that it faces. In particular, we addressed the two key issues of incentivising Network Rail to efficiently manage inflation and dealing with budgetary uncertainty, in the same way, i.e. by proposing to remove the automatic indexation of allowed revenue by general inflation.

Table 4.2: Breakdown of Network Rail's revenue requirement

Component of revenue requirement	Percentage of revenue requirement	Is the management of inflation risk an issue?
Support, operations, maintenance	30%	Yes: 25%
Industry costs and rates	10%	
Other single till income	-15%	
Schedules 4 & 8	5%	No: 75%
Allowed return	40%	
Amortisation	30%	
Total revenue requirement	**100%**	**100%**

4.37 However, as shown in table 4.2 above, the majority (approximately 75%) of Network Rail's revenue requirement is composed of income and expenditure assumptions that are not related to costs where we think there could be an issue with Network Rail's management of general inflation risk, i.e. amortisation, allowed return and schedule 4 & 8 payments. This is because those costs either relate to:

(a) past decisions, e.g. amortisation;

(b) how we fund Network Rail for the general inflation element of its financing costs[73]; or

(c) are compensation schemes, e.g. schedule 4 & 8 payments, where indexing those payments by general inflation maintains their value in real terms.

[73] As our determination is set in real prices, we need to adjust the financing costs included in Network Rail's allowed revenue for general inflation in CP5.

4.38 We were trying to incentivise Network Rail's management of inflation in relation to the 25% of its allowed revenue that relates to support, operations, maintenance costs, industry costs and rates and other single till income. But the August 2012 proposal did this in a way that exposed Network Rail to the effects of general inflation risk on 100% of its allowed revenue. We update the value of Network Rail's RAB through the RAB roll forward mechanism, which adjusts our PR08 assumptions for renewals and enhancements by RPI. This has the effect that Network Rail's RAB is indexed by actual, outturn inflation, rather than by the inflation rates we assumed in our PR08 determination. This is important in maintaining the real value of Network Rail's asset base (against which it raises finance) and therefore its financial capital, to enable it to continue to access financial markets and finance the renewal and enhancement of the network.

4.39 One of the main issues that the August 2012 proposal addressed was ensuring that Network Rail is incentivised to manage inflation efficiently. However, because the August 2012 proposal was a relatively broad brush approach, it is likely that the communication of our key message, that we want Network Rail to efficiently manage inflation, could be ineffective.

Alternative approach

Introduction and issues

4.40 Given our aim of improving incentives on Network Rail to manage inflation risk efficiently, we now consider that it is more appropriate to use the alternative approach instead of the August 2012 proposal[74]. This is because we now consider that, as our August 2012 proposal was a relatively broad brush approach, it would mean it was likely that our key message, that we want Network Rail to efficiently manage inflation, could be ineffective. The main difference between our August 2012 proposal and the alternative approach lies in the treatment of variances between the general inflation assumptions we will make in our PR13 determination and the actual outturns.

4.41 The alternative approach focused on the areas of inflation management that we thought Network Rail could control, instead of taking a relatively broad brush approach by restricting the indexing of allowed revenue by inflation. The alternative approach, which was not set out in detail in the August 2012 consultation, is described below.

4.42 In the alternative approach, we allocate input price risk to Network Rail but we do not allocate general inflation risk to Network Rail, as we do not think that general inflation risk is efficiently controllable by Network Rail[75]. Indeed, if Network Rail were to bear this risk it is likely that there

[74] To be clear, in our August 2012 consultation, we included both a proposal and an alternative to that proposal.

[75] To a large extent, general inflation is an uncontrollable risk as it results from the interaction of various macro-economic forces both national and international, including the fiscal and monetary policies of governments around the world. However, each consumer can affect the particular inflation which it faces by the choices it makes in the selection of goods and services to buy and the way in which it buys them. To this extent, the impact of inflation can be managed.

would be windfall gains and losses – the company would gain if general inflation turned out to be lower than we had expected, even though the company had played no part in general inflation being lower, and vice versa.

4.43 The issues that we have addressed in our alternative approach are[76]:

(a) our approach to setting our ex-ante inflation assumptions;

(b) should we adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index);

(c) should we continue to adjust Network Rail's RAB by the actual movements in general inflation; and

(d) how should we treat the variances between our general inflation assumptions and the actual outturns? This issue has three aspects to it:

(i) should we expose Network Rail to variances between our general inflation assumptions and the actual outturns;

(ii) if we decide that we should not expose Network Rail to variances between our general inflation assumptions and the actual outturns, how should we do it; and

(iii) if we use an automatic adjustment approach, how would it work?

Our approach to setting our ex-ante inflation assumptions

Issues

4.44 In setting Network Rail's price control, we need to consider the potential effects of inflation on Network Rail's activities. This means that we need to consider what our general inflation and input price assumptions should be.

4.45 We recognise that it is not easy to split the inflation risk that Network Rail faces into general and input price inflation and that setting Network Rail a fixed budget can have attractive incentive properties as it helps to focus Network Rail on managing its costs efficiently. However, we need to identify general and input price inflation separately as some aspects of our determination, such as financial sustainability, are considered in nominal prices.

4.46 Also, we want our determination to be transparent and we want to maintain the transparency of Network Rail's efficiency reporting, where, for the first time in 2011-12, we have identified the potential effect of input prices on Network Rail's financial performance.

[76] The issues included in 4.43 (b) to (d) are related to our RAB roll forward process.

Decisions

4.47 We think that the efficient management of inflation risk is critically important in delivering improved value for money, so in order to incentivise Network Rail to manage inflation efficiently we have decided that we will set ex-ante inflation assumptions by:

(a) including an ex-ante forward looking assumption of general inflation (i.e. RPI) in our PR13 determination (i.e. before CP5 starts)[77];

(b) we will include our forecast of input price inflation in our efficiency assumptions as this will incentivise Network Rail to manage inflation efficiently[78]; and

(c) we are about to commission a study on the management of inflation risk by Network Rail. Following this study, if we think that Network Rail does not efficiently manage inflation then we will further adjust our efficiency assumptions in addition to our input price inflation assumptions, e.g. increase or decrease them. This will incentivise Network Rail to efficiently manage inflation.

4.48 Any variances between our efficiency assumptions (including input price inflation) and the actual efficiency achieved by Network Rail (including input price inflation) will be borne by Network Rail, and this strong incentive will provide a clear message that it is critically important that Network Rail efficiently manages inflation.

Should we adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index)?

Background

4.49 We proposed in our August 2012 consultation that we would not adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index). Instead, we would improve incentives on Network Rail to manage inflation risk related to its costs by including an upfront estimate of input price inflation in our efficiency assumptions.

4.50 Network Rail considers IOPI to be volatile, difficult to forecast and may not be an accurate reflection of its costs and thought that as a result in CP4 it has led to some planning uncertainty. Therefore, it does not favour retaining an adjustment for movements in IOPI.

4.51 Railfuture thought that the IOPI or COPI indices, could more accurately reflect the inflation that Network Rail faces.

[77] In addition, to its use in the calculation of allowed revenue, we need to make a general assumption because our assessment of Network Rail's financial sustainability and corporation tax position is done in nominal prices.

[78] Including input price inflation in our efficiency assumption has a similar effect, in terms of efficiency, as adjusting our inflation assumptions for an estimate of input price inflation.

Decision

4.52 We recognise that IOPI and other specific inflation indices can be volatile, difficult to forecast and may not be an accurate reflection of Network Rail's costs and we want to avoid unnecessarily complicating the price control. Therefore, to be consistent with the allocation of input price risk to Network Rail, we have decided that we will not adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index). Instead, we will improve incentives on Network Rail to manage inflation risk related to its costs by including an upfront estimate of input price inflation in our efficiency assumptions.

Should we continue to adjust Network Rail's RAB by the actual movements in general inflation?

Background

4.53 We proposed in our August 2012 consultation that we would continue to uplift Network Rail's RAB by the actual movements in RPI, as otherwise the real value of its asset base would be eroded, which could ultimately reduce the company's ability to access financial markets.

Decision

4.54 As we do not think that general inflation risk is efficiently controllable by Network Rail, we have decided not to expose Network Rail to variances in general inflation by adjusting Network Rail's RAB by the actual movements in general inflation, so that Network Rail will neither gain nor lose from the effects of general inflation.

4.55 Respondents to our May 2011 and August 2012 consultations generally favoured retaining the use of RPI for the indexation of the RAB[79], and the use of RPI to index Network Rail's RAB would be consistent with regulatory precedent.

4.56 Given these factors, and in particular that at the moment most financial instruments are normally indexed by RPI and approximately 50% of Network Rail's debt (£15bn) is indexed by RPI, we have decided that we will continue to adjust Network Rail's RAB by RPI[80]. Otherwise the real value of its asset base (against which it raises finance) and therefore its financial capital would be eroded, which could ultimately reduce the company's ability to access financial markets and finance the renewal and enhancement of the network.

4.57 After we published our August 2012 consultation, the ONS published a consultation document on options for changing the definition of RPI. After the ONS has published its decision on this issue, we will review the definition of RPI and whether we should continue to use it. One issue that we may need to consider is how we handle a transition from the old definition of RPI to a revised definition.

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[79] However, TfL favoured using CPI and Railfuture preferred to use IOPI or COPI.

[80] This means that revalorisation of Network Rail's allowed revenues and regulatory asset base to reflect the outturn level of general economy-wide inflation, as measured by RPI.

How should we treat the variances between our general inflation assumptions and the actual outturns?

4.58 Inevitably, there will be differences between our general inflation assumptions and the actual outturns. Considering how we should treat these variances is an important part of our approach to the treatment of inflation risk and in particular:

(a) whether we should expose Network Rail to these variances;

(b) if we do not expose Network Rail to these variances, how should we do it; and

(c) if we use an automatic adjustment approach, how it would work and our evaluation of the options.

4.59 In our August 2012 consultation, we said that in the alternative approach we would index Network Rail's allowed revenue by general inflation, so that it was not exposed to general inflation risk but since then we have considered other options as well.

4.60 In our May 2012 document[81], we said that we have decided to generally maintain the PR08 approach to the treatment of variances between our assumptions on income and expenditure[82] and the actual outturns, e.g. variances in our efficiency assumptions should be borne by Network Rail. We can confirm that this also applies to input price inflation, as we are incentivising Network Rail to efficiently manage input price inflation. This is consistent with our approach in PR08.

Should we expose Network Rail to variances between our general inflation assumptions and the actual outturns?

Issues

4.61 The key issue in deciding whether we should expose Network Rail to variances between our general inflation assumptions and the actual outturns, is whether we consider general inflation risk to be efficiently controllable by Network Rail.

4.62 We do not consider that general inflation risk is efficiently controllable by Network Rail. This is consistent with conventional regulatory practice which also regards general inflation risk as not being controllable by a regulated entity. This was also the view of the respondents who commented on this issue.

4.63 Also, as we mention above, the majority (approximately 75%) of Network Rail's revenue requirement (i.e. the part relating to amortisation, allowed return and schedule 4 & 8 payments) is not related to income and expenditure assumptions where we think there could be an issue with Network Rail's management of inflation risk.

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[81] This document is available at: http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf.

[82] Network Rail is exposed to 100% of the risk of variances in income, support costs, operations costs, industry costs and rates (except where we have said we will not expose Network Rail to an issue) and maintenance expenditure. Network Rail is, subject to some specific rules, exposed to 25% of a variance in renewals and enhancement expenditure.

Decisions

4.64 Given that we do not think that general inflation risk is efficiently controllable by Network Rail, we do not consider it is appropriate for Network Rail to bear the risk of general inflation. Indeed, if Network Rail were to bear this risk it is likely that there would be windfall gains and losses – the company would gain if inflation turned out to be lower than we had expected, even though the company had played no part in inflation being lower, and vice versa. So, we have decided not to expose Network Rail to variances between our assumptions and the actual outturns. The potential materiality of windfall gains and losses is illustrated in table 4.3.

Table 4.3: Materiality of inflation variances (for the last year of CP5 in nominal prices)

Category	£m at 2.75%	£m at 3.75%	Variance	Overspend after adjustment for risk sharing
Maintenance	961	1,009	48	48
Support costs	436	458	22	22
Operating costs	390	409	19	19
Renewals	2,309	2,424	115	29
Enhancements	2,430	2,551	121	30
Total	**6,526**	**6,851**	**325**	**148**

4.65 Therefore, we have decided not to expose Network Rail to general inflation risk in relation to all of its income and expenditure. This includes:

(a) renewals and enhancements;

(b) income, support costs, operations costs, industry costs and rates and maintenance expenditure; and

(c) amortisation, allowed return and schedule 4 & 8 payments.

How should we adjust for variances between our general inflation assumptions and the actual outturns?

Options

4.66 The main options for the treatment of any variances between our general inflation assumptions and the actual outturns are:

(a) undertake an ex-post review of the effect of general inflation. This was the approach set out in our August 2012 proposal; or

(b) make an automatic adjustment.

Decisions

4.67 In our August 2012 consultation, we suggested that an ex-post review could be suitable because we did not want Network Rail to retain windfall gains or bear windfall losses in relation to general

inflation. We agree with respondents that undertaking such a review would be difficult as it would require us to understand Network Rail's approach to inflation management at a very granular level at which output based regulators do not normally review. For example, we would need to consider why Network Rail decided to accept a fixed price contract for one job and agreed an indexed approach for other jobs. This analysis would have to be done retrospectively after the contracts were awarded. So, because of this additional complexity and the associated uncertainty it will bring, we have decided not to take this approach.

4.68 Instead, given that we do not think that general inflation risk is efficiently controllable by Network Rail we have decided that the most appropriate approach to the ex-post treatment of variances in general inflation is to use an automatic adjustment mechanism for general inflation on all of its income and expenditure. This includes[83]:

(a) renewals and enhancements;

(b) income, support costs, operations costs, industry costs and rates and maintenance expenditure; and

(c) amortisation, allowed return and schedule 4 & 8 payments.

How would an automatic adjustment work?

Options and issues

4.69 An automatic adjustment can either be done yearly through the indexing of allowed revenue by general inflation or through the RAB roll forward process, or at the end of CP5 through a logging up mechanism (i.e. where the variances in CP5 are included in the opex memorandum account[84] and the adjustment to revenue happens in CP6).

