PR23 final determination

Policy position - financial framework

31 October 2023

About this document

This financial framework policy document is one of five policy positions documents of our final determination for the 2023 periodic review (PR23).

PR23 determines what the infrastructure manager for the national rail network, Network Rail, is expected to deliver with respect to its operation, support, maintenance and renewal (OSMR) of the network during control period 7 (CP7), which will run from 1 April 2024 to 31 March 2029, and how the available funding should be best used to support this.

This strongly influences:

- the service that passengers and freight customers receive and, together with taxpayers, ultimately pay for; and
- the charges that Network Rail's passenger, freight and charter train operator customers pay to access its track and stations during CP7.

Our final determination sets out:

- our decisions on Network Rail's outcome delivery and its planned expenditure to secure the condition and reliability of the network;
- changes to access charges and the incentives framework; and
- relevant policies on the financial framework, managing change and holding to account.

In addition to **this document**, we have also published as part of our final determination:

Document type	Details
Summary of conclusions and overviews	Our decisions on what Network Rail will need to deliver and how funding should be allocated: • Summary of conclusions and overview for England & Wales • Summary of conclusions and settlement for Scotland

Document type	Details
Consolidated decisions	A summary of our final decisions across Great Britain
Introduction	An overview of PR23 and background to our final determination
Settlement documents	Detailed final decisions for the System Operator and each of Network Rail's regions in England & Wales: • Eastern region • North West & Central region • Southern region • Wales & Western region See our summary of conclusions and settlement document for detailed information for Scotland.
Supporting documents	Technical assessments of: • Health and safety • Outcomes • Sustainable and efficient costs • National Functions • Other income
Policy positions	How we intend to regulate Network Rail during CP7 in relation to: • **Financial framework** • Access charges • Schedules 4 and 8 incentives regimes • Managing change • Holding to account With the exceptions of managing change and holding to account, our policy position documents include our assessment of stakeholder views on our proposals. Stakeholder views for managing change and holding to account are published in a separate document.

Document type	Details
Impact assessments	A consolidated set of assessments of the impact of our final policies on access charges and contractual incentives on affected parties

Next steps

We will now implement our final determination. Implementation is the process through which we amend operators’ track and station access contracts to give effect to new access charges and incentives (such as Schedule 8 benchmarks and payment rates) determined through the periodic review. We expect to issue our review notices in December 2023 and, subject to Network Rail’s acceptance, issue notices of agreement and review implementation notices in time for CP7 to commence from of 1 April 2024.

We expect Network Rail to publish a delivery plan for CP7 that is consistent with our final determination. We have published a notice alongside our final determination which sets out expectations for the scope and timing of the delivery plan.

Contents

Executive summary

Introduction

This supplementary document to our final determination for the 2023 periodic review (PR23) sets out our financial framework for the infrastructure manager of the mainline railway, Network Rail, for control period 7 (CP7, which runs from 1 April 2024 to 31 March 2029). We describe the policy choices we have made and explain why we consider that most features of the existing financial framework should be retained. It follows the consultation on our draft determination and takes account of the responses we received.

The full set of documents that form our PR23 determination is available here.

Policy matters set out in this document

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 set out our position on the following matters:

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

A cost of capital and cost of debt are not necessary components of our determination of revenue requirements for CP7. However, these values and our approach to them are relevant for some contractual purposes and retaining them also supports other policy decisions. We have concluded on values for Network Rail's cost of capital and cost of debt for CP7 (3.98% real (CPI) pre-tax cost of capital, 2.33% cost of debt).

(2) Setting and updating regulatory asset base balances

We have not used Network Rail's regulatory asset base (RAB) in the calculation of the company's revenue requirements for CP7. However, the RAB underpins the fixed asset valuation in Network Rail's statutory financial statements. Removing it could be problematic for Network Rail. Retaining it also supports future decision-making. We have retained our current approach for the setting and updating of RAB balances for CP7 (the value of the RAB at 31 March 2023 was £84.4 billion).

(3) Our policy on rebates of unused funds

We have retained our policy that rebates of funding that Network Rail does not need to deliver its outputs via operators should only be made in exceptional circumstances and should not create risks to the financial sustainability of Network Rail's business. Our approval is required before a rebate is paid. Other options are also available for the return of funding to governments.

