PR23 – Consultation on the financial framework for CP7

19 December 2022

Contents

Executive Summary

In this consultation we set out our approach to the financial framework for the infrastructure manager of the mainline railway, Network Rail, for Control Period 7 (CP7), the five-year period starting 1 April 2024. We describe the policy choices we have identified and explain why we consider that most features of the existing financial framework should be retained. Where possible, we draw attention to how rail reform may affect some of these choices.

We received the UK Government's High-Level Output Specification (HLOS) and Statement of Funds Available (SoFA) for Control Period 7 (CP7) on 1 December 2022. The SoFA sets out that the UK Government will make available £40.3 billion to Network Rail for its operations, support, maintenance, and renewals work in England and Wales for the five years from 1 April 2024[1]. This funding is intended to deliver the outputs in the HLOS. While the UK Government's announcement represents a critical input to the PR23 process, we need to undertake further work, including with Network Rail, to understand what the company can deliver for this level of funding, including in key outcome areas such as asset management. This will be the focus of our review of Network Rail's CP7 strategic business plan (which we expect to receive in February) and our wider work up to October 2023. We continue to work closely with Transport Scotland to help inform Scottish Ministers' HLOS and SoFA, which we currently expect to receive in January 2023.

Choices around the financial framework for CP7 matter because, taken together, they affect the:

- success of our regulatory settlements;
- total costs borne by train operators, rail users, and taxpayers, now and in the future;
- management of financial and other risks and the early identification of problems;
- quality of network development decisions, with consequences for output achievement and service levels;
- effective renewal of rail infrastructure and its impact on asset performance and safety; and
- potential for new sources of financing and funding.

The chapters of this document sets out the matters that we are consulting on. These are:

[1] In cash prices and excluding funding for British Transport Police and for traction electricity costs. This represents around a 2 percent increase compared with Network Rail's CP6 funding.

(1) Network Rail's cost of capital and cost of debt;

(2) setting and updating regulatory asset base balances for CP7;

(3) our policy on rebates of unused funds to governments;

(4) grant dilution provisions in access charges;

(5) re-opener provisions process to vary the terms of our regulatory determination;

(6) management of financial risk;

(7) Governments' budgetary processes; and

(8) the Performance innovation fund.

We are seeking views on these matters. We intend to publish our minded-to decisions in our PR23 draft determination (June 2023) and our final decisions in our PR23 final determination (October 2023).

Some of the matters that we are consulting on are linked to our managing change policy where we recognise that there may be circumstances where Network Rail needs to make changes to the level of funding for regions (and System Operator and National Functions) or to the outputs that it is required to deliver. For example, there may be legislation changes or the organisation may decide to restructure. We consulted on our managing change policy in our July PR23 policy framework consultation and we are setting out our policy conclusions on these today (see here).

There are a few matters that relate to the financial framework which we consider do not require consulting on:

- as set out in our PR23 launch letter, we have not identified any reasons to depart from a five-year control period over which to set the revenue requirement for CP7, meaning that the control period will run from 1 April 2019 to 31 March 2024;
- the inflation measure used for indexing charges. We have already consulted and concluded on this in relation to our review of access charges (see here); and
- the treatment of Network Rail's historic debt and related financing costs, and British Transport Police costs are outside the scope of PR23 as they are now a separate matter for the Department for Transport.

Responding to this consultation

This consultation closes on 24 February 2023. Please submit your responses, in electronic form, to our PR23 inbox: pr23@orr.gov.uk.

We plan to publish all responses to this consultation on our website. Accordingly, when sending documents to us, we would prefer that you send your correspondence to us in Microsoft Word format or Open Document Format. This allows us to apply web standards to content on our website. If you do email us a PDF document, where possible please:

- create it from an electronic word-processed file rather than sending us a scanned copy of your response; and
- ensure that the PDF's security method is set to "no security" in the document properties.

Should you wish any information that you provide, including personal data, to be treated as confidential, please be aware that this may be subject to publication, or release to other parties or to disclosure, in accordance with the access to information regimes. These regimes are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations (2004). Under the FOIA, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

In view of this, if you are seeking confidentiality for information you are providing, please explain why. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on ORR.

If you are seeking to make a response in confidence, we would also be grateful if you would annex any confidential information, or provide a non-confidential summary, so that we can publish the non-confidential aspects of your response.

1. Cost of capital and cost of debt

1.1 We do not consider that a weighted cost of capital (WACC) or cost of debt are necessary components to determine revenue requirements, track access charges, or network grant levels for CP7.