4.70 For general inflation on renewals and enhancements, given there is no effect on revenue in CP5, it would be simpler to retain the PR08 approach and make the adjustments yearly through the RAB roll forward mechanism rather than unnecessarily waiting for the end of the control period.

4.71 For general inflation on income, support costs, operations costs, industry costs and rates and maintenance expenditure and for general inflation on amortisation, allowed return and schedule 4 & 8 payments. The adjustment could either be made yearly through indexing allowed revenue by general inflation or at the end of CP5 through a logging up mechanism (i.e. where the variances in CP5 are included in the opex memorandum account and the adjustment to revenue happens in CP6).

[83] In our analysis, we grouped Network Rail's income and costs into these three categories based on the nature of the inflation issue.

[84] How the opex memorandum account is used is discussed in chapter 6.

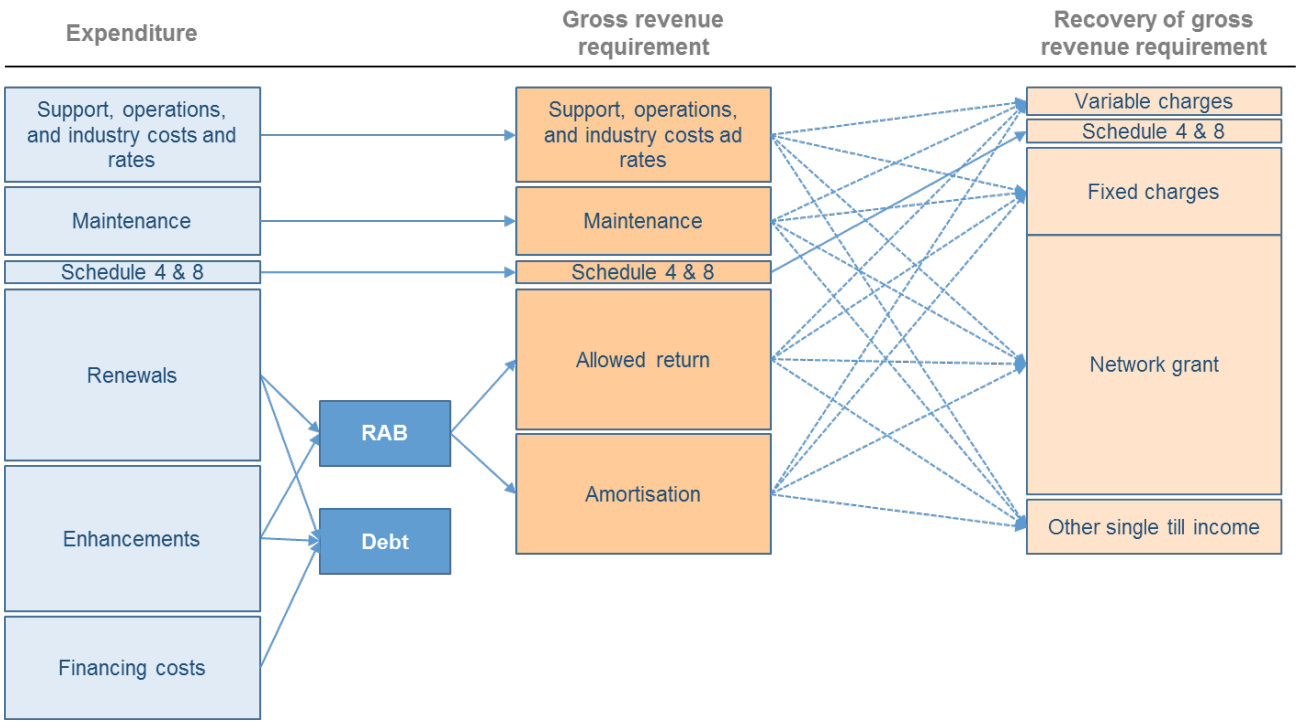
4.72 In addition, for general inflation on income, support costs, operations costs, industry costs and rates and maintenance expenditure and general inflation on amortisation, allowed return and schedule 4 & 8 payments we could use a combination of these two approaches, i.e. we could continue to index charges by general inflation but set the network grants ex-ante and the impact of any variances in general inflation on network grants could be logged up and adjusted in CP6. This hybrid approach was suggested by Network Rail and FirstGroup.

4.73 The hybrid approach is more complicated than the other approaches and not as transparent, as we would be taking different approaches to different elements of Network Rail's revenue (i.e. indexing access charges by general inflation and fixing the network grants for CP5). Therefore, we do not think that it is a more appropriate approach.

4.74 One of the issues that makes the hybrid approach complicated is that costs are recovered through both access charges and network grants and there is not a straightforward relationship between the split of income and costs into access charges and network grants.

4.75 Figure 4.1 below shows the connection between the types of income and costs that we assess in determining the level of Network Rail's gross revenue requirement and the types of revenue that it receives in access charges, network grants and through performance and possession regimes (i.e. schedule 4 and 8).

Figure 4.1: Recovery of Network Rail's expenditure through income and charges



Evaluation of the automatic adjustment options

4.76 The key differences between indexing allowed revenue by general inflation and the logging up mechanism are the effect on:

(a) efficient management of inflation risk/budgetary uncertainty for Network Rail, DfT, Transport Scotland and train operating companies (TOCs);

(b) simplicity of the process;

(c) transparency;

(d) Network Rail's financial sustainability;

(e) the flexibility to change Network Rail's financing structure; and

(f) the volatility of Network Rail's profits.

Efficient management of inflation risk/budgetary uncertainty

4.77 If we reduce budgetary uncertainty for the governments by fixing ex-ante Network Rail's allowed revenue for CP5 and logging up variances in general inflation between our assumptions and the actual outturns. Then by definition we increase risk and budgetary uncertainty for Network Rail and increase the risk and budgetary uncertainty for TOCs.

4.78 For franchised TOCs the increase in risk and budgetary uncertainty in CP5 from using the logging up approach may not be an issue. This is because as TOC revenue is adjusted by RPI, it is likely that the governments would adjust payments to/from the TOCs in the year concerned for any change in the way we index Network Rail's access charges, otherwise the TOCs will benefit from windfall gains and bear windfall losses.

4.79 However, the risks and budgetary uncertainty faced by freight and open access operators in CP5 would be increased if we use a logging up approach and they would not necessarily be capable of efficiently managing that increased risk or dealing with that budgetary uncertainty.

4.80 Therefore, given the potential effects of a logging up approach on operators and in particular freight and open access operators, a logging up approach may not be appropriate.

Simplicity of the process

4.81 It is important that we do not add to the costs of the industry by introducing overly complex mechanisms and processes if there are alternative ways of achieving the same goals that are simpler and less costly to implement. Having as simple a process as possible, will also enhance transparency.

4.82 Indexing Network Rail's allowed revenue by general inflation is a simple process that is well understood by the industry. Whereas the logging up approach would be more complicated and

not well understood. Therefore, in terms of the simplicity of the process, indexing allowed revenue by general inflation is more appropriate than the logging up approach.

Transparency

4.83 It is important that our approach identifies the risks that we are incentivising Network Rail to manage, the risks that we do not think it can efficiently manage and also clearly identifies how we have dealt with these risks when we determine Network Rail's revenue requirement and financial framework.

4.84 It is more transparent to index Network Rail's allowed revenue by general inflation, so that income and costs are reported on the same basis in each year of the control period. Also, if we did adopt a logging up approach to compensating Network Rail for variances in general inflation, then Network Rail may accrue for the differences in its statutory and regulatory accounts anyway, to reduce volatility in its reported results. This would potentially complicate our annual assessment of Network Rail's results. Therefore, in terms of transparency, indexing allowed revenue by general inflation is more appropriate than the logging up approach.

Network Rail's financial sustainability

4.85 Considering the long-term financial sustainability of Network Rail is a key issue. Given that in both options (indexing allowed revenue by general inflation and the logging up mechanism) Network Rail will be reimbursed in full for the variances between our general inflation assumptions and the actual outturns, there should be no effect on Network Rail's long term financial sustainability. However, there will be a short term effect on financial sustainability. Also, if general inflation is higher than we expected, for financial sustainability reasons, it is better to start paying for those additional costs immediately, instead of waiting for the next control period.

4.86 If we took the logging up approach, we would also need to assess the impact of the potential variances in general inflation when determining the limits on Network Rail's financial indebtedness for CP5 and these limits provide an important incentive for Network Rail to manage its costs efficiently.

4.87 Given that is difficult to determine the right balance between incentivising Network Rail and providing it with sufficient headroom, further complicating this issue, by also having to take account of the impact of the potential variances in general inflation, will make it harder to determine the most appropriate limits on Network Rail's financial indebtedness.

4.88 Given these factors, in terms of financial sustainability, indexing allowed revenue by general inflation is more appropriate than the logging up approach.

Flexibility to change Network Rail's financing structure

4.89 By flexibility to change Network Rail's financing structure, we mean that given we support preserving the option of introducing risk capital and unsupported debt into Network Rail, we do

not want to do anything in CP5 that makes it harder for Network Rail to issue risk capital and unsupported debt in the future.

4.90 Therefore, it is important that where possible we do not introduce additional complexity in PR13 that makes it harder to adopt a conventional treatment in later control periods and having a consistent approach over time and with other regulators is beneficial.

4.91 The logging up approach would add additional complexity and is not consistent with the approach used in PR08 or the approach used by other regulators. Therefore, in terms of the flexibility to change Network Rail's financing structure, indexing allowed revenue by general inflation is more appropriate than the logging up approach.

4.92 It is very important to communicate our approach to inflation risk effectively to financial markets and credit rating agencies, so they have a good understanding of the approach and of how changes to Network Rail's financial structure could be accommodated within it. We will therefore discuss our approach with the credit rating agencies shortly.

Volatility of Network Rail's profits

4.93 If we continue to index Network Rail's revenue requirement by general inflation then there will be no volatility in the profits reported in Network Rail's statutory accounts for this issue. If we log up the variances in general inflation, there also may be no effect in the profits reported in Network Rail's statutory accounts of the variance between our general inflation assumptions and the actual outturns, as Network Rail may accrue the variances in the years concerned. This would potentially complicate our annual assessment of Network Rail's results.

4.94 Therefore, in terms of the volatility of the profits reported in Network Rail's statutory accounts, indexing allowed revenue by general inflation is more appropriate than the logging up approach.

Decision

4.95 After considering these issues, we have decided:

(a) for general inflation on renewals and enhancements, given there is no effect on revenue in CP5 it would be simpler to retain the PR08 approach and make the adjustments for variances between our general inflation assumptions (i.e. RPI[85]) and the actual outturns, yearly through the RAB roll forward mechanism rather than unnecessarily waiting for the end of the control period; and

(b) for general inflation on income, support costs, operations costs, industry costs and rates and maintenance expenditure and general inflation in relation to amortisation, allowed return and schedule 4 & 8 payments we will fully adjust for variances between our general

[85] Using RPI is consistent with our approach to the indexation of Network Rail's RAB that is explained above.

inflation assumptions (i.e. RPI[86]) and the actual outturns. We will implement this by indexing Network Rail's allowed revenue by general inflation (i.e. RPI).

4.96 Our decision avoids increasing the risks and budgetary uncertainty faced by freight and open access operators in CP5, which they would not necessarily be capable of efficiently managing. It is also the approach that is the simplest, the most transparent, the most appropriate for retaining the flexibility to change Network Rail's financing structure in the future and it avoids introducing other complications to our financial framework, such as the need to assess the impact of the potential variances in general inflation when determining the limits on Network Rail's financial indebtedness.

Summary of our decisions on inflation and input prices

4.97 We have discussed our decisions on these issues above and explained the reasons for them. In summary, we have decided to:

Ex-ante decisions:

(a) including an ex-ante forward looking assumption of general inflation (i.e. RPI) in our PR13 determination (i.e. before CP5 starts) [87];

(b) we will include our forecast of input price inflation in our efficiency assumptions as this will incentivise Network Rail to manage inflation efficiently; and

(c) we will carry out a study on the management of inflation risk by Network Rail. Following this study, if we think that Network Rail does not efficiently manage inflation then we will further adjust our efficiency assumptions in addition to our input price inflation assumptions, e.g. increase or decrease them. This will incentivise Network Rail to efficiently manage inflation;

Ex-post decisions:

(d) to be consistent with the allocation of input price risk to Network Rail, variances between our efficiency assumptions (including our input price assumptions) and the actual efficiency achieved by Network Rail (including input price inflation) will be borne by Network Rail, as this will incentivise Network Rail to manage inflation efficiently;

(e) to be consistent with the allocation of input price risk to Network Rail, we will not adjust Network Rail's renewals expenditure for movements in IOPI (or another specific inflation index). Instead, we will improve incentives on Network Rail to manage inflation risk

[86] Using RPI is consistent with our approach to the indexation of Network Rail's RAB that is explained above.

[87] In addition, to its use in the calculation of allowed revenue, we need to make a general assumption because our assessment of Network Rail's financial sustainability and corporation tax position is done in nominal prices.

related to its costs by including an upfront estimate of input price inflation in our efficiency assumptions;

(f) as we do not think the effects of general inflation are controllable by Network Rail, we will continue to uplift Network Rail's RAB by the actual movements in general inflation, as otherwise the real value of its asset base (against which it raises finance) and therefore its financial capital would be eroded, which could ultimately reduce the company's ability to access financial markets and finance the renewal and enhancement of the network;

(g) as we do not think that general inflation risk is efficiently controllable by Network Rail, variances between our general inflation assumptions (i.e. RPI) and the actual outturns on renewals and enhancements, will be fully adjusted for through our RAB roll forward process, i.e. our PR13 renewals and enhancement assumptions will be adjusted for actual movements in general inflation. This means Network Rail will not be exposed to variances in general inflation on renewals and enhancements; and

(h) as we do not think that general inflation risk is efficiently controllable by Network Rail, variances between our general inflation assumptions (i.e. RPI) and the actual outturns on income, support costs, operations costs, industry costs and rates and maintenance expenditure and the actual general inflation on amortisation, allowed return and schedule 4 & 8 payments will be fully adjusted for. We will implement this by indexing allowed revenue by general inflation (i.e. RPI). This means Network Rail will not be exposed to variances in general inflation on renewals and enhancements.

4.98 Our decisions that we have set out above will incentivise Network Rail to manage input price inflation efficiently and provide stability for the rest of the industry.