(4) Network grant arrangements and dilution provisions

We will seek written confirmation of finalised network grant documentation (including payment amounts) by 7 December 2023. Additionally, we intend to strengthen Network Rail's protection against an unexpected shortfall in grant funding, by reducing the delay between a grant dilution event occurring and an increase in fixed track access charges (FTAC) payments to meet any shortfall from three months to one month.

(5) Re-opener provisions to vary the terms of our regulatory determination

Re-opener provisions are a formal process to amend the periodic review in extreme circumstances. We are retaining the current re-opener provisions because they provide an important mechanism that allows us to work with funders, Network Rail, and industry stakeholders to change the terms of our PR23 determination if material unforeseen circumstances arise.

(6) Management of financial risk

Like any company, Network Rail needs appropriate provisions in place to manage the risks it faces, such as inflation, cost shocks and adverse events. We describe how funding for those risks is managed and how we intend to increase our monitoring and reporting around the use of risk funding.

(7) Governments' budgetary processes

We explain our understanding of DfT's (Department for Transport) and Transport Scotland's budgetary processes in relation to Network Rail's funding under their own budgetary regimes, including providing for limited flexibility to move underspend and overspend between years and between budgetary categories.

Some of the matters in our financial framework 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 company may decide to restructure. We have set out our managing change policy here.

Summary of responses to our draft determination

We received ten responses to our draft determination relating to the financial framework for CP7. These are available here. Key points from respondents are summarised below, with these matters covered in detail in the relevant chapters of this document.

- **Arriva UK Trains (AUKT)**: AUKT supported our approach, and our holding of Network Rail to account.
- **SE Trains Limited (Southeastern)**: Southeastern did not support reducing the notice period for payment of additional FTAC payments, in the event of a shortfall in network grants, from three to one month as it does not allow sufficient time to agree and process changes during DfT budget cycles.
- **First Trains Limited (First Group)**: First Group considered that monitoring of financial risk is an area that needs strengthening, both by Network Rail and ORR. First Group would also like some assurance that the individual CP7 risk provisions are adequate, especially in relation to weather extremes (this matter is addressed in our Sustainable and Efficient Costs supporting document to our PR23 final determination).
- **Freightliner**: Freightliner agreed that the CP6 financial framework remains fit for purpose and limited changes are required. Freightliner strongly supported our approach to compare Network Rail's proposed cost of capital with the values used by other regulated sectors in the UK.
- **Govia Thameslink Railway Limited (GTR)**: Having experienced multiple cancellations of planned engineering access at the back end of this year, GTR questioned how ORR will monitor expenditure during the control period so that

passengers receive the benefits of performance resilience through maintenance and renewals work. These matters are addressed in our Holding Network Rail to Account and Monitoring Network Rail's Performance.

- **DB Cargo (UK) Limited (DB Cargo)**: DB Cargo was content that the CP6 financial framework remains largely fit for purpose and limited changes are required. DB Cargo noted that PR23 is taking place within a challenging economic environment and that it is key that ORR monitors Network Rail's finances closely to ensure it is operating efficiently and able to deliver on its commitments. ORR should require recovery plans if it is falling short.

- **Abelio East Anglia Limited (Greater Anglia):** Greater Anglia was content with our draft determination and agreed that the CP6 financial framework remains broadly fit for purpose requiring only limited changes for CP7.

- **Rail Partners**: Rail Partners agreed that the CP6 financial framework remains largely fit for purpose and limited changes are required. It supported ORR's approach to compare the proposed cost of capital outlined in Network Rail's SBPs with the values used by other regulated sectors in the UK. Rail Partners stated that we should closely monitor Network Rail's cost efficiency and require recovery plans if it is falling short.

- **Network Rail**: Network Rail provided a detailed response which focused on our CP7 cost of capital estimate, government budgetary processes, network grant arrangements and the management of financial risk. These matters are covered within this document.

- **Northern Trains Limited (Northern)**: Northern was concerned about reducing the maximum length of time between a grant dilution event being triggered and an additional FTAC payment from operators from three months to one month. Northern noted that this is insufficient time to plan its cashflow and considers this is why it was three months originally.

- **Department for Transport (DfT)**: DfT responded on Government's budgetary flexibility rules for CP7.