1.2 However, these values are relevant for the following purposes:

- calculating facility charges payable by third parties who have promoted enhancements financed by the governments through Network Rail;
- calculating what Network Rail's revenue requirements might be under a full building blocks approach to the periodic review (i.e. determining the allowed return on the asset base using a hypothetical cost of capital Network Rail might face if it were financed in the private sector by a mix of debt and equity);
- providing a benchmark discount rate/internal rate of return for internal projects (and other economic decisions) by Network Rail in CP7; and
- the cost of debt that we determine also affects the Crossrail supplemental access charge (CSAC) income that Network Rail will receive in CP7.

1.3 For reference, for control period 6 (CP6), we specified a real (CPI) pre-tax cost of debt of 2.45% and a real (CPI) pre-tax weighted average cost of capital of 4.15%.

Proposal

1.4 We are minded to specify cost of capital and cost of debt values for Network Rail in CP7 as part of our final determination. We will draw on the work of the UKRN's Cost of Capital Working Group to inform our decisions (see here).

Consultation question

1.5 Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?

2. Setting and updating regulatory asset base balances for CP7

2.1 Network Rail's regulatory asset base (RAB) was not used in the calculation of its revenue requirements for CP6, and we do not intend to use the RAB for this purpose for CP7. However, there are benefits in maintaining RAB values for each of Network Rail's geographical regions together with total values for England and Wales, and for Scotland to:

- provide a valuation of Network Rail's assets (for example, as used in CP6 for the divestment of the Core Valley Lines;
- enhance understanding of the long-term financing of the network;
- facilitate comparability with other regulated network businesses; and
- support the valuation of assets for disposal or transfer purposes.

2.2 We decided not to establish a RAB value for any of Network Rail's central functions other than its System Operator (SO) in CP6 because they have few tangible assets of their own.

2.3 For reference, the value of Network Rail's regulatory asset base was £76.3 billion at 31 March 2022.

Proposals

2.4 We are minded to retain our CP6 approach for the setting and updating of regulatory asset base balances for CP6. In particular:

RAB balances for geographical regions and SO

2.5 We will determine a provisional opening RAB balance for each geographical region and SO together with an indicative forecast value for each year of CP7.

Updating RAB balances during CP7

2.6 We will use the following steps to update RAB balances in CP7:

- Inflate the value at the start of each year using CPI indexation.

- Add capital expenditure (renewals and non grant-funded enhancements) during the year.
- Deduct renewals funding included in our revenue determination, at the end of the year, as a proxy for amortisation.

2.7 Under this approach, in real terms, RAB values going forward should remain broadly in line with their opening values during CP7 because additions and deductions each year should broadly be in line with each other.

2.8 We will include detailed provisions setting out how RAB values will be rolled forward from year to year in regulatory accounting guidelines that we will publish for CP7.

Consultation question

2.9 Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

3. Rebates

3.1 Our policy on rebate payments by Network Rail to governments in CP6 has been that they should only be made in exceptional circumstances and should not create risks to the financial sustainability of Network Rail's business.

3.2 The current rebate mechanism is contained in the CP6 track access contracts for franchised passenger operators. It provides for Network Rail to rebate income that it does not require to discharge its obligations under its network licence and any contracts to which it is a party. ORR's approval is required before a rebate is paid. In broad terms, the rebate to franchised passenger operators flows through to the governments under the commercial terms of franchise arrangements.

3.3 We note that other options exist in network grant letters for return of funding to governments. We are reviewing how the process for making rebates is set out in track access contracts.

Proposal

3.4 Given that it could be appropriate for Network Rail to make rebate payments during CP7, we are minded to keep the CP6 rebate mechanism in place.

3.5 As in CP6, we are minded that payments should only be made in circumstances where Network Rail is confident that surplus funds will not be required in CP7 and should not create risks to the financial sustainability of its business.

Consultation question

3.6 Do you agree with our proposal to retain the current rebate mechanism for CP7?

4. Network grant arrangements and dilution provisions

4.1 Network Rail recovers a proportion of its fixed costs through direct network grants from funders. This is in lieu of fixed track access charges (FTACs) paid by passenger operators on concession-style agreements. In CP6, the network grant represented around 70 percent of funding for operations, support, maintenance and renewals (and we note that the recently published SOFA for England & Wales (see here) would imply a similar proportion (75%) for CP7).

4.2 For CP6, there has been a deed of grant between DfT and Network Rail, and a grant agreement between Transport Scotland and Network Rail, in respect of network grant payments. These set out the dates and amounts for network grant payments.