4.99 Table 4.4 summarises how we dealt with inflation and input prices in PR08 and how we have decided to deal with it in PR13.

Table 4.4: Summary of our approach to inflation risk

Issue	PR13	PR08
Include an ex-ante forward looking assumption of RPI in our determinations	Yes	Yes
Include our estimate of input price inflation in our efficiency assumptions	Yes	Yes
We will carry out an inflation management study, to inform our challenge of Network Rail's costs	Yes	No
Adjust our assumptions of Network Rail's renewals expenditure for movements in a specific inflation index	No	Yes
Variances between our input price assumptions and actual input prices will be borne by Network Rail	Yes	Yes
Adjust our assumptions for renewals and enhancements expenditure each year for actual movements in RPI	Yes	Yes
Automatically adjust Network Rail's allowed revenue for actual movements in RPI	Yes	Yes
Adjust Network Rail's opening RAB each year by actual movements in RPI	Yes	Yes

5. Cost of capital

Key messages from this chapter

- We think that if there were a significant change in the industry affecting Network Rail e.g. if the company were to let a concession, we would evaluate the consequences with Network Rail, DfT, Transport Scotland and other stakeholders and if the changes are not material we 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 we could re-open the price control as discussed in Chapter 3.
- We have decided to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail benefits from.
- We have decided to take account of the impact of embedded debt costs in our forecast of efficient financing costs.
- We will roll forward the debt assumption used in CP4 for efficient movements in debt.
- We have decided to keep the introduction of the adjusted WACC approach as simple and transparent as possible by calculating efficient financing costs on a cash basis (in real prices) and adjusting separately for financial sustainability for financing costs and amortisation. We will also index the whole of the RAB by RPI.
- We will assess financial sustainability 'in-the-round' and have set out the financial indicators that we will use in PR13.

Introduction and context

5.1 This chapter sets out our decisions in relation to our approach to Network Rail's cost of capital. This includes our approach to:

(a) an industry reform initiative, e.g. a concession;

(b) the calculation of the FIM fee;

(c) the treatment of financing costs;

(d) the use of the semi-annual rate for calculating allowed revenue;

(e) the roll forward of Network Rail's debt into CP5;

(f) calculation of financing costs in the adjusted WACC approach; and

(g) our approach to financial sustainability.

5.2 Network Rail's ultimate parent company is a not for dividend company limited by guarantee (CLG[88]) and has members instead of shareholders. As a CLG, Network Rail's ultimate parent company is a private organisation operating a commercial business owned by its members.

5.3 Although members are appointed largely to perform the role of shareholders in general meetings (e.g. approve/reject major transactions and vote on remuneration arrangements), there are crucial differences. In particular, members have virtually no capital at risk[89], whereas shareholders who provide equity for a business would take significant risk. The owners of Network Rail do not therefore bear the risks or realise the rewards of Network Rail's activities, and therefore the company does not pay them the dividends that shareholders would expect as a return on their risk capital.

5.4 Network Rail is solely financed by debt, therefore all of the profits left after interest has been paid on its debts are retained within Network Rail rather than being distributed to members or, if it had shareholders, as dividends[90]. As members have no material amount of capital at risk they are not directly incentivised to seek to drive the company to improve its financial performance.

5.5 In addition, Network Rail currently benefits from the FIM provided by the UK Government for the company's debt (which at 31 March 2012 stands at around £26bn). So, although Network Rail raises debt like a normal company (from private sector investors who choose to put money into Network Rail rather than into other companies or investments) the debt is government guaranteed[91].

5.6 In our May 2012 document, we confirmed that we will use the adjusted WACC approach to determine Network Rail's allowed revenue in CP5. Using the adjusted WACC approach is consistent with Network Rail not issuing unsupported debt in CP5. Also, given that Network Rail is financed entirely by debt, and its debt is indemnified by the UK Government through the FIM, i.e. the UK Government takes the risk of default, the adjusted WACC approach is consistent with Network Rail's efficient financing costs being significantly lower than its cost of capital. Network Rail pays a fee to DfT for the credit enhancement[92] it gains from the FIM (the FIM fee).

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[88] A company limited by guarantee is one not limited by shares (i.e. with no share capital), whose members undertake to contribute to the assets of the company in the event of its being wound up. This is in distinction to a company limited by shares whose liabilities on winding it up are limited to the amount unpaid on the company's shares.

[89] Network Rail's members have £1 of capital at risk.

[90] Network Rail has used its profits to pay a rebate to DfT and Transport Scotland, invest in the network and pay down debt.

[91] The amount of debt that can be raised under the FIM is currently capped at 108% of the RAB, which is well above Network Rail's current level of gearing (62.5% at 31 March 2012). Network Rail's estimated value of the RAB at 31 March 2012 was approximately £42bn, so the FIM cap was around £46bn at 31 March 2012.

[92] By credit enhancement we mean that effectively Network Rail can borrow at cheaper rates than if it did not have the FIM. This is equivalent to having a higher credit rating.

5.7 In the adjusted WACC approach we:

(a) first, identify the full cost of capital of Network Rail (reflecting all the risks that it faces before some of them are ultimately transferred to funders) and hence its full funding requirement. Therefore, the full cost of capital would still be visible. It will still be the basis of the cost of capital that will be used in the investment framework for calculating the financing costs of non-HLOS investment schemes as it is important that investment decisions are made using Network Rail's full cost of capital. In the interests of transparency, the full cost of capital will still provide the basis for a calculation of what Network Rail's charges would have been if we allowed it to recover the full cost of capital rather than our forecast of its efficient financing costs;

(b) second, identify Network Rail's efficient financing costs[93] including any additional financing costs that need to be provided for financial sustainability purposes, e.g. for the difference between efficient financing costs (in real prices) and efficient financing costs that include implied inflation on nominal debt;

(c) third, recognise that Network Rail's efficient financing costs are lower than its full cost of capital, due to the existence and use by Network Rail of the FIM. The difference between Network Rail's full cost of capital and its efficient financing costs is called the equity surplus;

(d) then, the equity surplus is recycled before the revenue requirement is determined, i.e. the equity surplus is netted off Network Rail's bottom-line revenue requirement. We do this by including in the calculation of Network Rail's revenue requirement Network Rail's full cost of capital in the calculation of the allowed return, then we deduct the equity surplus; and

(e) we then recognise that this approach, everything else being equal, significantly reduces Network Rail's revenue. This reduction in revenue could cause additional financial sustainability issues. So, we address this issue by increasing the amortisation charge, and in our advice to ministers, we made amortisation in CP5 equal to our forecast of renewals expenditure in CP5.

5.8 As a general principle, we support preserving the option of introducing risk capital and unsupported debt into Network Rail because of the incentives this would bring to bear on management and because, more generally, it should establish Network Rail as a more conventional company. The introduction of risk capital and unsupported debt directly into Network Rail is not being considered at the moment but the adoption of the adjusted WACC approach

[93] Efficient financing costs are calculated on a cash basis, i.e. they exclude inflation accretion on index-linked debt.

does not preclude the introduction of unsupported debt in future control periods and unsupported debt could also be introduced in CP5 if the circumstances were appropriate.

Industry reform

Background

5.9 Although the introduction of risk capital and unsupported debt directly into Network Rail is not currently being considered, the adoption of the adjusted WACC approach does not preclude this happening in future control periods and unsupported debt could also be introduced in CP5 if the circumstances were appropriate. Also, other industry reform initiatives could happen, such as further alliances or a concession.

Options

5.10 We said in our May 2012 document, that we could put in place a mechanism that could allow adjustments to be made to the price control, access contracts and the licence that would allow unsupported debt to be introduced in CP5, e.g. one possibility would be to include a switch in access contracts to turn off the equity surplus adjustment. Also, we will show what the charges would be if the equity surplus and additional amortisation adjustments had not been made (i.e. if the full cost of capital was included in the net revenue requirement and total amortisation was just average long-run steady state renewals plus the amortisation of the non-capex RAB).

5.11 However, we also want to avoid unnecessarily complicating the PR13 financial framework, especially when it is not clear what the effect of some aspects of industry reform could be on Network Rail.

5.12 Financially, if there is a change to industry structure there are broadly two issues that could need to be addressed in respect of Network Rail:

(a) how we would unwind the effects of the adjusted WACC approach, e.g. by turning off the equity surplus adjustment; and

(b) how do we adjust for the other issues, e.g. adjusting for the funding that Network Rail has received for outputs/work in the geographical area concerned, for which it is no longer responsible.

5.13 A policy of turning off the equity surplus adjustment is difficult to put in place ex-ante, as we do not know with enough clarity which industry reform initiatives could happen and how material they could be. Therefore, it would not be clear how much of the equity surplus adjustment should be turned off. There are also other financial effects of the adjusted WACC approach, such as additional amortisation, which need to be considered.

5.14 In an extreme case, where all of Network Rail's business was sold to another party that is conventionally funded by unsupported debt and equity, then we would unwind the effects of the adjusted WACC approach, e.g. turn off the equity surplus adjustment. Different industry reforms, such as alliances or operating concessions, may not raise the same issues and may not therefore require an unwinding of the adjusted WACC approach.

5.15 As an alternative, if one of these industry reform changes does happen, we could evaluate the consequences with Network Rail, DfT, Transport Scotland and other stakeholders and if the changes are not material, and do not require an unwinding of the adjusted WACC approach, we 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. This would include amending the equity surplus adjustment and adjusting for the other issues, e.g. the funding that Network Rail has received for outputs/work in the geographical area concerned, for which it is no longer responsible. If the initiative has a material effect on Network Rail, then we could re-open the price control as discussed in Chapter 3.

Consultation responses

5.16 The majority of respondents agreed with our proposal and said that it was difficult to know with certainty which reforms would happen in CP5.

5.17 Network Rail said that, where industry reform requires it, the adjusted WACC approach should be reversed and a more conventional full WACC approach used. However, it also said that the adjustment should be mechanistic and set out in our CP5 determination.

5.18 DfT agreed that the effect of industry reform initiatives should be evaluated if and when they arise, and any consequences, if material, can be addressed through a re-opener.

5.19 Transport Scotland highlighted the need for early dialogue if industry reforms go ahead and said that any non-Scottish reforms should not automatically affect the Scottish settlement.

5.20 FirstGroup said that it was inevitable that there will be some form of industry reform in CP5 and suggested a wider drafting of the re-opener to cover industry reform.

Our comments on the consultation responses

5.21 We have considered these responses, and will take them into account in reaching our decisions. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we agree that it is difficult to know with certainty which reforms will happen in CP5;

(b) we agree that we should identify where we are using an approach for PR13 that may need to be amended, e.g. reversing the adjusted WACC approach, if industry reform requires a more conventional approach to be used. Where relevant, we have done this;

(c) we do not agree that the adjustments needed to reverse the adjusted WACC approach should be mechanistic (including amortisation) and we have asked Network Rail to set out how it thinks a mechanistic adjustment mechanism would work and we will review their ideas;

(d) we can confirm that any non-Scottish reforms will not automatically affect the Scottish price control; and

(e) we do not agree that we need a specific re-opener for industry reform as the material change in circumstances re-opener discussed in chapter 3 would cover this issue.

Decision

5.22 We will decide how we would handle some possible industry reforms such as further alliancing or concessions, in our draft determination in June 2013, after we have considered Network Rail's suggested automatic mechanism.

FIM fee

Background

5.23 The FIM fee is a fee payable by Network Rail to DfT for the provision of the FIM. For PR08, this was set at 80 basis points (that is, 0.8%) on the actual amount of outstanding FIM-backed debt in CP4 and broadly reflected the long-run value of the credit enhancement that Network Rail benefits from as a result of the FIM.

5.24 In our advice to ministers, we assumed a range of 78 to 129 basis points (that is, 0.78% to 1.29%) for CP5. We were also aware that the current short-run credit enhancement that the FIM could provide is significantly more than 80 basis points, reflecting the turbulence in financial markets in recent times.

Options

5.25 Our August 2012 consultation explained that we still consider it appropriate to calculate the FIM fee for CP5 by reference to the long-run value of the credit enhancement because it is consistent with the way that the full cost of capital is calculated, is cost reflective and sends the right price signals. We also recognised that if we did adjust the calculation of the FIM fee, given the way the adjusted WACC approach determines Network Rail's allowed revenue, it would have no overall effect on Network Rail's or funders' financial position. This is because an increase in the FIM fee increases the efficient financing costs that we would assume that Network Rail pays, which would then increase the allowed return that it receives.

Consultation responses

5.26 The majority of respondents agreed with our proposal to base the FIM fee on the long-run credit enhancement it provides.

5.27 Network Rail stated that the proposed range of 78 to 129 basis points for the FIM appears reasonable and it also considered that the fee should be paid directly to HM Treasury (HMT) rather than DfT to avoid a conflict of interest.

5.28 DfT noted the need to ensure that any over funding of the FIM fee in CP4 was recovered from Network Rail.

5.29 Transport Scotland said that it did not have a strong view on our FIM fee proposal, however, it made clear that we should determine the fee in such a way as to deliver value for money and reflect the current financial and fiscal conditions.

5.30 Go-Ahead and FirstGroup agreed with our proposal.

5.31 TfL agreed with our proposal and it said that a long-run approach would best suit current market conditions, however, it said that market variability over the course of the control period could potentially require us to consider the introduction of a variable FIM fee in future control periods.

Our comments on the consultation responses

5.32 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we do not agree with DfT's comment that there is a benefit in relation to the funding of the FIM fee in CP4, which should be returned to funders. This is because we have not materially changed our approach to the calculation of the cost of debt from CP4 to CP5, i.e. it is still a forward looking assessment of Network Rail's efficient financing costs. The main change in the calculation of allowed revenue introduced by the adjusted WACC approach, is the effect of the equity surplus adjustment, which is a cost of equity issue;

(b) our calculation of the long-run value of the credit enhancement provided by the FIM will take account of current financial and fiscal conditions but not fully reflect them because the calculation of the FIM fee should be consistent with the way that the full cost of capital is calculated; and

(c) we would consider a variable FIM fee if it was appropriate based on market conditions.

Decisions

5.33 We have decided that we will calculate the FIM fee for CP5 by reference to the long-run value of the credit enhancement it provides because that is consistent with the way that the full cost of capital is calculated, is cost reflective and sends the right price signals. To help inform our view of Network Rail's cost of capital and the FIM fee, we are about to commission consultants to carry

out a cost of capital study that, for example, will look at market evidence of efficient borrowing costs.