- **Transport Scotland:** Transport Scotland considered that Network Rail's governance of risk funding in CP6 is at best, inadequate. It will be important for the ORR to provide assurance that there is full transparency and appropriate use of risk funding (both at Scotland and central levels) and that this will be embedded in Network Rail processes.

- **Transport for London (TfL)**: TfL was broadly comfortable with our approach for determining Network Rail's cost of debt that is used to calculate the Crossrail Supplementary Access Charge (CSAC), subject to some matters which are examined in this document. TfL also noted that it would like Network Rail and the DfT to engage with it during CP7 on wider reform of the CSAC given the significant changes that have taken place in the rail industry and wider economy since it was designed.

1. Cost of capital and cost of debt

1.1 As set out in our December financial framework consultation, 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. However, these values are relevant for the reasons explained below.

1.2 Respondents agreed with our consultation questions about whether we should largely retain the approach that we adopted for CP6, making changes only where necessary. We received detailed responses from Network Rail and TfL regarding the values for cost of capital and cost of debt which are examined in this chapter.

Decision

1.3 We have specified cost of capital and cost of debt values for Network Rail in CP7 as part of our final determination. We include values below.

Reason for decision

1.4 We consider that cost of capital and cost of debt 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;
- providing a benchmark discount rate/internal rate of return for internal projects (and other economic decisions) by Network Rail in CP7;
- the cost of debt that we determine affects the Crossrail Supplemental Access Charge (CSAC) income that Network Rail will receive in CP7; and
- 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 the cost of capital Network Rail might face if it were financed in the private sector by a mix of debt and equity).

Determining values for the cost of debt and cost of capital

1.5 UKRN published guidance for economic regulators in 2023 on the approach that should be adopted for calculating cost of capital parameters. ORR was a member of the UKRN taskforce that developed this guidance, which we have followed in our approach set out below.

1.6 We note that Network Rail's calculation of cost of capital parameters included in its CP7 strategic business plan preceded publication of the UKRN guidance. In its response to our draft determination, Network Rail has provided new cost of capital values which align with the UKRN guidance. Consequently, the methodological differences between the cost of equity parameters in Network Rail's strategic business plan and our draft determination have been resolved.

Cost of debt

1.7 Network Rail's strategic business plan included a forecast real (CPI) pre-tax cost of debt of 2.33% for CP7. In our draft determination, we agreed with this proposal[1].

1.8 In its response to our draft determination, Network Rail provided an updated forecast real (CPI) pre-tax cost of debt of 2.47% for CP7. This is higher than our draft determination value. Network Rail stated that its update included the latest CPI inflation forecasts and new debt costs. It also noted its working assumption for the CPI/RPI wedge is between 0.7% and 1.0%, based on historic data, compared to our use of a 0.54% wedge.

1.9 In contrast, TfL proposed a lower value of 2.21% for Network Rail's real (CPI) pre-tax cost of debt in CP7. In support of its draft determination response, TfL commissioned Frontier Economics to analyse Network Rail's forecast cost of debt in CP7. Frontier Economics' report is available as part of TfL's response to our draft determination.

1.10 Frontier Economics mostly agreed with how Network Rail has calculated its CP7 cost of debt. However, Frontier Economics calculated a 0.12% lower forecast for the cost of new debt. This was based on the following matters which are examined below:

(a) a 0.04% increase to reflect for market movements;

(b) a 0.10% reduction to reflect the latest CPI inflation forecast which is higher than assumed in the draft determination; and

(c) a 0.05% reduction to deduct the Debt Management Office (DMO) margin.

1.11 The net effect of (a) and (b) above is a 0.06% reduction in the cost of debt compared to our draft determination. In contrast, subsequent to our draft determination, Network Rail has proposed an increase to the cost of debt due to these factors, in particular due to an increase in the interest rate on the National

[1] For reference, for CP6, we specified a real (CPI) pre-tax cost of debt of 2.45%.

Loan Fund (NLF) borrowing. We note that Frontier Economics' analysis shows that whilst the spot rate has recently increased, looking at forward rates into the early part of CP7, the rate is projected to fall. We consider that this is a relevant consideration when estimating the cost of new debt issued across CP7, rather than just using the current rate.