4.3 Considering Network Rail's classification as a public sector arm's length body and the creation of Great British Railways ('GBR'), these documents might be replaced for CP7 by more straightforward letters of grant reflecting the 'grant in aid' nature of network grants. Grant in aid refers to funding provided to government bodies to finance their operations within parameters set by governments.

4.4 This is something that would need to be agreed by DfT and Transport Scotland with Network Rail. We expect that, as with the grant deed/agreement, letters of grant would still set out a schedule of network grant payments and dates payable. However, they might also provide for payments to be varied in certain circumstances, such as Network Rail proposing to bring forward or defer expenditure under its budgetary flexibility rules.

4.5 Furthermore, the existing track access contracts held by passenger operators on concession-style agreements also contain network grant dilution provisions[2]. These provide that, in the unlikely event that a network grant payment is not made *during* the control period, operators would each be obliged to pay a share of the shortfall to Network Rail, three months after the 'dilution date'. This reflects that the network grants offset an amount of income that would otherwise be recovered through higher FTACs.

[2] These are currently set out in Part 3A of Schedule 7 of operators' contracts.

Proposal

4.6 As part of our PR23 charges review, we have considered the process and timings for confirming the terms of network grant arrangements for CP7 – and the implications for operators' FTACs. We said in our October 2022 conclusions document that it would be preferable to agree signed deeds of network grant (setting out the dates, amounts and conditions for network grant payments) *before* we take a final decision on the level of FTACs in our final determination[3]. This would serve to provide certainty over the level of network grant funding and the terms of the arrangements at this stage of PR23.

4.7 Having considered this further, we are proposing the following approach for CP7:

- we will seek written confirmation from Network Rail and funders of the dates, amounts and conditions for network grant payments, in signed network grant documentation from funders before our final determination. If this is achieved, we will reflect network grant payments in FTACs in the same way as for CP6 (i.e. the FTAC amounts which are set out in Network Rail's Schedule of Fixed Charges will be *net* of network grant payments)[4]; and

- if network grant documentation is not in place before we publish our final determination, we would assume for the purposes of our final determination that there will be no grant funding for CP7, and the Schedule of Fixed Charges would be set to recover Network Rail's total net revenue requirement. However, we would also include a variation clause in passenger operators' track access contracts whereby FTAC amounts would be adjusted downwards to reflect the amount of network grant which we agree should be paid to Network Rail, if this is confirmed before the start of CP7.

  We note that the inclusion of this clause may require some related amendments to the existing 'grant dilution' provisions in operators' contracts, as it will remain important that operators' FTACs can be re-adjusted upwards, in the event that any network grant payments are not made *during* the control period[5].

4.8 This would be a change to the process in PR18, where the level of FTACs were set in price lists in December 2018, based on an assumed level of grant funding

[3] See paragraphs 1.12-1.13 of our conclusions document.

[4] This is normally published in the December of the year before the next control period starts. Consistent with this, we expect final CP7 price lists – including the Schedule of Fixed Charges – to be published by Network Rail in December 2023.

[5] Furthermore, the grant dilution provisions in access contracts would still be enforceable whether a deed of grant or grant letter is used.

that had not been formally confirmed. We consider this would improve the overall governance and assurance around Network Rail's funding certainty for CP7, while still allowing flexibility for funders and Network Rail to agree network grant documentation after the final determination, and make grant payments.

4.9 We would consult on the form of the variation clause in operators' access contracts that would be required to implement this, and any associated changes to existing grant dilution provisions, as part of our broader consultation on changes to model contracts which we expect to publish next summer, shortly after our draft determination.

Consultation question

4.10 Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

5. Re-opener provisions

5.1 Track access contracts presently contain a provision relating to "Access charges reviews capable of coming into operation before 1 April 2024". This is commonly referred to as a re-opener provision and refers to the ability to amend the revenue requirements that Network Rail can recover through access charges and network grants in extreme circumstances. A re-opener is a formal process to vary the terms of our regulatory determination.

5.2 For CP6, we included provisions in track access contracts for there to be a re-opener in two scenarios:

(a) A material change in the circumstances of Network Rail or in relevant financial markets. Under this provision we would consider whether there were compelling reasons to initiate an access charges review, having regard to our duties under section 4 of the Act. This re-opener applies to events in England and Wales, and in Scotland; and

(b) If expenditure in Scotland is forecast to be more than 15 percent higher than our determination over a forward-looking three-year period. This provision applies to Scotland only.