Financing costs

Background

5.34 Network Rail is best placed to efficiently manage its financing costs, as it understands its risks and how to finance those risks better than customers and funders do. In setting Network Rail's allowed revenue, we estimate Network Rail's cost of capital for the control period and forecast Network Rail's financing costs on the basis it operates economically and efficiently. This places on Network Rail the risk of movements in the underlying financial markets, i.e. that its cost of capital changes. Market conditions are an important driver of Network Rail's financing costs and are largely beyond Network Rail's control, although they can be efficiently managed through the use of financial instruments, e.g. hedges, which can provide insurance against these risks.

5.35 Network Rail's financing costs in CP5 will also be partly based on financial instruments that it has already taken out, i.e. part of its financing costs in CP5 are already fixed. These costs are referred to as embedded debt costs. In our August 2012 consultation, we considered the most appropriate way of treating these embedded debt costs in CP5, especially given that:

(a) we are using the adjusted WACC approach to determine Network Rail's full cost of capital, which after the equity surplus adjustment, only funds Network Rail's efficient financing costs; and

(b) that we proposed not to provide Network Rail with an in-year risk buffer (as discussed in chapter 3), which means that it is more exposed to variances in financing costs between our PR13 assumptions and its actual financing costs in CP5.

Options and our August 2012 proposal

5.36 The three main ways in which we could take account of embedded debt costs, which we set out in August, are:

(a) do not take account of embedded debt costs, i.e. just take account of forward looking interest rates;

(b) fully include all embedded debt costs; or

(c) partly include embedded debt costs.

5.37 We have reduced the headroom available to Network Rail, e.g. we are using the adjusted WACC approach to determine Network Rail's allowed return (which means that the net revenue requirement funds efficient financing costs) and we have decided not to provide Network Rail

with an in-year risk buffer, so we have decided to take embedded debt costs into account in CP5 (i.e. option b).

5.38 It is important that Network Rail efficiently manages its financing costs, so we will only fund embedded debt costs in our PR13 determination for CP5, where they can be shown to have been incurred efficiently. This should help to ensure that Network Rail faces the financial consequences of its actions in the period before our PR13 final determination, i.e. it cannot take out debt and just assume that we will allow the costs associated with it

5.39 We also explained, in our August 2012 consultation, that we did not think that it was necessary to consider other ways that we could reduce the interest rate risk that Network Rail takes, such as indexing movements in the risk free rate. This is because these mechanisms would add complexity to our determination and it is unlikely that the potential benefit of these mechanisms, in reducing Network Rail's exposure to movements in interest rates, would outweigh the added complexity they would bring to the determination.

Consultation responses

5.40 The majority of respondents agreed with our proposal to fully take into account embedded debt, although Network Rail is concerned that we should clearly set out how efficiently incurred financing costs would be assessed.

5.41 Both DfT and Transport Scotland supported our proposal.

5.42 ATOC suggested considering whether any change from the approach in previous control periods is warranted given the need for transparency and simplicity in the regulatory system.

Decisions

5.43 Given that we are using the adjusted WACC approach to determine Network Rail's cost of capital (which means that the net revenue requirement funds efficient financing costs) and we have decided not to provide Network Rail with an in-year risk buffer, this reduces the headroom available to Network Rail, so we have decided to take embedded debt costs into account in CP5[94].

5.44 It is important that Network Rail efficiently manages its financing costs, so we will only allow embedded debt costs to be included in our PR13 determination where they can be shown to have been incurred efficiently[95]. This should help to ensure that Network Rail faces the financial consequences of its actions in the run up to our PR13 final determination, i.e. it cannot take out debt and just assume that we will allow the costs associated with it.

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[94] If we were not using the adjusted WACC approach in CP5, we would need to consider whether this approach is still appropriate.

[95] Our assessment will be in the round and not an examination of every treasury instrument Network Rail has taken out.

5.45 We have also decided not to introduce other policies that could reduce the interest rate risk that Network Rail takes, such as indexing movements in the risk free rate. This is because these mechanisms would add complexity to our determination and it is unlikely that the potential benefit of these mechanisms, in reducing Network Rail's exposure to movements in interest rates, would outweigh the added complexity they would bring to the determination. This is especially the case given that Network Rail's financing costs are close to the rates at which the UK Government borrows, Network Rail has already fixed a significant part of its financing costs in CP5 and we are proposing to take account of embedded debt costs in our forecast of efficient financing costs.

Cost of capital

Background

5.46 The cost of capital is one component of our determination and is dependent on the risk profile of the business. The appropriate cost of capital will therefore depend on how risks are allocated between the company, customers and funders. The greater the extent to which Network Rail is protected against risk, the lower the rate of return required to accommodate fluctuations in cash flow[96]. We can therefore only take a final view on the cost of capital as part of our determination of the overall PR13 framework for Network Rail. To help inform our view of Network Rail's cost of capital and the FIM fee, we are about to commission consultants to carry out a cost of capital study that, for example, will look at market evidence of efficient borrowing costs.

August 2012 proposal and options

Use of the semi-annual rate for calculating allowed revenue

5.47 In our August 2012 consultation, we said that it is appropriate to use a semi-annual rate in the calculation of allowed revenue because a regulated utility should be able to re-invest any cash surplus that it has available during the year at its cost of capital, as that is the discount rate that is appropriate to use to assess investment opportunities.

Roll forward of Network Rail's debt into CP5 and into CP6

5.48 In our PR08 determination, we said that in CP5, for the purpose of sizing the ring-fenced fund, calculating the interest cost assumption used in the calculation of the corporation tax allowance, forecasting corporation tax payments and considering financeability issues, we intend to roll forward the debt assumption used in CP4 for efficient movements in debt. This assumed that we would continue to use the PR08 approach to cost of capital (i.e. the unsupported debt-gradualist approach).

[96] Although this means customers and funders may, everything else being equal, need to pay Network Rail less for the same outputs in CP5, those customers and funders will be bearing more risk and may pay more in the future.

5.49 This policy is also relevant to determine the CP5 opening balance as we need to maintain appropriate incentives on Network Rail to manage expenditure efficiently. This issue is also relevant to the adjusted WACC approach for CP5, as we need to maintain appropriate incentives on Network Rail to manage expenditure efficiently in CP5 and roll forward the debt assumption to CP6.

Calculation of financing costs in the adjusted WACC approach

5.50 When developing our financial framework policies we need to take account of how each policy affects the overall financial framework and how the policies interact with each other.

5.51 By indexing the RAB for actual inflation, we are not exposing Network Rail to general inflation risk on its whole asset base and hence its debt. Debt includes both nominal and index-linked debt. We index the RAB in this way to maintain the value of the past investment that has been made by Network Rail.

5.52 In our advice to ministers and in our August 2012 consultation we presented the calculation of Network Rail's efficient financing costs for the allowed revenue requirement including the inflation element[97] of nominal financing costs as that is a cash cost, and the adjusted WACC approach funds cash efficient financing costs, and we did not include inflation accretion[98] on index-linked debt as that is not a cash cost.

5.53 This approach to the calculation of the RAB and efficient financing is appropriate, given our adjusted WACC approach. However, the way we present these policies can confuse stakeholders' perception of our treatment of inflation.

5.54 We could make the treatment of inflation in the indexation of the RAB and the calculation of efficient cash financing costs clearer by:

(a) adjusting the indexation of the RAB, so that we only index the part of the RAB that is not related to nominal debt; or

(b) only funding cash financing costs excluding the inflation component of financing costs (i.e. fund real financing costs, which is the methodology we used to calculate allowed revenue in PR08).

5.55 Using either of these options would mean that we would potentially need to make a further financial sustainability adjustment as well as the amortisation financial sustainability adjustment.

5.56 Adjusting the indexation of the RAB downwards, so that we only index the part of the RAB that is not related to nominal debt and then potentially adjusting the RAB upwards for financial

[97] The interest rate on nominal debt includes compensation for the use of the money that has been borrowed for the life of the debt, e.g. if the real interest rate was 2% and the expected inflation rate was 3%, then the nominal rate would be approximately 5%.

[98] The amount of inflation added to the value of index-linked debt.

sustainability would be inconsistent with the conventional regulatory approach and the approach used in previous price controls, which could make it harder in the future to change Network Rail's financing structure. It would also be complicated, which would reduce transparency.

5.57 Adjusting efficient cash financing costs (in real prices) for financial sustainability though would be straightforward and would be consistent with the approach to amortisation, where we firstly calculate the amortisation assumption using our conventional approach and then we adjust for financial sustainability, given the adjusted WACC approach.

5.58 If we had adopted this approach in our advice to ministers the overall net revenue requirement would, everything else being equal, have been the same. This is because overall we were content, that for CP5, the revenue requirement and forecast financial position of Network Rail were at appropriate levels.

Consultation responses

5.59 The majority of respondents agreed with our proposal to keep the introduction of the adjusted WACC approach as simple and transparent as possible.

5.60 Network Rail agreed with the approach for calculating efficient financing costs on a cash basis as long as the ORR takes a 'normal' regulatory approach to indexing the whole of the RAB. It also does not think that it is being compensated twice for inflation on nominal debt. Network Rail thinks that our decision not to provide it with the funding associated with the equity component of its cost of capital means that it will be funded significantly less than would be the case under a conventional regulatory approach. Given the extent to which the adjusted WACC approach reduces Network Rail's funding, it thinks that it is inappropriate to characterise this approach as 'over compensation'.

5.61 Whilst DfT agreed that the approach should not be excessively complicated, it considers that our proposed approach may risk double counting the effect of inflation (on Network Rail's nominal debt) which could transfer surplus to Network Rail as well as create an unjustified divergence to the debt/RAB ratio.

5.62 Transport Scotland supported the adjusted WACC approach and wants it to be simple and transparent.

5.63 Train operators supported our proposal and ATOC thinks that we should retain the PR08 approach.

5.64 TfL said that we should only index the proportion of the RAB that relates to index-linked debt.

Our comments on the consultation responses

5.65 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) DfT raised the same point that we mentioned in our August 2012 consultation and as we have explained above and below, we think the real issue is not that we are providing Network Rail with too much compensation for inflation. Instead, given that we are not funding the equity risk part of Network Rail's cost of capital, the key issue is what is the overall effect of the adjusted WACC approach on Network Rail's financial sustainability and how should we present our adjustments for financial sustainability in our draft determination and final determination; and

(b) we think that only indexing the proportion of the RAB that relates to index-linked debt, would be inconsistent with the conventional regulatory approach and the approach used in previous price controls, which could make it harder in the future to change Network Rail's financing structure. It would also be complicated, which would reduce transparency.

Decisions

Use of the semi-annual rate for calculating allowed revenue

5.66 We have decided that it is appropriate to use a semi-annual rate in the calculation of allowed revenue because a regulated utility should be able to re-invest any cash surplus that it has available during the year at its cost of capital, as that is the discount rate that is appropriate to use to assess investment opportunities.

Roll forward of Network Rail's debt into CP5 and into CP6

5.67 We have decided to maintain our PR08 policy of rolling forward the debt assumption used in our PR08 determination for CP4 for efficient movements in debt, even though we are not assuming that Network Rail will issue unsupported debt in CP4, as we need to maintain appropriate incentives on Network Rail to manage expenditure efficiently. In practice this means that we will not just use Network Rail's forecast of debt at the end of CP4 as our opening balance for CP5. Instead, the debt assumption will be consistent with our forecast of Network Rail's income and expenditure in CP4, as we need to maintain appropriate incentives on Network Rail to manage expenditure efficiently in CP4. We have also decided to use this approach to roll forward the debt assumption from CP5 to CP6.

Calculation of financing costs in the adjusted WACC approach

5.68 After considering the issues, and reviewing the responses, we have decided to keep the introduction of the adjusted WACC approach as simple and transparent as possible by:

(a) calculating real efficient financing costs on a cash basis (i.e. using the conventional regulatory approach to the calculation of allowed revenue, except that it is based on

financing costs instead of a cost of capital) and adjusting for financial sustainability[99]. This is consistent with the approach to amortisation where we first calculate the amortisation assumption using our conventional approach and then we adjust for financial sustainability taking account of the adjusted WACC approach; and

(b) indexing the whole of the RAB by RPI (i.e. using the conventional regulatory approach to the indexation of the RAB).

Financial sustainability

Background

5.69 We have a statutory duty to act in a manner which we consider will not render it unduly difficult for persons who are holders of network licences to finance any activities or proposed activities of theirs in relation to which we have functions under the Railways Act[100]. This means that besides making decisions on each of the separate building blocks that make up our determination, we need to satisfy ourselves that the overall package (which includes protections to deal with risk and uncertainty), and the level of access charges and income we assume Network Rail (as a holder of a network licence) will earn, will enable it to finance itself in CP5 on reasonable terms, provided it acts efficiently.

5.70 Considering the long-term financial sustainability of Network Rail, when deciding on our approach to Network Rail's cost of capital, is a key issue. Financial sustainability can mean a number of things, some of which are interconnected (e.g. the level of the revenue requirement is partly dependent on the level of debt). In particular, it includes the following questions:

(a) is the level of debt appropriate for a company such as Network Rail; and

(b) can the debt be re-financed when appropriate and serviced efficiently.

5.71 In common with other regulators, we will assess financial sustainability 'in the round' by looking at the level and trend of certain financial indicators. In other words, in our assessment, we will take into account a suite of financial indicators, e.g. the debt/RAB ratio, consistent, where appropriate, with those used by the ratings agencies, and the business risks and regulatory protections provided to Network Rail in our determination.

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[99] For the avoidance of doubt, if we had adopted this approach in our advice to ministers the overall net revenue requirement would, everything else being equal, have been the same because overall we were content that for CP5, the revenue requirement and forecast financial position of Network Rail were appropriate.

[100] Our interpretation of this duty is that we should act in a manner which we consider will not render it unduly difficult for persons who are holders of network licences, acting efficiently, to finance any activities or proposed activities of theirs in relation to which we have functions under the Railways Act. Condition 12 of Network Rail's network licence also requires the company to use all reasonable endeavours to ensure that it maintains an investment grade credit rating. Investment grade ratings from the three main ratings agencies (Standard & Poors, Moody's Investors Services and Fitch Ratings) mean that the issuer is unlikely to default on its debt repayments. Given Network Rail has not issued unsupported debt it does not have a credit rating.