1.12 Frontier Economics proposed a 0.05% reduction to the cost of debt to deduct the Debt Management Office (DMO) margin. Frontier Economics noted that the 2014 loan agreement between Network Rail and DfT stated that the national loans fund rate used should be "the national loan funds new loans rate under the heading "maturity…after the deduction of the margin added by the DMO". Network Rail's SBP did not apply this deduction, though Network Rail has informed us that this was applied in its response to our draft determination. We agree with Frontier Economics that it is appropriate to apply this deduction.

1.13 Both Network Rail and Frontier Economics suggested a higher value for the CPI/RPI wedge for cost of debt than the value that we used in our separate draft determination calculation of the cost of equity. Frontier Economics has proposed a 0.85% wedge, noting that the tenor of the DfT debt assumed by Network Rail is much shorter, at around five years, compared to the 20 years used in our calculation of cost of equity. We agree with Frontier Economics' findings and consider that a 0.85% CPI/RPI wedge is appropriate for calculating a real (RPI) cost of debt[2].

1.14 We consider that both Network Rail and TfL have put forward good evidence in support of their estimated cost of debt values for CP7. Network Rail's suggested value would increase the real (CPI) cost of debt by 0.14% compared to our draft determination and TfL's suggested value would decrease the real (CPI) cost of debt by 0.12%. Network Rail and TfL have used different valid methods to estimate the cost of debt. Given the relatively small differences between the two, and the uncertainty in estimating the cost of debt (particularly in the current inflationary and interest rate environment), we have decided to retain our draft determination real CPI cost of debt of 2.33%. We have also decided to apply a higher (0.85% compared to 0.54%) RPI/CPI wedge, which was supported by both Frontier Economics and Network Rail for the cost of debt.

[2] This value was also within the 0.7% to 1.0% range proposed by Network Rail.

1.15 Based on the above, our view is that the real (CPI) pre-tax cost of debt for Network Rail in CP7 should be 2.33% and that the real (RPI) pre-tax cost of debt should be 1.48%[3].

Cost of capital

1.16 When corporation tax is not separately modelled as an allowed revenue item, price controls work off a pre-tax weighted average cost of capital (WACC):

> Real pre-tax weighted average cost of capital
>
> = (pre-tax cost of debt x gearing) +
>
> (cost of equity grossed up for corporation tax x 1-gearing)

1.17 When corporation tax is separately modelled as an allowed revenue item, the formula above is calculated without 'grossing up' the cost of equity by the amount required to recover corporation tax and is known as the 'vanilla' WACC. The gearing value is commonly a notional percentage, representing the proportion of finance provided by borrowing.

1.18 UKRN publishes an annual update report on cost of capital decisions taken by economic regulators. UKRN's most recent report was published in July 2023 and is available here. Recently published regulatory determinations of cost of capital values from this report are shown in Table 1.1, together with Ofwat's final methodology for PR24 and Network Rail's proposed values for CP7.

[3] We have included an (RPI) real cost of debt value as this is relevant to the CSAC charge.

Table 1.1 Comparison of recent regulatory values for cost of capital

Date	Mar- 21	Mar-21	Nov-22	Dec-22	Feb-23	Mar-23	Aug-23
Sector	Telecoms Openreach	Telecoms other	Gas & Electricity	Water	Gas (NI)	Network Rail SBP	Network Rail DD response
Cost of debt	1.5%	1.6%	3.01%	2.60%	2.52%-3.94%	2.33%	2.47%
Cost of equity	5.8%	7.1%	n/a	4.14%	6.67%-7.50%	4.44%	4.69%
Notional gearing	45%	45%	60%	55%	55%	62.5%	62.5%
Risk free rate	-1.0%	-2.0%	1.2%	0.5%	1.8%	2.6%	1.0%
Total market return	6.7%	6.7%	6.5%	6.00-6.92%	6.5%	5.23%	6.5%
Corporation tax	19%	19%	n/a	n/a	19%	25%	25%
WACC (vanilla)	3.8%	4.6%	3.9%	3.23%	3.93%-4.42%	3.12%	3.30%

Sources: UKRN annual cost of capital report 2023, Ofwat final methodology for PR24 and Network Rail PR23 submissions.

1.19 In its response to our draft determination, Network Rail provided an updated WACC (real vanilla CPI) of 3.30%, slightly higher than our draft determination value of 3.27%, due to a proposed increase in the cost of debt (see Table 1.2).