Proposal

5.3 We are minded to retain the re-opener provision in track access contracts, updated to refer to 'before 1 April 2029'. This is because the provision provides an important mechanism that allows us to work with the governments, Network Rail, and industry stakeholders to change the terms of our determination of track access charges if material unforeseen circumstances were to arise during CP7.

Consultation question

5.4 Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

6. Management of financial risks

6.1 This section covers the approach to managing the financial risk and uncertainty that Network Rail will face during CP7. Reflecting the different funding sources, different approaches could be adopted in England & Wales, and in Scotland. This section does not address uncertainty related to British Transport Police costs, external financing, enhancements, and corporation tax costs, as we expect these to be funded outside of the PR23 settlement.

6.2 The CP6 approach for Network Rail's management of financial risks included flexibility provided by the ability to set CP6 outputs on a P80 basis[6] and not having to commit all its expenditure into asset management plans at the start of the control period. In addition to using risk funds to cover unanticipated costs, particularly relating to Covid-19 and inflationary pressures, Network Rail also drew down on its risk funds to implement the recommendations of reports by Lord Mair and Dame Slingo (in relation to the tragic accident near Stonehaven, Aberdeenshire), improve track worker safety, support work on rail reform, and other matters.

6.3 Network Rail's risks and funding settlement are expected to be absorbed into Great British Railways in due course. The financial management framework for Great British Railways is in development. In the meantime, Network Rail expects to face many of the same type of financial risks in CP7 as in CP6 with some expected to be more significant (for example, general inflation), some less (the impact of Covid-19) and some new risks including the transition to Great British Railways.

6.4 Network Rail is currently proposing to retain a broadly similar approach in principle to CP7 as is in place for CP6, with some funding in a risk fund and some funding ringfenced to prioritise some asset management activities (these could be called "contingent asset management activities"). This would require suitable governance arrangements to be in place. This is effectively an internal management tool, to retain some flexibility within its plans and manage the business efficiently and effectively. Recognising the difficult economic environment for the industry and the level of funding in the SoFA, it is unlikely that Network Rail will be able to transfer as much funding from its core plan into risk funds as it did in CP6.

[6] Meaning that there is an 80% chance of the outputs being delivered within the available funding.

Consultation question

6.5 Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

7. Governments' budgetary processes

7.1 Following reclassification, government budgeting for Network Rail's expenditure operated under the Annually Managed Expenditure (AME) regime during the remainder of control period 5 (CP5). For CP6, Network Rail's budget operated under the Resource Departmental Expenditure Limit (RDEL) and Capital Departmental Expenditure Limit (CDEL) rules that apply to DfT's own budget. Unlike under AME, UK Government departments have limited flexibility to amend RDEL and CDEL.

7.2 This section summarises the flexibilities that Network Rail was provided within the DfT's RDEL and CDEL regimes for CP6 for funding in England and Wales, and the flexibilities applied by Transport Scotland over the funding for Network Rail Scotland. We expect these flexibilities to remain broadly the same for CP7.

7.3 The budgetary flexibility that Network Rail received for England and Wales funding during CP6 was set out in DfT's response to our second consultation on the PR18 financial framework.

Capital expenditure funded in the England and Wales SoFA

7.4 The term "CP6 Budget lines" below means the CP6 budget profile formally agreed by the UK Government following the publication of our final determination.

7.5 Six weeks before the UK Government's Budget is announced to Parliament, DfT will inform HMT of the flexibilities Network Rail wishes to use. DfT would expect to approve movements of up to 10% of current and future year's CDEL deferred to later years and up to 10% of any future year's CDEL accelerated to earlier years (excluding the current year). These flexibilities are subject to a cap of a 10% increase in CDEL for any individual year when compared to the CP6 Budget lines, although Network Rail would also be able to request larger movements six weeks before the Budget, which HMT would consider as part of the wider fiscal picture.

7.6 HMT would then decide at the Budget whether to approve the submitted flexibilities.

7.7 At Supplementary Estimates[7], DfT then submits its latest estimate of the flexibility Network Rail requires as part of the normal Budget Exchange process. HMT would expect this request with respect to the current year to be within £200m of the original Budget request for re-profiling with respect to future years. Given the importance of Network Rail's work over the Christmas period, HMT would accept one final update in the first week of January. Again, HMT would expect this request with respect to the current year to be within £200m of the original Budget request for re-profiling with respect to future years.

7.8 Twenty working days after year-end, Network Rail should inform DfT about any year-end underspends and the reason for the underspend. DfT will then inform HMT within another twenty working days. HMT would expect to approve re-profiling up to 2% of CDEL year-end underspends (compared to the CP6 Budget lines) deferred to later years.