5.72 We also need to take account of the effect of the adjusted WACC approach on the financial indicators, e.g. by definition under the adjusted WACC approach, the adjusted interest cover ratio (AICR) is close to one (depending on the value of the in-year risk buffer) and amortisation does not directly affect the AICR. This means that our forecast AICR for Network Rail in CP5, would not be directly comparable with the normal levels for this financial indicator, as we are taking a different approach to calculating Network Rail's allowed revenue compared to other economic regulators.

August 2012 proposal

5.73 We proposed in August 2012 that we would use the financial indicators we used to assess financeability in PR08, for PR13 as well. These financial indicators are set out in table 4.1 below. We are also including the definitions we have used to calculate these indicators, since different definitions are available. This range of financial indicators allows us to consider both long-term solvency and shorter-term cash flow in CP5.

Table 4.1: Financial indicators

Indicator	Definition
Adjusted interest cover ratio (AICR)	FFO* *less* capital expenditure to maintain the network in steady state *divided by* net interest**
FFO / Interest	FFO *divided by* net interest
Debt*** /RAB (Gearing)	Net debt *divided* by RAB
FFO / Debt	FFO *divided* by net debt
RCF**** / Debt	FFO less net interest *divided by* net debt

Notes: * Funds from operations (FFO) is defined as gross revenue requirement less opex less maintenance, less schedule 4 & 8 costs less cash taxes paid. ** Net interest is the total interest cost including the FIM fee, but excluding the principal accretion on index linked debt. *** Debt is as defined in the Regulatory Accounting Guidelines[101]. **** Retained cash flow (RCF) is defined as FFO minus net interest.

Consultation responses

5.74 The majority of respondents agreed with our proposal.

5.75 Network Rail said that although it saw its forecast debt levels as sustainable relative to the RAB, that there was still the requirement to service its debt from current earnings in CP5 and that we should therefore take account of the interest cover ratios. Network Rail also made clear that any change to the UK's sovereign credit rating could impact its cost of refinancing.

5.76 Network Rail mentioned that the risk of reporting an accounting loss should also be taken into account by us as negative profits would significantly hinder its long term ambition to issue debt unsupported by a government guarantee. Network Rail thinks that our August 2012 proposals

[101] This document is available at http://www.rail-reg.gov.uk/upload/pdf/regulatory-accounting-guidelines-2012.pdf.

are likely to leave little headroom to absorb the impact of cost volatility, which undermines the credibility of the company and the regulatory regime for CP5 and beyond.

5.77 DfT stated that given the adjusted WACC approach it wants to understand further how credit rating agencies' financial ratios tests can be meaningfully applied to inform the assessment of financial sustainability.

5.78 FirstGroup was supportive of our proposal, but cautioned that "investments" in the RAB have not always been as rigorously controlled as they are now and as a result noted the need for any ratio founded on the RAB to allow for a sensible margin of error. ATOC added that we should consider long term "affordability" as well as short term "financeability".

Our comments on the consultation responses

5.79 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we agree with Network Rail that interest cover financial indicators are important but our assessment needs to take account of the effect of the adjusted WACC approach on the financial indicators, e.g. by definition under the adjusted WACC approach, the AICR is close to one (depending on the value of the in-year risk buffer) and amortisation does not directly affect the AICR;

(b) we do not think that Network Rail's comment, that the risk of reporting an accounting loss should also be taken into account by us as negative profits would significantly hinder its long term ambition to issue debt unsupported by a government guarantee, is an issue for our decision on how we will assess financial sustainability, as it primarily relates to the decision we took in May 2012 to use the adjusted WACC approach and the effect on financial sustainability is a consequence of that decision;

(c) Network Rail also said that there will be little headroom to absorb the impact of cost volatility, which undermines the credibility of the company and the regulatory regime for CP5 and beyond. As we discuss above Network Rail's balance sheet buffer will be fully available for it to use to manage risk and hence fund unexpected increases in costs; and

(d) when we take our decision on the overall revenue requirement we will consider affordability as well as financial sustainability in both the short and long term.

Decisions

5.80 We have found no evidence to suggest that the financial indicators we used for PR08 are no longer appropriate and we have therefore decided that they are also suitable for PR13.

5.81 Before the draft determination we will discuss with the credit rating agencies their current approach to financial sustainability and financial indicators and will take account of the effect of

the adjusted WACC approach on the financial indicators, e.g. by definition under the adjusted WACC approach, the AICR is close to one (depending on the value of the in-year risk buffer) and amortisation does not directly affect the AICR.

5.82 We will test the sensitivity of the financial indicators to changes in our regulatory assumptions and use Monte Carlo analysis to help identify the robustness of Network Rail's financial position in the face of cost and revenue uncertainty.

6. Amortisation and RAB

Key messages from this chapter

- In the calculation of Network Rail's average long-run steady state renewals, we have decided to take account of the scope for future efficiency improvement after CP5 and to use the thirty-five year period from 2014-15 as the period for our assessment.
- We have decided to largely keep the overall approach to the RAB roll forward the same as in PR08 but we will not index renewals for changes in input prices.
- In our draft determination, we will consult on our approach to CP5 efficiency reporting and consider how to take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient.
- As we decided in PR08, we will only allow capex to be added to the RAB and we have decided to keep using the opex memorandum account.

Introduction and context

6.1 This chapter covers our decisions on the following amortisation and RAB related financial issues:

(a) amortisation;

(b) RAB roll forward;

(c) non-capex additions to the RAB and the opex memorandum account; and

(d) legacy debt and RAB issues.

Amortisation

Background

6.2 Amortisation is the remuneration of past investment that has been previously added to the RAB. It forms a major part of Network Rail's revenue requirement as Network Rail is a capex intensive business.

6.3 As we confirmed in our advice to ministers, our high-level approach to amortisation in CP5 is that it will be based on long-run efficient annual average capital expenditure required to maintain the network in steady state (i.e. average long-run steady state renewals) subject to financial sustainability considerations. This means that the total allowance for amortisation in any year should be broadly equivalent to the long-run efficient annual average investment expenditure that is required in order to maintain the overall capability, age, condition, and serviceability of the

network in steady state (i.e. the network would be neither getting better or worse if that level of capital expenditure is sustained over the long-run).

6.4 In addition, as we decided in PR08, we will be amortising the non-capex RAB (just over £4bn in 2011-12 prices) on a straight-line basis over thirty years.

6.5 In our May 2012 document, we confirmed that we would use the adjusted WACC approach[102] to calculate Network Rail's allowed return. In order to address the financial sustainability issues that the adjusted WACC approach may cause, we also said that we would increase amortisation. We estimated the additional amortisation as being around £2bn (for Great Britain, in 2011-12 prices) in our advice to ministers.

6.6 This estimate was based on our forecast of Network Rail's renewals spend in CP5. When considering financial sustainability issues we need to look at all the aspects of our determination. Therefore, we need to update our views on financial sustainability when we make our draft and final determination. In particular, our advice to ministers was based on Network Rail's committed enhancement expenditure of around £5bn in CP5 (for Great Britain, in 2011-12 prices) and the HLOSs for England & Wales and Scotland have set out enhancement expenditure for Great Britain of around £10bn in CP5.

Funding of enhancements

6.7 In our August 2012 consultation, we consulted further on our approach to amortisation, and in particular whether enhancements should be amortised immediately after they come into use. We raised this issue because amortisation based on average long-run steady state renewals does not fund the original construction cost of an enhancement, just the renewals needed to maintain the asset in a suitable condition[103].

6.8 This is appropriate for an enhancement that adds long-term economic value to the network, e.g. some rail bridges are over 100 years old and are still in regular use. If there are significant levels of enhancements proposed in the HLOSs that do not add to the economic value of the network in the long-term, we need to consider how they should be funded.

Reactive maintenance

6.9 Network Rail, before 2003-04, accounted for certain reactive maintenance costs in civils and operational property, of approximately £140m per annum in 2011-12, as capital expenditure (renewals). However, since 2003-04, Network Rail has accounted for these costs in its statutory accounts as an operating cost following a change to its accounting policies for its statutory accounts.

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[102] The adjusted WACC approach is described in chapter 5.

[103] The operating, maintenance and financing costs of the asset would be funded in future periodic reviews.

6.10 To maintain consistency with previous price controls, the calculation of the revenue requirement in the 2003 access charges review (ACR2003) (for control period 3 (CP3)) and PR08 (for CP4) treated reactive maintenance costs as renewals.

Calculation of average long-run steady state renewals

6.11 Given the adjusted WACC approach and the associated financial sustainability adjustment, Network Rail's revenue requirement is unlikely to be affected by the way we calculate average long-run steady state renewals. However, it is still important to make an appropriate calculation of average long-run steady state renewals as we want to present charges both before and after the effect of the adjusted WACC approach.

Options

Funding of enhancements

6.12 In August 2012, we set out two options for funding HLOS enhancement expenditure where it does not add to the economic value of the network in the long-term.

6.13 The two options were:

(a) through amortisation. As our amortisation policy takes into consideration long-term financial sustainability issues, i.e. if we thought that the increase in debt as a result of these enhancements would not be sustainable, we could increase amortisation to reduce Network Rail's debt; or

(b) pay-as-you-go. Another option would be to fund the enhancements that do not add to the economic value of the network in the long-term on a pay-as-you-go basis, i.e. they are remunerated like maintenance, or to amortise them over a fixed period of time reflecting their useful economic life.

6.14 Both of these options can resolve the funding issue and it is more transparent to fund the enhancements that do not add to the economic value of the network in the long-term, on a pay-as-you-go basis, or amortise them over a fixed period of time, reflecting their useful economic life instead of increasing amortisation for financial sustainability reasons.

Reactive maintenance

6.15 In August 2012, we explained that we were considering whether Network Rail's reactive maintenance costs should be remunerated in the year the cost is incurred, (i.e. for the purpose of calculating the revenue requirement, treat them in the same way as operating and other maintenance costs). 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 our PR08 determination), which means that at the moment Network Rail needs to provide a reconciliation of maintenance and renewals costs between its statutory accounts and its regulatory accounts.

6.16 Everything else being equal, the increase in maintenance costs (and hence the revenue requirement) would largely be offset by a reduction in amortisation (and hence the revenue requirement), as we would expect the average long-run steady state renewals to be lower by an equivalent amount[104]. This means that a change in this policy should not have a material impact on the revenue requirement.

Calculation of average long-run steady state renewals

6.17 The main issues that we considered in August 2012 in relation to the calculation of average long-run steady state renewals were:

(a) the period of time that should be used as a proxy for the long-run period; and

(b) whether the amortisation charge should take account of the scope for future efficiency improvement after CP5 (the control period we are assessing in PR13).

Consultation responses

Reactive maintenance

6.18 Most respondents thought that we should remunerate reactive maintenance costs in the year the cost is incurred.

6.19 Network Rail did not want to remunerate reactive maintenance costs in the year the cost is incurred because it thinks:

(a) there could be an increase in preventative maintenance in CP5;

(b) there will still be differences between the regulatory and financial accounts; and

(c) the current regulatory treatment reflects how it manages civils expenditure.

6.20 DfT was in favour of treating reactive maintenance costs in the same way as opex. Transport Scotland said it was in favour of treating reactive maintenance costs in the same way as opex, as it was the most likely to ensure greater transparency of costs.

6.21 FirstGroup said that reactive maintenance has negative consequences for train operators and in order to set the right incentives (i.e. towards preventative maintenance) reactive maintenance should impact Network Rail's bottom line. Go Ahead were in favour of treating reactive maintenance costs in the same way as opex.

Calculation of average long-run steady state renewals

6.22 Two respondents (Network Rail and TfL) supported our proposal to include future efficiency improvements in the average long-run steady state renewals calculation but Railfuture did not support the proposal, as it was concerned that enhancements were not being amortised.

[104] Although there could be an effect as our calculation of efficiency for maintenance in CP5 is based on the five years of that control period, whereas the calculation of efficiency for average long-run steady state renewals in CP5, is over thirty-five years.

6.23 Network Rail agreed that future scope and frontier shift efficiency should be taken into account in the amortisation calculation, but highlighted the challenge in estimating these numbers. In addition, it pointed out that costs not funded during the control period in which they fall due would impact on financial sustainability, resulting in higher charges and intergenerational issues.

6.24 Transport Scotland said it wanted an absolute assurance from the ORR that the intended approach would not increase the overall revenue requirement for CP5.

6.25 Only two respondents gave their views on the appropriate asset life to be used. Go Ahead thought that an asset life of thirty years was appropriate. Network Rail noted that the difference between using a thirty-five year period for the amortisation (per PR08), instead of thirty years, will have a negligible effect.

6.26 FirstGroup agreed with our proposal in principal, but thought that an increasing number of assets are being replaced by modern equivalents dependent on modern electronics and software and that these items should be treated differently.

Our comments on the consultation responses

6.27 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) as discussed above and in our August 2012 consultation, we recognise that not amortising enhancements that do not add to the economic value of the network in the long-term, is an important issue. However, given the additional amortisation that we are planning to include in Network Rail's revenue requirement in CP5 for financial sustainability, we think it is an issue for PR18[105];

(b) we need to assess Network Rail's SBP before we can judge whether there will be an increase in preventative maintenance in CP5 and what the implications could be;

(c) the remaining differences between the regulatory and financial accounts that Network Rail identifies do not relate to reactive maintenance as they concern issues such as pension costs;

(d) it is not possible to give Transport Scotland an absolute assurance that changing the treatment of reactive maintenance would not increase the overall revenue requirement;

(e) irrespective of whether reactive maintenance is classified as maintenance or renewals expenditure, we have incentivised Network Rail to efficiently manage these costs;

(f) we think that using an average long-run steady state renewals methodology to fund renewals expenditure instead of funding renewals expenditure in the control period that it

[105] The periodic review of Network Rail's access charges for control period 6.

is expected to be incurred, helps to reduce intergenerational issues caused by the lumpiness of Network Rail's renewals expenditure; and

(g) our calculation of average long-run steady state renewals is a weighted average of all the different types of renewals expenditure. Some of this expenditure e.g. on bridges will have a very long expected life, whilst other expenditure on, for example, information management, may have a relatively short expected life. By using a weighted average, we take appropriate account of these issues.