1.20 As documented in our draft determination, we used slightly different approaches for calculating some cost of equity components than Network Rail based on UKRN guidance that was published after Network Rail had submitted its CP7 strategic business plan to us. In its response to our draft determination, Network Rail has followed our approach which does align with the UKRN guidance. Consequently, the methodological differences between the cost of equity parameters in Network Rail's strategic business plan and our draft determination have been resolved.

1.21 As examined in the Cost of Debt section of this chapter, we have determined a lower value for Network Rail's cost of debt than Network Rail in its response to the draft determination (2.33% real (CPI) pre-tax compared to 2.47%).

1.22 We have calculated a cost of equity using the same approach for our draft determination, updated for the Bank of England's latest 20-year data for calculating the risk free rate[4] which results in a 5.05% cost of equity.

1.23 Based on the above, we have determined a real (CPI) pre-tax WACC for Network Rail of 3.98% in CP7, which equates to a real (CPI) vanilla WACC of 3.35%. The parameters that we used to calculate Network Rail's WACC are set out in Table 1.2.

Table 1.2 Parameters used to calculate Network Rail's cost of capital in CP7

Parameter	Network Rail's SBP	Our draft determination	Network Rail's response to our draft determination	Our final determination
Cost of debt	2.33%	2.33%	2.47%	2.33%
Cost of equity	4.44%	4.84%[5]	4.69%	5.05%
Notional gearing	62.5%	62.5%	62.5%	62.5%
Total market return	5.23%	6.50%	6.50%	6.50%
Risk free rate	2.6%	0.98%	0.98%	1.68%
Equity beta	0.70	0.70	0.70	0.70
Corporation tax	25.0%	25.0%	25.0%	25.0%
WACC (pre-tax, real, CPI)	3.68%	3.88%	3.89%	3.98%
WACC (post-tax, real, CPI)	2.76%	2.91%	2.92%	2.99%
WACC (vanilla, real, CPI)	3.12%	3.27%	3.30%	3.35%

Source: Network Rail's CP7 submissions and ORR own analysis.

[4] Using the Bank of England's latest available data (31 August 2023), the yield on 20-year index linked gilts was 1.14% at the end of August 2023. Appling the 0.54% 20-year RPI-CPI wedge used by Ofwat (see Table 3.3 in PR24 final methodology) gives a risk free rate (RFR) of 1.68%. The Bank of England data is available at Yield curves | Bank of England.

[5] This value was incorrectly stated in our draft determination, this did not affect any of our calculations which used 4.84%.

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 have not used a 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 & Wales, and for Scotland for reasons that are explained below.

2.2 For reference, the value of Network Rail's regulatory asset base was £84.4 billion on 31 March 2023[6]. We decided not to establish a RAB value for any of Network Rail's national functions other than its System Operator (SO) in CP6 because they have few tangible assets of their own.

2.3 Further to our December 2022 consultation on the CP7 financial framework, we did not receive any further substantive consultation responses to our draft determination on these matters.

Decision

2.4 We are retaining our CP6 approach for the setting and updating of regulatory asset base balances for CP7. In particular:

RAB balances for geographical regions and SO

2.5 We will determine an opening RAB balance for each Network Rail region and SO together with an indicative forecast value for each year of CP7. We will publish these values in our Annual Efficiency and Finance Assessment throughout 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.

[6] Network Rail's valuation using the depreciated replacement cost (DRC) approach is around £370 billion, see Note 5 of the DfT's annual report and Accounts 2021–22.

- Add capital expenditure (renewals and non-grant funded enhancements[7]) 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 update and publish for CP7.

Reason for decision

2.9 We consider that RAB values are relevant for the following purposes, in order to:

- provide a valuation of Network Rail's assets (which are important national infrastructure);
- 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, such as the Core Valley Lines disposal in Wales in CP6.

[7] Non-grant funded schemes require separate funding, as opposed to those which have been funded through government grants. Excluding grant funded enhancements understates the full asset value of the network.

3. Rebates

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

3.2 The current rebate mechanism is set out 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. We note that other options exist in network grant letters for Network Rail to return funding to governments.

3.3 Further to our December consultation on the CP7 financial framework, we did not receive any further substantive consultation responses to our draft determination on these matters.

Decision

3.4 We are retaining a rebate policy to keep the CP6 rebate mechanism in place for Network Rail to potentially make rebate payments during CP7. As in CP6, 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.