7.9 There is no flexibility to transfer budgeted amounts from capital expenditure to resource expenditure.

Resource expenditure funded in the England and Wales SoFA

7.10 Network Rail can expect to be allowed, at the time of Supplementary Estimate submission each year:

- full flexibility to transfer budgeted amounts for the year concerned from operating to capital expenditure; and
- to defer up to 0.75% of operating expenditure for the year concerned to a later year,

in each case, having obtained permission from DfT (because DfT itself is subject to an overall flexibility limit of 0.75% for its RDEL).

Capital and resource expenditure funded in the Scotland SoFA

7.11 Recognising the different funding arrangements whereby funding flows from HMT via the Scottish Government, the process in Scotland is slightly different. Network Rail Scotland can request approval from Transport Scotland to carry forward up to 10% of the total budget for each financial year into the subsequent year, or to use up to 10% of the subsequent year’s budget in advance. This budget is based on initial projections from Network Rail Scotland on the profile of CP6 spend, prior to

[7] Supplementary estimates set out proposals for amending the departmental spending to that which has been previously authorised.

the finalisation of its grant agreements, and is reflected in the profile of funding Transport Scotland agreed with HMT.

7.12 The 10% flexibility limit applies to the whole of Network Rail Scotland's budget, i.e., it is inclusive of operations, maintenance and renewals funding, as well as enhancements. Any request for a rollover of funding between years must be made by November in the financial year the adjustment is requested, to align with Scottish Government budgetary processes. Additional amounts above this 10% can be requested to adjust the overall control period profile, provided such a request meets the criteria set by, and gains approval from, the Scottish Government.

Income and capital receipts

7.13 Network Rail's budgetary settlement with the governments will take account of its forecast income levels excluding DfT grants (because these are not treated as resource income in the UK Government's accounts). Network Rail is allowed to retain additional income that it receives up to a level of 10% of the agreed annual forecasts for use in its business. It may be allowed to retain additional amounts with agreement from HMT.

7.14 Under public sector finance rules, Network Rail needs to obtain approval to retain capital receipts, for example proceeds from asset disposals.

7.15 We report on Network Rail's use of governments' budget flexibility for England & Wales, and for Scotland in our annual efficiency and finance assessments of Network Rail. For example, we commented that Network Rail requested, and was granted, that £95 million of its England & Wales capital budgets were rolled over from 2021-22 into the 2022-23 financial year following delays on projects, notably in enhancements, which was within the permitted range set out in the guidance from HM Treasury. Network Rail Scotland overspent against Transport Scotland's budget for 2021-22 by £8 million, which was managed within the Scottish Government's budget flexibility process.

Consultation question

7.16 Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

8. Performance innovation fund

8.1 The CP6 Performance Innovation Fund has provided Network Rail's regions, System Operator and train operators access to funding, worth £40 million at the beginning of CP6, to support the industry in undertaking innovative projects aimed at driving improvements in train performance. In particular, the funding is designed to facilitate collaboration between Network Rail and the wider industry on certain initiatives that may be seen to carry too much risk for one company to develop alone. The fund is governed by a board with equal representation from Network Rail and train operators.

8.2 This fund has seen projects undertaken with matched funding from other sources, with a total of £38.6 million authorised for expenditure, with £12.5 million of that having been spent, as of the end of the most recent financial year (2021-22). There has been a difference in authorised funding seen across Network Rail's regions, with the North West and Central region having the most at £12.0 million allocated.

8.3 Some examples of projects undertaken with PIF funding are:

- 'Deter, Detect, Track CCTV', which uses infrared CCTV to provide early detection of trespassers on the tracks near Birmingham New Street station. This received funding of c£240,000 from the PIF, with c£120,000 matched funding from the Project Alpha fund within Network Rail.

- Double Variable Rate Sanders (DVRS) trials, which attach a twin set of variable rate sanders to class 323 units belonging to Northern to improve performance in low adhesive conditions, such as wet leaves on the track. This has the most funding for a single project with a total of £4.4 million authorised.

8.4 ORR does not govern the fund, however, we do report on its use in our annual efficiency and finance assessments of Network Rail and in other reports. The process for accessing the fund has seen iterative changes and improvements since the start of CP6, which has allowed for projects to be approved more efficiently as the control period has progressed. We acknowledge that the size and usage of the fund will have to be considered relative to the available funding and priorities in CP7.

Consultation questions

8.5 Do you have any views on the use of the performance innovation fund in CP6?

8.6 Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

8.7 Do you have any comments on how such a fund should be managed?