Decisions

Funding of enhancements

6.28 Overall, given the additional amortisation that we are planning to include in Network Rail's revenue requirement in PR13 (as a result of the adjusted WACC approach), we do not think that there is an issue with the funding of enhancements in PR13. However, at a high-level we think that enhancements that can be added to Network Rail's RAB should be projects that are broadly consistent with our investment framework criteria for a RAB addition[106]. However, we recognise that the investment framework is addressing different issues to the periodic review/HLOS process.

Reactive maintenance

6.29 We have not yet been able to consider the implications of Network Rail's review of its civils asset policy on reactive maintenance, as the policy is still being developed. Therefore, we will decide on the treatment of reactive maintenance in our draft determination after reviewing Network Rail's revised civils asset policy.

Calculation of average long-run steady state renewals

6.30 In our August 2012 consultation, we said that Network Rail's PR13 SBP and our strategic direction statement will cover a period of at least thirty years. It is now clear that Network Rail's SBP will cover a period of thirty-five years from 2014-15. Thirty-five years is an appropriate period of time to evaluate Network Rail's long-term expenditure plans, taking account of the requirement to maintain the capability, age, condition, and serviceability of the network. It will also assist our analysis and be more transparent to use the same period as Network Rail's SBP. Therefore, we have decided to use the thirty-five year period from 2014-15 as the period for our assessment of Network Rail's long-run efficient annual average capital expenditure.

6.31 For PR13, we have decided to take account of the scope for future efficiency improvement after CP5 (the control period we are assessing in PR13) in our calculation of long-run efficient annual average capital expenditure and will include an estimate of frontier shift over our thirty-five year

[106] The criteria are included in our investment framework consolidated policy and guidelines document, which is available at: http://www.rail-reg.gov.uk/server/show/ConWebDoc.10081.

assessment period in our calculation of the efficiency adjustment that will need to be made. This is because both current and future, customers and funders should be sharing the cost burden of Network Rail's inefficiency.

RAB roll forward

Background

6.32 The RAB is a key building block in our methodology for determining access charges as it forms the basis for calculating the level of allowed return and impacts on the allowance for amortisation within Network Rail's revenue requirement. This is because the RAB is reduced by the amortisation charge including a financial sustainability adjustment if necessary (although average long-run efficient annual average renewals are calculated independently of the RAB). Also, the non-capex part of the RAB is amortised over a period of thirty years[107]. It also acts as a store of value that is released to Network Rail over time through amortisation.

August 2012 proposal

High level principles

6.33 In our August 2012 consultation, we proposed that we would retain for CP5, the high level principles that we established in our ACR2003, and also used in PR08, for valuing the RAB. These principles are:

(a) transparency: we will publish our assumptions and calculations in full. Network Rail's current and future lenders will have a clear and transparent basis on which to value the company. Looking ahead to the future, this should assist Network Rail if it raises additional debt without a government guarantee;

(b) consistency: our methodology must be consistent with the policy statements made previously. This is because predictability and consistency over time in our approach serves to improve confidence in the regulatory regime and will enhance Network Rail's ability to finance its business in the future; and

(c) simplicity: we will strive, where possible, to ensure that the calculation of the RAB remains as straightforward as possible.

[107] The non-capex part of the RAB consists of RAB additions in relation to revenue re-profiling, which was a one-off adjustment reflecting an issue with government finances following ACR2003, and incentive payments relating to the company's performance in respect of the volume and asset stewardship incentives in CP3. The non-capex part of the RAB does not include all non-capex expenditure that has been added to the RAB, e.g. the expenditure in relation to the Hatfield derailment in 2000 is not included in the non-capex part of the RAB as we only started treating non-capex expenditure in this way in CP3.

RAB roll forward in CP5

6.34 In our August 2012 consultation, we set out the key features of the RAB roll forward policy in CP4. We also explained that because we are keeping the current opex and capex incentive strengths for CP5[108] the same as in CP4, we intended to retain the same overall approach to the RAB roll forward in CP5 as it has appropriate incentive properties. We did, however, set out some areas where our RAB roll forward approach could be improved for CP5. These areas include:

(a) not indexing our renewals assumptions for changes in input prices as discussed in chapter 4;

(b) being consistent, where possible, between the treatment of renewals and enhancements to minimise any perverse incentives for Network Rail to favour one form of expenditure over the other;

(c) treating an overspend on enhancements in England & Wales in the same way as in Scotland (although we need to take account of the two price controls being separate);

(d) considering where our policies should distinguish between volume and unit cost based variances and how net underspend/overspends should be treated;

(e) whether to set out in our PR13 determination our criteria for determining when a failure to deliver outputs or maintain the serviceability and sustainability of the network, would require a RAB adjustment and possibly an adjustment to efficiency;

(f) considering whether it would be useful to set out in our PR13 determination, guidance on how we would adjust for a failure to deliver outputs or maintain the serviceability and sustainability of the network in the short, medium and long term;

(g) whether we should treat all renewals underspends in the same way, given the difficulty we have in confirming that some types of renewals underspends are efficient, e.g. volume related underspends; and

(h) considering how the lack of clarity over the links between inputs, outputs and the serviceability and sustainability of the network in the short, medium or long-term could affect our RAB roll forward policy.

[108] Under our PR08 approach, generally, deviations from the capital expenditure allowance are retained/borne by the company as out/under-performance for a period of five years, provided Network Rail has delivered the required outputs and maintained the serviceability and sustainability of the network in the short, medium or long-term. This general approach is used widely in other regulated industries and represents a key feature of the incentive framework established by our PR08 determination and, as we set out in our May 2012 document, we have decided to retain this approach.

Consultation responses

6.35 Network Rail considers the existing RAB roll forward process is overly complex and thinks that:

(a) the RAB roll forward policy should not distinguish between unit cost and scope variances as it is overly complicated when the aggregate position is more important;

(b) there should be simple, automatic log ups between control periods and a symmetric mechanism, arguing that there should be no ex-post efficiency review for renewals overspend; and

(c) the RAB roll-forward mechanism should be simple whilst being clear on the treatment of incremental activity.

6.36 Network Rail also thought that there should be consistency between the treatment of enhancements and renewals, and consistency between the treatment of overspend on enhancements in England & Wales and Scotland. It also considered that the enhancements deadband should be removed, which would mean that Network Rail is exposed to 25% of any enhancements overspend but would not bear the first £50m of enhancements overspend.

6.37 Network Rail also thinks that we should set out in our determination the criteria for when a failure to deliver outputs or maintain the serviceability and sustainability of the network would require a RAB adjustment. It thinks that 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 the route-level efficiency benefit sharing mechanism (REBS).

6.38 It does 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. This is because it considers 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.

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

Our comments on the consultation responses

6.40 We have considered these responses in reaching our decisions, which are set out below. We will discuss these issues more fully in our draft determination when we consult on our approach to CP5 efficiency reporting. Where possible we will avoid having overly complicated regulatory mechanisms as they reduce transparency. However in some situations, in order to ensure that the incentives on Network Rail are appropriate, it may not be possible to have simple mechanisms, e.g. to ensure consistency with another part of the regulatory framework.

Decisions

6.41 We have decided to retain for CP5, the high level principles for valuing the RAB that we established in our ACR2003 and also used in PR08, as they provide a suitable basis for our RAB roll forward policy.

6.42 Given the importance of setting out clearly our methodology for reporting on Network Rail's efficiency in CP5 we will set out our decisions on the above issues in our draft determination, together with our proposed approach to CP5 efficiency reporting. As discussed in chapter 4, we have decided not to index our renewals assumptions for changes in input prices.

6.43 We have decided to largely keep the overall approach to the RAB roll forward the same as in PR08 and our detailed approach will be set out in our updated regulatory guidelines for CP5, which will be published in December 2013. This is because we are keeping the current opex and capex incentive strengths for CP5.

Non-capex additions to the RAB and opex memorandum account

Background

6.44 In PR08, we said that in line with regulatory good practice, only capex will be added to the RAB from the start of CP4. Incentive payments, which before CP4 we have added to the RAB at the start of the next control period, will instead be remunerated via an opex style memorandum account. This would work by 'logging up' the payment to the account during the control period. Monies could then be released from this account over an appropriate period, which will generally be across the subsequent control period.

6.45 After we published our PR08 determination, we also published a clarification letter[109] that identified issues that needed clarification or correction. Some of the adjustments that might be made as a result of these issues will be made through the opex memorandum account, e.g. adjustments for the costs of the seven day railway and capacity charges. Some of these adjustments relate to monies that Network Rail should have received in CP4. Therefore where appropriate, we need to reimburse Network Rail with that money.

August 2012 proposal and options

6.46 In our August 2012 consultation, we proposed to retain the use of the opex memorandum account and release our forecast of the monies in the opex memorandum account at 31 March 2014, evenly over CP5, in order to smooth the effect on charges, i.e. the increase in the charges

[109] This is available at: http://www.rail-reg.gov.uk/upload/pdf/pr08_ORRlet2NR_clarific_iss.pdf.

would be the same for each year[110]. We also said that we think 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 our PR13 assumption will be adjusted for.

6.47 An alternative to the opex memorandum account would be to have an informal approach, which would not be as transparent or either adjust revenues immediately an issue arises or have an adjustment in the first year of the next control period for all issues relating to the current control period, which could unduly affect charges in that year.

6.48 The use of the opex memorandum account avoids distorting the RAB. Therefore, we proposed that we should keep using it for CP5, as the use of this account has the advantage of formalising the way these issues are resolved and allows us to smooth the effect on charges.

Consultation responses

6.49 All seven respondents agreed with the proposal to retain the opex memorandum account.

6.50 Network Rail agreed with our proposal, as this would avoid distorting the RAB, but noted that capitalised financing is not taken into account.

6.51 DfT agreed with our proposal. Transport Scotland also agreed with our proposal but said that the costs of England & Wales need to be correctly apportioned separately from Scotland costs.

Our comments on the consultation responses

6.52 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we do not want to overly complicate Network Rail's price control by treating the opex memorandum account as a "mini" RAB that capitalised financing is added to[111]; and

(b) there are separate opex memorandum accounts for England & Wales and Scotland, which England & Wales and Scotland income and costs are allocated to.

Decisions

6.53 We will retain the use of the opex memorandum account for CP5. This is because it avoids distorting the RAB, formalises the way these issues, e.g. the volume incentive are resolved, and allows us to smooth the effect on charges.

[110] In PR08, we said that any monies in relation to the volume incentive would be released in the first year of CP5, to improve incentives, subject to financeability.

[111] The balance on the account, as shown in Network Rail's 2011-12 regulatory accounts, was £54m at 31 March 2012.

Legacy debt and RAB issues

Background

6.54 As we highlight above, for the start of CP4 onwards, we have been clear that non-capex additions should not be added to the RAB[112]. However, before CP4 there were a number of additions to Network Rail's debt and RAB that were not related to capex (i.e. did not improve the network), e.g. opex and maintenance overspends after the Hatfield derailment in 2000 and a CP3 deferral of revenue due from government[113]. Our estimate is that this amounted to around £15bn at the end of CP4 (at 2011-12 prices).

6.55 The financing of these legacy issues by Network Rail could distort the future funding of the railway industry by making it more expensive, as Network Rail's debt and hence financing costs are higher than they otherwise would be.

Options

6.56 If an adjustment for these legacy issues was made, we would need to consider the effect on debt and RAB. Most of the adjustments would in theory equally affect both debt and RAB. If we made an adjustment to debt and RAB on that basis, Network Rail's debt and RAB would reduce by around £15bn and its debt/RAB ratio would be reduced to an average of approximately 54%[114].

6.57 If instead we looked at how the financial markets and potential investors would appraise Network Rail if, for example, a concession was being considered, then it may be appropriate to reduce debt by less than the reduction in the RAB, to maintain the gearing ratio at 31 March 2012 (63%). This would reduce debt by £10.7bn (assuming the RAB adjustment is £15bn). If we took this approach and used the adjusted WACC approach, Network Rail's revenue requirement would go down by approximately £2bn (8% in CP5).

6.58 An adjustment for these legacy issues could be made by the UK Government paying down part of Network Rail's debt and the ORR adjusting Network Rail's RAB to be consistent. In our view, there could be a value for money case for this because Network Rail finances these legacy issues at interest rates higher than the UK Government. The UK Government paying down this debt would contribute to the long-term financial sustainability of the company. But we recognise that there would be an impact on government borrowing and therefore the availability of public funds, at a time when there is considerable pressure on the public purse.

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[112] For further detail see paragraph 15.74 of our PR08 determination. This is available at http://www.rail-reg.gov.uk/upload/pdf/383.pdf.

[113] The non-capex part of the RAB referred to in the RAB roll forward section of this document only includes a part of all non-capex related expenditure that has been added to the RAB (approximately £4bn at 2011-12 prices).

[114] If this adjustment was made, we would have to reconsider the limits on Network Rail's financial indebtedness in its network licence.

Consultation responses

6.59 Some respondents thought that there may be a case for reviewing the treatment of legacy debt and RAB and thought that it was an issue for the governments.

6.60 DfT does not see the case for paying down Network Rail's actual debt to achieve a notional position. If in future such a requirement were to arise as a result of an industry reform initiative, DfT considers that it should be evaluated at that time and in that context.

6.61 Transport Scotland said that it thought the legacy debt was a matter for the UK government. This is because, although it funds its notional proportion of Network Rail's debt, the FIM guarantee is provided by HMT. Transport Scotland also asked us to provide an analysis of how much of the debt and RAB that it is responsible for funding, has occurred as a direct result of investment by Scottish Ministers.

Our comments on the consultation responses

6.62 We have considered these responses in reaching our decision, which is set out below. Scottish Ministers became responsible for funding Network Rail's activities in Scotland from 1 April 2006. We will separately identify for Transport Scotland, the part of Network Rail's revenue requirement that relates to the debt and RAB that was allocated between England & Wales and Scotland as at 1 April 2006[115] and the part that relates to investment after 1 April 2006.

Decision

6.63 Ultimately this is a decision for the governments as reducing Network Rail's debt and RAB would require the UK Government to pay down some of Network Rail's debt. Given the views of DfT and Transport Scotland, we do not think this is an issue for PR13 but it could be an issue for PR18.

[115] From 1 April 2006, Scottish Ministers have had responsibility for the strategy and funding of the network infrastructure in Scotland.