Reason for decision

3.5 We consider that there have been no significant changes that justify a change to our CP6 rebate mechanism. Retaining the existing rebate provisions in track access contracts does not appear to raise any material issues as it does not preclude Network Rail returning funds to government through other channels.

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, network grant represented around 68% of operating and renewals expenditure in England & Wales, and around 54% in Scotland. Both DfT (see here for its SoFA for England & Wales) and Transport Scotland have confirmed that they want to use the similar proportions for operating and renewals expenditure in CP7 as in CP6. This equates to an 84/16 ratio of network grant to FTAC in England & Wales, and a 56/44 ratio in Scotland[8]. See our separate PR23 final determination: policy position on access charges for details of the level of network grant payments.

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, which set out the dates and amounts for network grant payments.

4.3 The existing track access contracts held by passenger operators on concession-style agreements contain network grant dilution provisions[9]. These provide that, in the unlikely event that a network grant payment is not made *during* the control period, operators are obliged to pay a share of the shortfall to Network Rail, three months after the 'dilution date'. This reflects that network grants offset an amount of charges that would otherwise be recovered through higher FTACs.

4.4 As part of PR23, we have considered the process and timings for confirming the terms of network grant arrangements for CP7. In PR18, we received written confirmation from Network Rail and funders of the dates, amounts and conditions for network grant payments after our final determination (in the first quarter of 2019)[10]. This meant that the PR18 settlement, and the level of FTACs set out in price lists, was based on an assumed level of grant funding that had not been formally confirmed at that point.

4.5 In our December consultation on the financial framework, we proposed that, for CP7, we would seek written confirmation of the dates, amounts and conditions for

[8] There are separate grant funding arrangements for enhancements, British Transport Police and financing costs.

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

[10] In the case of Scotland, this was in late March, i.e. very close to the start of CP6.

network grant payments (in signed network grant documentation) *before* our final determination. In light of stakeholder feedback, we proposed in our draft determination that we continue to seek provisional confirmation of the profile and level of network grant payments before our final determination. Written confirmation of finalised network grant documentation (including payment amounts) would then be submitted to ORR by 7 December 2023.

4.6 Additionally, as part of our [July 2023 consultation on drafting changes to model access contracts,] we consulted on an amendment to the existing network grant dilution provisions in Schedule 7 of operators' track access contracts. Specifically, we proposed shortening the delay between a dilution event occurring and an increase in FTAC payments. We said this would strengthen Network Rail's protection against an unexpected shortfall in network grant funding, compared to the provisional amounts confirmed in our final determination.

Decision

Network grant arrangements

4.7 There is little change to the documentation from CP6 for both England & Wales and Scotland. Network Rail has sent a draft of the documentation to DfT. DfT is confident that there should not be any problems with concluding the drafting.

4.8 We will continue to liaise with Network Rail and the funders to ensure that written confirmation of finalised network grant documentation (including payment amounts) is submitted to us by 7 December 2023. At this stage, we do not expect there to be any changes to the terms and amounts of network grant payments that our final determination has been based on.

4.9 If the network grant documentation for either England & Wales or Scotland has not been signed and submitted to ORR by this date, we will write to Network Rail by the end of December 2023. We will ask it to set out its contingency arrangements, for how it will deal with a shortfall in network grant funding from 1 April 2024, to ensure there is sufficient certainty over Network Rail's ability to deliver the PR23 determination. This would also serve to provide advance notice to industry that a grant dilution event may be triggered.

Grant dilution provisions

4.10 We are confirming our decision to shorten the delay between a dilution event occurring and an increase in FTAC payments. We consider this is necessary to reduce the duration of Network Rail’s exposure to a funding shortfall for an interim period, particularly as it can no longer directly borrow from the capital markets.

4.11 Some train operators said reducing the length of time between a dilution event being triggered and an additional FTAC payment from operators from 3 months to 1 months is insufficient time for them to plan cashflow because it would require them to secure additional funding from commissioning authorities (which involves strict governance processes). As stated in our draft determination, we consider this would be achievable within one month, particularly as meeting these grant payments would be necessary for Network Rail’s continued operations. We also note that industry would in practice have more than one months’ notice of a grant dilution event, because a grant dilution event would be caused by a funder (which is also the commissioning authority for the majority of passenger services with grant dilution clauses in their contracts). Furthermore, as noted above, if a grant dilution event may be necessary at the beginning of CP7, we will make industry aware of this three months in advance of the start of CP7.

5. Re-opener provisions

5.1 Track access contracts currently 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 The provision in CP6 track access contracts is for there to be a re-opener of our regulatory determination 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 & 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.

5.3 Further to our December consultation on the CP7 financial framework, we did not receive any further substantive consultation responses to our draft determination on these matters.

Decision

5.4 We are retaining the re-opener provision in track access contracts, updated to refer to ‘before 1 April 2029’. The bar for a re-opener is high, requiring a material change in the circumstances of Network Rail or in relevant financial markets. We are also retaining the Scotland specific provision for a re-opener if expenditure in Scotland is forecast to be more than 15% higher than our determination over a forward-looking three-year period.

Reason for decision

5.5 Noting SETL’s view in its response to our December financial framework consultation that most train operators should support a re-opener for it to be used, we consider that the current 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. We do not consider that it would be appropriate to be only able to implement a re-opener if it was supported by most train operators.

5.6 In response to Transport Scotland's view in its response to our December financial framework consultation that the re-opener provision could be an appropriate mechanism to respond to the significant uncertainty posed by high rates of inflation in the UK economy, we agree that a re-opener may be appropriate if such uncertainty represents a material change to Network Rail's circumstances and could not be absorbed within existing funding or planned expenditure (including any risk-funding).

6. Management of financial risks

6.1 This chapter covers our approach for Network Rail's management of financial risk and uncertainty in CP7. It does not examine the amount that Network Rail has put aside as a group risk fund for CP7 as this matter is covered in our sustainable and efficient costs supporting document. It also does not address uncertainty related to British Transport Police costs, external financing, enhancements, and corporation tax costs, as these will be funded outside the PR23 settlement.

6.2 Like any company, Network Rail needs appropriate provisions in place to manage the risks it faces, such as inflation, cost shocks and adverse events. In addition to using risk funds to cover unanticipated costs, particularly relating to the Coronavirus (COVID-19) pandemic 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 Carmont accident), to improve track worker safety, to support work on rail reform, and other matters.

6.3 Network Rail expects to face many of the same types of financial risks in CP7 as in CP6, with some expected to be more significant (in particular, inflation and economic uncertainty), some less so (for example, the impact of the pandemic) and potentially some new risks. If these risks are not managed efficiently, there is the potential for seriously adverse impacts on the deliverability of renewals and other activities.

6.4 Further to our December consultation on the CP7 financial framework, we received a number of responses in support of our proposal to enhance our reporting on these matters in CP7. In particular, Transport Scotland considered that Network Rail's governance of risk funding in CP6 is at best, inadequate. It said that it will be important for the ORR to provide assurance that there is full transparency and appropriate use of risk funding (both at Scotland and central levels) and that this will be embedded in Network Rail processes, given some of the experiences in CP6. It also said that using the risk fund should not be Network Rail's first resort to managing cost pressures (particularly those arising from poorly planned or poorly managed works by Network Rail) rather than the proper pursuit of efficiencies and cost control. Network Rail must provide clear reporting on how and when such events take place.

6.5 Since the publication of our draft determination, Network Rail has been working with us, DfT and HM Treasury to agree principles for the use, and oversight, of risk funding in England and Wales in CP7. Similar work has taken place with Transport Scotland for the use risk funding in Scotland, for which similar principles will apply.

Decision

6.6 We will increase our scrutiny of, and transparency around Network Rail's management of financial risks in CP7. This will include monitoring Network Rail's compliance with the agreed principles for the use of risk funding in CP7, and enhanced reporting on Network Rail's use of risk funds in our quarterly reviews of Network Rail's delivery plan updates and our Annual Efficiency and Finance Assessments. We have also sought to align our managing change policy and the approach to governance of risk funding by incorporating our principles into the policy, which will mean they are enforceable through Network Rail's network licence. Our approach avoids duplication between these policies and allows for changes to be made in a transparent manner. Our managing change policy for CP7 is explained separately here.