7. Corporation tax

Key messages from this chapter

- Our 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 we set out clearly our approach to corporation tax in CP5 as the effect on corporation tax of income and expenditure decisions in CP5 will affect future control periods and can be material.
- We want our approach to corporation tax to be as simple and transparent as possible, so we will decide on our approach once we have reviewed Network Rail's forecast corporation tax position in its PR13 SBP.

Introduction and context

7.1 Corporation tax is a normal business cost and as such is one of the building blocks of the revenue requirement. In PR08, we changed our approach to corporation tax following a review of the incentives on Network Rail and also that it was planning to issue unsupported debt in CP4. The main change that we made was that we allowed a specific corporation tax allowance instead of providing a tax wedge[116] in the cost of capital. This approach better matches the allowed revenue with expected corporation tax liabilities during a control period and we are proposing to retain this approach for CP5.

7.2 Also in PR08, we decided that Network Rail had been overfunded for corporation tax in CP3 and decided that we would adjust for this overfunding. This adjustment is called the corporation tax double-count[117]. The adjustment is made by holding the amount of the double-count (£1.3bn) on account[118] and we are reducing it every year by the amount of corporation tax that we estimated would be payable by Network Rail, until the balance on the account reaches zero. After that, we will fund Network Rail's efficient corporation tax payments through the regulatory corporation tax allowance.

Corporation tax incentive strengths

7.3 Network Rail is unlikely to make significant corporation tax payments until CP7[119], given its forecast brought forward corporation tax losses at the start of CP5. Therefore, when combined

[116] The tax wedge is a name for the grossing up of the cost of equity for corporation tax.

[117] Network Rail's debt is lower as a result of this overfunding.

[118] This is a regulatory balance that we use to adjust Network Rail's revenue requirement for this overfunding.

[119] If we continue to use the adjusted WACC approach in the future, the date we forecast Network Rail will start to make significant corporation tax payments will be significantly pushed back.

with the impact of our policy on the CP3 corporation tax double-count it is unlikely that we will provide any funding for Network Rail's corporation tax payments in CP5.

7.4 As a result of these two factors, the incentive effect on Network Rail of our corporation tax policy in CP5 could be significantly diluted as the effects of our incentives on corporation tax are largely realised in later control periods. However, it is still important that we clearly set out our approach to corporation tax in CP5, as income and expenditure decisions in CP5, will affect corporation tax payments in future control periods and could affect efficiency reporting in CP5.

7.5 In PR08, when we determined our overall approach to the financial incentives on Network Rail, 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 £78 (this assumes a corporation tax rate of 22%)[120].

7.6 As we set out in our May 2012 document, we decided to retain the incentive strengths on income and expenditure. Therefore, as part of our PR13 determination we now need to determine whether we want to retain the net of tax basis for incentive strengths. The way the incentive strengths are given effect is through our decisions on the roll forward of corporation tax balances from CP4 into CP5 and from CP5 into CP6.

Roll forward of corporation tax balances from CP4 into CP5

Background

7.7 In PR08, when we decided how to roll forward corporation tax balances into CP5 we considered the effect on Network Rail's incentives and in particular the balance between risk and incentives and decided at a high level that we would not adjust the corporation tax balances for CP5, if Network Rail's actual position during CP4 was different to our forecast. By taking this approach, the incentive on Network Rail to make savings in expenditure and to increase other single-till income is lower but the financial consequences of underperforming (e.g. costs increasing) are reduced as discussed above.

7.8 This means that in rolling forward corporation tax allowances from CP4 into CP5:

[120] A more detailed example of this issue, is if the company outperforms by, say, £100 and an ex-ante approach has been adopted to the opening corporation tax CP5 balances, then the corporation tax the company will pay on the outperformance will not be reimbursed by us so the net benefit is £78 (this assumes a corporation tax rate of 22%). If the company underperforms by £100 and an ex-ante approach has been adopted then the reduction in corporation tax, as a result of the underperformance, will not be captured by us so the net cost is say £78. Using an ex-ante approach therefore reduces the net incentive to outperform as the financial consequences of outperforming (e.g. costs being lower than expected) are reduced. If we adjusted the corporation tax opening balances at the next control period for actual income and expenditure, then in the above example the taxation effects of the outperformance or underperformance would be adjusted for, so the company would retain £100 of the outperformance and bear £100 of the underperformance. Therefore, the incentive is increased but the financial consequences of underperforming (e.g. costs being higher than expected) are also increased.

(a) we will not adjust the roll forward of corporation tax balances from CP4 into CP5 for variances in income, support costs, operations costs, BT Police costs, RSSB costs, maintenance costs, financing costs and corporation tax[121];

(b) we will take account of the changes in future income, costs and hence potentially capital allowances as a result of our policies on rolling forward the RAB, when rolling forward the corporation tax balances for variances in these elements of renewals and enhancements expenditure;

(c) we will take account of the changes in future revenue as a result of our policies on traction electricity and the licence fee and safety levy, when rolling forward the corporation tax balances for variances in those costs, to ensure that Network Rail is appropriately compensated for changes in these costs on a net of tax basis;

(d) where appropriate, we will adjust the roll forward of corporation tax balances in CP5 for any additional allowances that Network Rail has gained during CP4[122]; and

(e) we will consider whether changes in the treatment of some of its costs during CP4 should affect the CP5 opening corporation tax balances.

7.9 Also, given investment framework capital expenditure in CP4 is funded outside of PR08 and where appropriate is added to the RAB for CP5, we will include the effects of the CP4 investment framework schemes on Network Rail's corporation tax balances for CP5.

Options

7.10 We have recently been constructively discussing these issues with Network Rail and we may amend the above approach to take more account of Network Rail's actual corporation tax position in CP4, as that may be a simpler and more transparent way of rolling forward Network Rail's corporation tax position from CP4 into CP5, without unduly affecting customers and funders and without having an effect on Network Rail's incentives. This is because the issues relate to events that have already happened and as explained above the incentive effect of our decisions is diluted anyway, as Network Rail is unlikely to make significant corporation tax payments in CP4 or CP5. This would also be consistent with the views of respondents who generally wanted us to take as simple an approach to this issue as possible. We will decide on this issue in our draft determination.

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[121] This means changes in corporation tax excluding the underlying differences in income, expenditure and financing costs, e.g. if a capital allowance rate changed.

[122] In PR08, some aspects of the calculation of Network Rail's corporation tax payments where Network Rail could possibly claim enhanced allowances (e.g. for research and development expenditure or expenditure on energy saving or environmentally beneficial equipment) were uncertain and Network Rail did not provide an estimate of the impact of these issues. Given this uncertainty, we assumed that Network Rail would not receive any benefit from these schemes. Therefore, we have asked Network Rail to forecast the effects of these issues for CP4 and we will make the adjustment in our PR13 determination.

Roll forward of corporation tax balances from CP5 into CP6

Background

7.11 Our overall approach to determining Network Rail's income and expenditure is likely to be similar to PR08. The CP5 allowances for income, support costs, operations costs, BT Police costs, RSSB costs, maintenance costs, financing costs and corporation tax are likely to be set on an ex-ante basis, so Network Risk will bear the cost of an overspend and benefit from an underspend. Also, our treatment of capital expenditure (renewals and enhancements) and the RAB, and traction electricity (with the exception of transmission losses), the licence fee and the safety levy are also likely to be similar to PR08.

7.12 This means that the wider regulatory framework that we need to take account of when deciding how we address the corporation tax issues for PR13 is similar to PR08, with the exception that we are assuming that Network Rail is unlikely to issue unsupported debt in CP5.

Options

7.13 In our August 2012 consultation, we set out two main options for how we roll forward corporation tax balances from CP5 into CP6. We can either take:

(a) the PR08 approach as set out above, which is consistent with our overall approach to risk and incentives. This means that Network Rail is exposed to the net of tax effect of an underspend/overspend in income and expenditure; or

(b) a simpler approach to the roll forward of corporation tax balances and 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 the incentive effect in CP5 on Network Rail of our corporation tax policy could be significantly diluted as the effects of our incentives on corporation tax are largely realised in later control periods.

Consultation responses

7.14 While Network Rail supported taking a simpler approach to the roll forward of corporation tax balances, it did not think that it was clear that either of our options would do this. However, it did not suggest an alternative option. It also noted that prior to this process being determined, the calculation of the regulatory estimates of corporation 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.

7.15 Network Rail continues to disagree with our PR08 decision to adjust for the £1.3bn of corporation tax 'pre-funded' in CP3. However, if we do not change our mind on this issue it wants us to consider adjusting for it through a one-off RAB adjustment at the start of CP5.

7.16 Transport Scotland and TfL supported the simplified approach in Option (b), while DfT proposed maintaining the current approach in Option (a).

7.17 FirstGroup highlighted its concern that Network Rail has no tax capacity to claim capital allowances and Network Rail's funding agreements with TOCs require, where possible, train operators to make the capital allowances available to Network Rail. This means that the benefits are not passed back to the investor.

7.18 Railfuture said that it would like to see Network Rail become more like a commercial business and, where it takes risks on income and costs, it should take the related corporation tax liability or gain. It also made clear that the amount of taxes and loan guarantees paid by Network Rail to government should be publicly disclosed in order to allay concerns about the extent of public support for the railway industry.

Our comments on the consultation responses

7.19 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) our forecast of Network Rail's corporation tax position will be consistent with tax legislation where possible, but we may need to make some simplifying assumptions in our financial model. If we do use simplifying assumptions, we will keep the effect of using them under review at each price control;

(b) in addition to its response to the August 2012 consultation, Network Rail has also sent us a paper about the CP3 corporation tax double-count. We have reviewed that paper and do not think that it raises any relevant new issues, that we had not already considered when we took our decision in PR08. Therefore, we do not think it is appropriate to review our decision. Network Rail has also said that if we do not change our mind on this issue it wants us to consider adjusting for it through a one-off RAB adjustment at the start of CP5. We are considering whether we should adjust Network Rail's RAB for the corporation tax double-count and will decide on this issue in our draft determination;

(c) Network Rail's costs should reflect all the costs of its activities and be calculated net of any corporation tax implications, i.e. it has incurred the cost and should therefore also be liable for the corporation tax costs and benefits as appropriate; and

(d) where possible we do treat Network Rail as a commercial business, so Network Rail does take the corporation tax effect of its decisions. Network Rail's regulatory accounts show Network Rail's corporation tax payments and the FIM fee.

Decisions

7.20 Our 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 we set out clearly our 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.

7.21 We want our approach to corporation tax in CP5 to be as simple and transparent as possible. Therefore, we will decide on our approach in our draft determination in June 2013, after we have reviewed Network Rail's forecast corporation tax position in its PR13 SBP.

8. Other financial issues

Key messages from this chapter

- Our preferred method of funding Network Rail is for all of its income to come from train operators and other customers. This is in line with our preference for cost-reflective charges, which will in turn send signals for the efficient usage and provision of the network. It would also help avoid blurring the roles and responsibilities of Network Rail and the governments. The provision of network grants by the governments can make them look too close to Network Rail, which is not consistent with the more commercial relationships we would like to see drive behaviour in the industry, e.g. we think that it is important to strengthen the customer relationship between Network Rail and train operators. However, we see these changes happening over time and do not want to destabilise the industry.
- Therefore, we have decided 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.
- Given the importance of driving more commercial relationships in the industry, we are keen to see the level of network grants decline in CP5 and we are considering taking a different approach to setting the level of network grants to the method we used in PR08.
- Given the practical issues involved in identifying 'game-changers' and that we are trying to keep the calculation of efficiency as simple as possible, we have decided that it is not appropriate to more heavily incentivise 'game-changers' from normal efficiency savings in CP5. However, we do consider that this is an important issue for CP6, so we will start work developing our ideas in this area in 2014-15 and consult on the issues as part of PR18.

Introduction

8.1 This chapter covers the following other financial issues:

(a) network grants;

(b) financial ring-fence; and

(c) outperformance.

8.2 Our August 2012 consultation also discussed the disaggregation of the financial framework. Network Rail was the only respondent to comment on this issue, but it focused on what the future risk sharing arrangements would be, if disaggregated regional price controls were in place. We did not consult in our August 2012 consultation on this issue and it is not an issue for CP5.

Network grants

Background

8.3 A proportion of Network Rail's revenue requirement has in the past been paid directly by DfT and Transport Scotland to Network Rail in the form of network grants, in lieu of fixed track access charges on a pound-for-pound basis[123]. The governments in England & Wales and Scotland want to continue to use network grants to fund Network Rail in CP5.

8.4 In PR08, DfT and Transport Scotland requested, and we approved, the payment of network grants as a substitute for access charges, this resulted in around two-thirds of Network Rail's income in CP4 being forecast to come from network grants. The way we determined the size of the network grant in PR08 was based on the governments' accounting rules, which contained two financial tests[124]. The use of these rules by the governments means that money paid as government subsidies to franchised train operators (who in turn pay track access charges to Network Rail) is booked as resource expenditure in national accounts but payments to Network Rail are booked as capital expenditure.

8.5 Network grants can, or at least appear to, blur the accountabilities of Network Rail, and the accountability of it to train operators. Direct payments to Network Rail can also worsen the incentives on Network Rail as it could make it appear like it is less of a commercial business, which could reduce its focus, e.g. on cost control. It also worsens the transparency of the whole industry reporting of financial performance[125].

August 2012 Proposal

8.6 Our preferred method of funding Network Rail is for all of its income to come from franchised train operators and other customers. This is in line with our preference for cost-reflective charges, which will in turn send signals for the efficient usage of the network.

8.7 However, we recognised that the emergence of the new industry structure and procedures through the Railways Act 2005 clarify the roles and responsibilities of the governments and other parties. In particular, the HLOSs give a clear role for the governments in respect of their relationship to Network Rail. We also recognised that in CP5, 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 due to the governments' accounting rules and the processes the governments use to record expenditure.

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[123] The level of the network grants in CP4 is similar to our forecast of Network Rail's capital expenditure.

[124] These tests are the investment test and the market body test.

[125] Our report on whole-industry financial performance for 2010-11 is available at: http://www.rail-reg.gov.uk/server/show/ConWebDoc.10814.

8.8 In determining our PR13 policies, we need to take into account all of our statutory duties. In relation to this issue we consider that our duty to have regard to the funds available to the Secretary of State and our duty that requires us, in summary, to have regard to the expenditure that is to be incurred by Scottish Ministers are particularly relevant.

8.9 Taking all these factors into account, we proposed, in August 2012, that we would allow part of Network Rail's income to be provided directly from the governments through network grants, which will be set ex-ante for each year of CP5.

8.10 Current track access contracts include a provision that automatically increases track access charges, if the governments do not pay network grants according to a pre-determined schedule, to ensure that Network Rail recovers the revenue that it is due[126].

8.11 In order to ensure that Network Rail can finance its activities in the unlikely situation where the governments were not meeting their funding obligations, our intention is to include the same, or a similar, provision in track access contracts for CP5.

Consultation responses

8.12 Most respondents agreed with our August 2012 proposal to allow part of Network Rail's income to be provided directly from the governments through network grants.

8.13 Network Rail stated that it would prefer all of its income to come from train operators and other customers. However, it is mindful of the effect this may have on its borrowing costs as the rating agencies could determine that there is a greater counterparty risk for payments from the train operators compared to payments from the governments.

8.14 DfT agreed with our August 2012 proposal. Transport Scotland also agreed with our August 2012 proposal, as it thought that our approach provides sufficient flexibility, and it thinks that the efficiency benefits of routing funding through the TOCs has not been proven.

8.15 The train operators who responded were supportive of our August 2012 proposal. Although they think that direct payments from train operators would strengthen incentives through re-enforcing their role as customers of Network Rail.

Our comments on the consultation responses

8.16 Generally, respondents agreed with our August 2012 proposal to allow part of Network Rail's income to be provided directly from the governments through network grants. We have considered these responses in reaching our decisions, which are set out below.

[126] Part 3A of Schedule 7 of the track access contracts also includes provisions that automatically increase track access charges, when conditions are placed on the payment of network grants.

Decisions

8.17 Our preferred method of funding Network Rail is for all of its income to come from train operators and other customers. This is in line with our preference for cost-reflective charges, which will in turn send signals for the efficient usage and provision of the network. It would also help avoid blurring the roles and responsibilities of Network Rail and the governments. The provision of network grants by the governments can make them look too close to Network Rail, which is not consistent with the more commercial relationships we would like to see drive behaviour in the industry, e.g. we think that it is important to strengthen the customer relationship between Network Rail and train operators. However, we see these changes happening over time and do not want to destabilise the industry.

8.18 It is also particularly important to improve the transparency of industry cash flows. This is because there is a real focus on whole-industry performance, and one of the effects of paying network grants straight to Network Rail, is that it makes Network Rail appear to be the loss making part of the industry.

8.19 We also recognise that, at the moment, 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 due to the governments' accounting rules and the processes the governments use to record expenditure.

8.20 In determining our PR13 policies, we need to take into account all of our statutory duties. In relation to this issue we consider that our duty to have regard to the funds available to the Secretary of State and our duty that requires us, in summary, to have regard to the expenditure that is to be incurred by Scottish Ministers are particularly relevant. Taking this into account, we have decided to allow part of Network Rail's income to be provided directly from the governments through network grants, which will be set ex-ante for each year of CP5.

8.21 Given the importance of driving more commercial relationships in the industry, we are keen to see the level of network grants decline in CP5. We would also expect, everything else being equal, that the efficiencies that Network Rail has delivered in CP4 and that we will challenge it to achieve in CP5, would reduce the level of the network grants in CP5. However, a significant proportion (c.70%) of Network Rail's revenue requirement funds past investment, so the effect of efficiency savings in CP5 on Network Rail's revenue requirement is not as significant as that of some financial issues, such as the efficiency of Network Rail's financing costs and our approach to amortisation.

8.22 It is also important that the method we use to determine the level of the network grants in CP5 is transparent and understandable. For example, it is clearer if network grants fund specific costs, such as the financing costs of enhancements. This was not the case in CP4. Calculating the

network grants in this way, would allow funders to clearly see how future efficiencies affect the level of network grants[127]. Therefore, we are considering taking a different approach to setting the level of network grants from the one we adopted in PR08.

8.23 To provide further transparency, we will also set out clearly in our determination what the appropriate level of fixed track access charges for each franchised passenger train operator would be in the absence of direct network grant payments. We will also show this by operating route. In this way, it will be clearer where the network grant subsidy goes, and – through our work in setting and monitoring outputs and key performance indicators (KPIs) – what taxpayers are getting for their money.

8.24 Current track access contracts include a provision that automatically increases track access charges, if the governments do not pay network grants according to a pre-determined schedule, to ensure that Network Rail recovers the revenue that it is due.

8.25 In order to ensure that Network Rail can finance its activities in the unlikely situation where the governments were not meeting their funding obligations, we have decided to include the same, or a similar, provision in track access contracts for CP5.

Financial ring-fence

Background

8.26 The financial ring-fence protects customers and funders from the company being exposed to financial risks, e.g. it limits Network Rail from taking part in activities that are not part of its core business as the operator of the majority of Great Britain's rail infrastructure.

8.27 As part of PR08, we reviewed some aspects of the financial ring-fence but deferred a review of other financial ring-fence issues. The work we deferred included a review of the activities that Network Rail is permitted to carry out under the provisions of its network licence. We did consult on this issue in March 2010[128] but deferred taking a decision as the structure of the industry was being reviewed, which could have impacted on our decisions.

8.28 Although there is still some uncertainty about the future structure of the industry there is more clarity in some areas and we have started to discuss with Network Rail, DfT and Transport Scotland and other stakeholders their views of the activities that Network Rail should be permitted to carry out under the provisions of its network licence.

[127] In CP4, the link between how the network grants were calculated and what they fund is not transparent.
[128] Our consultation is available at: http://www.rail-reg.gov.uk/upload/pdf/ring-fence-consultation-310310.pdf.

Options

8.29 In our August 2012 consultation, we said that we will consult on the options for Network Rail's financial ring-fence in our draft determination and conclude in our final determination.

Consultation responses

8.30 Network Rail said that there should be more flexibility to expand the scope of Network Rail's operations, as that should improve value for money.

8.31 DfT said that it will engage separately on this matter. Transport Scotland said that it was in principle, supportive of non-core activities in circumstances where this is to the direct benefit of passengers, freight users and the taxpayer. Transport Scotland thought that the activities Network Rail is allowed to carry out is a matter for us under the terms of our Section 4 duties. It also thought that we must provide assurance that such activities 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.

8.32 Train operators and ATOC had mixed views. They recognised the opportunities to improve value for money but were also concerned that extending the scope of Network Rail's permitted activities, as that could be a distraction from its core activities.

8.33 The RMT suggested extending Network Rail's ring-fence to include railway operations and it opposed any extension of scope in Network Rail's activities which may allow its assets to be "sweated for private profit".

Our comments on the consultation responses

8.34 We will set out our proposed approach to Network Rail's financial ring-fence in our draft determination and consult on a draft of the licence conditions by 12 July 2013. We have considered these responses and we will take them into account when we develop our proposals.

8.35 We agree with respondents that the key issue is the trade-off between:

(a) the potential improvement in the value for money of the railway from Network Rail exploiting opportunities to increase its income and reduce its costs; and

(b) the potential distraction to Network Rail's management and the additional risks that Network Rail could face, if it carries out activities outside of its core business.

8.36 We do not agree with Transport Scotland's comment that we should provide an assurance that such activities 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. This is because the purpose of the financial ring-fence is to limit the risk of non-core activities on Network Rail's core railway infrastructure business but this does not guarantee that there will not be an adverse effect on its core business.

8.37 Also, where these non-core activities are successful the profits earned are transferred back into the core railway infrastructure part of Network Rail's business. We take account of this when we calculate Network Rail's revenue requirement.

8.38 Following our draft determination, we will publish our proposed detailed changes to track access contracts and the network licence by 12 July 2013. In respect of the network licence, we expect that this will include, amongst other potential changes:

(a) changes to the financial ring-fence; and

(b) PR13 related financial framework changes, e.g. the limits on financial indebtedness.

8.39 Whilst we do not intend to carry out a full review of the network licence, we are currently considering the need to update or revise other licence conditions.

Outperformance

Background

8.40 In our May 2012 document, we confirmed the incentive strengths for opex and capex for Network Rail in PR13. In our August 2012 consultation we explained that, since May 2012, we had considered whether that approach needed refining to encourage Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination. We also considered 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 Network Rail's long-term efficiency challenge.

Options

8.41 In our August 2012 consultation, we asked consultees for their views on the following issues in relation to incentivising different levels of Network Rail's outperformance:

(a) how do we distinguish between normal efficiency savings and outperformance, i.e. which efficiency initiative takes Network Rail beyond the target level and into the outperformance area;

(b) should any changes to incentives be symmetrical, i.e. should the financial consequences (how much money Network Rail keeps/pays out) of a material outperformance be the same as for a material underperformance;

(c) while we want our incentives to encourage appropriate management actions, we also need to keep the calculation of efficiency as simple as possible. These two objectives can conflict with each other, so we need to consider ways to improve incentives without overly complicating the reporting process; and

(d) how do we distinguish between a 'game changer' and a normal efficiency initiative.

Consultation responses

8.42 Network Rail thought that the incentive framework should, as far as reasonably possible, be simple and symmetrical. The framework should also be sufficiently flexible to evolve (e.g. to adapt to 'game changers').

8.43 Some respondents said that there is a need for clarity between a saving that is a normal efficiency saving and one that is deemed to be an outperformance and it is not easy to separate them.

8.44 Network Rail considered that the practicalities, complexities and transaction costs that would result from more heavily incentivising 'game changers' would significantly outweigh any potential benefits; it is not clear how 'game changers' would be separately identifiable; and it is concerned that this could create an undue focus on developing some initiatives to the detriment of 'ordinary' initiatives.

8.45 DfT thought that it is essential that the rail industry collectively is strongly incentivised to out-perform the regulatory efficiency target. It looks to ORR to take the lead in defining the correct structures of management incentives and how these should be balanced against corporate incentives.

8.46 Transport Scotland said that it expects that there will be a very strong incentive dynamic from the establishment of a deeper alliance in Scotland and the establishment of REBS in CP5.

8.47 ATOC noted that while 'game changers' may be considered in exceptional cases, it was vital ORR provides clarity quickly around how its proposals would work in practice, particularly given the range of work now being undertaken by the Rail Delivery Group in this area.

8.48 FirstGroup does not believe that it is desirable to increase the incentives on Network Rail to outperform or to increase the penalties should it underperform, as the dangers of creating perverse incentives and unpredictable behaviours are too great. FirstGroup considers improvements can be better achieved by giving greater weight to longer term thinking and planning.

Our comments on the consultation responses

8.49 We have considered these responses in reaching our decisions, which are set out below. Having regard to the key concerns expressed by consultees, we would make the following points:

(a) we agree that it is difficult to distinguish between 'game-changers' and normal efficiency initiatives. It is also difficult to identify which efficiency initiative takes Network Rail beyond the target level and into the outperformance area. It is also important that we keep the calculation of efficiency as simple as possible to be transparent; and

(b) we will consider FirstGroup's comment about potential perverse incentives and unpredictable behaviours, when we review this issue for PR18 and we also think that improvements in efficiency can be achieved by longer term thinking and planning. However, that is a different issue to how we incentivise Network Rail to make improvements in efficiency.

Decisions

8.50 Given it is difficult to distinguish between 'game-changers' and normal efficiency initiatives and it is also difficult to identify which efficiency initiative takes Network Rail beyond the target level and into the outperformance area, and that we are trying to keep the calculation of efficiency as simple as possible, we have decided that it is not appropriate to more heavily incentivise 'game-changers' than normal efficiency savings in CP5. However, we do consider that this is an important issue for CP6, so we will start work developing our ideas in this area in 2014-15 and consult on the issues as part of PR18.

Annex A – Overview of our approach to inflation risk

In order to make our decisions on our approach to inflation risk as clear as possible, we have provided the following high-level summary:

(a) Network Rail, like other businesses and households, faces the risk that the prices it pays for goods and services, may rise or fall, i.e. inflation is a general risk faced by everyone. This is called inflation risk. The inflation that each consumer faces depends on the particular mix of goods and services it consumes. This is no different for Network Rail, as inflation can affect not only the prices it must pay for labour and materials but also the interest rates it must pay on its borrowings and the real value of its assets and liabilities;

(b) the general level of inflation in the economy is usually measured by reference to the rate of change in the average prices of a basket of goods and services that is representative of typical consumption patterns. The most common measures of inflation are the indices of retail price inflation (RPI), and consumer price inflation (CPI);

(c) The RPI is the index most commonly used at the moment to adjust payment flows to maintain their real value. For example, payments of interest and repayments of capital on certain government bonds (known as index-linked gilts) are indexed to RPI;

(d) to the extent that a particular consumer faces higher or lower inflation, compared to RPI, because the average price of the basket of goods and services it consumes is rising or falling at a different rate compared to the RPI basket, there is a so-called relative price effect – the difference between the two reflects a change in the relative cost of the goods and services consumed compared to the economy-wide average;

(e) to a large extent, inflation is an uncontrollable risk as it results from the interaction of various macro-economic forces both national and international, including the fiscal and monetary policies of governments around the world. However, each consumer can affect the particular inflation which it faces by the choices it makes in the selection of goods and services to buy and the way in which it buys them. To this extent, the impact of inflation can be managed;

(f) we want to incentivise Network Rail to manage the inflation it faces as efficiently as it can. At the same time, we want to ensure that the real value of Network Rail's asset base (against which it raises finance) and therefore its financial capital is maintained, to enable it to continue to access financial markets and finance the renewal and enhancement of the network;

(g) we propose to do this by continuing to revalorise Network Rail's revenues and regulatory asset base to reflect the outturn level of general economy-wide inflation, as measured by RPI, so that Network Rail will neither gain nor lose from the effects of general inflation. Allowed revenue (track access charges and network grants) will therefore be set in the price levels of a base year (e.g. 2011-12 or 2012-13 as appropriate) and indexed to annual changes in RPI;

(h) we shall also take account of the relative price effects on Network Rail's input costs when we set the efficiency targets we require Network Rail to achieve in CP5, so that Network Rail will be exposed to variances in the outturn prices of the labour, materials and other services it consumes compared to the assumptions on which our determination is based, and will therefore have an incentive to manage the impact of inflation on its cost base as efficiently as it can; and

(i) our efficiency targets will also take account of our inflation study, to further incentivise Network Rail to manage its input price inflation efficiently.