Reason for decision

6.7 Network Rail intends to retain a broadly similar approach to the management of financial risk as is in place for CP6, although with a lower level of funding to manage financial risks in CP7. Risk funding is effectively an internal management tool, for it to retain some flexibility within its plans, and to manage its business efficiently and effectively. Because Network Rail is a publicly owned operator of national infrastructure, the using up of a larger risk fund (than we are providing for CP7) before the end of CP6, and the increased risks around inflation uncertainty as well as lower overall risk funding for CP7, we consider that it is important to increase transparency about how Network Rail is managing financial risks during the control period.

7. Governments' budgetary processes

7.1 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. UK Government departments have limited flexibility to amend RDEL and CDEL. We consider this budgetary flexibility in CP6 supports stable business planning and management of uncertainties.

7.2 This section summarises the flexibilities that we expect to apply for Network Rail within DfT's RDEL and CDEL regimes for CP7 for funding in England & Wales, and the flexibilities that Transport Scotland will apply for the funding for Network Rail Scotland. These remain broadly similar to the flexibilities in CP6.

7.3 We received responses from DfT, Transport Scotland and Network Rail.

DfT

7.4 DfT has confirmed to us that the UK Government's CP6 budgetary processes will remain in place. DfT previously stated that the objective of these financial flexibilities is to provide a robust mechanism to allow Network Rail to manage changes in circumstances during the five-year control period, so that it could make effective and efficient asset management decisions to support delivery for passengers, freight customers and taxpayers.

Transport Scotland

7.5 Transport Scotland's response to our draft determination stated that its proposed approach (for budgetary flexibility in CP7) reflects the full devolution of funding from HM Treasury to Scottish Government and the fact that this means that no definitive commitment can be made other than to attempt to manage a similar level of flexibility between financial years (which is currently 10% budgetary flexibility between years). Since our draft determination, discussions have been ongoing between Transport Scotland the UK Government on this issue. Transport Scotland has advised that for CP7 there will not be a similar budgetary mechanism with HM Treasury. However, the Scottish Exchequer has been provided with some additional general reserve flexibilities to manage funding between years across all government areas. Transport Scotland has advised us that this should be sufficient to accommodate any normal operational timing differences, but stressed the importance of early and accurate forecasting to inform this position and for Network Rail Scotland to raise any exceptional issues as soon as they arise.

Network Rail

7.6 Network Rail agreed that the current flexibilities are important in maximising value for money for rail users and taxpayers. Network Rail considers that the current CP6 financial flexibilities are critical to being able to efficiently manage its activities. These financial flexibilities have supported more effective and efficient asset management, and have allowed for better responses to issues (e.g. the pandemic).

7.7 Network Rail noted that its SBP was developed on the basis that the company will have the same financial flexibilities in CP7 as in CP6. Therefore, it welcomed the confirmation from DfT that the CP6 flexibilities will continue in CP7.

Decision

7.8 The nature of Network Rail's business comprises large capital renewals programmes as well as the operation and maintenance of the network for a five year period in return for relatively fixed funding. Governments' budgetary processes are not a matter for ORR to decide, so this chapter does not set out any decisions for CP7. However, we welcome HM Treasury's decision to maintain the budgetary flexibility applied in CP6 during CP7 as we see advantages in the flexibilities currently in place, in particular, in relation to supporting stable business planning and the management of uncertainties. We likewise welcome Transport Scotland's decision to maintain broadly the same process.

Capital expenditure funded in the England and Wales SoFA

7.9 To ensure transparency around the factors that affect Network Rail's financial framework, we set out below the processes that we expect for CP7. We will 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. If there are any changes to the arrangements described below, we will set these out in our annual efficiency and finance assessments.

Expenditure funded in the England and Wales SoFA

7.10 The budgetary flexibilities that Network Rail received for England and Wales funding during CP6, and which DfT has confirmed will continue in CP7 were set out in DfT's response to our second consultation on the PR18 financial framework, as set out below.

Capital expenditure funded in the England and Wales SoFA

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

7.12 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 [control period] 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.

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

7.14 At Supplementary Estimates[11], 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 £200 million 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 £200 million of the original Budget request for re-profiling with respect to future years.

7.15 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.

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

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

Resource expenditure funded in the England and Wales SoFA

7.17 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

7.18 The budgetary flexibilities that Network Rail received for Scotland funding during CP6, and which Transport Scotland intends to broadly continue in CP7 were set out in our PR18 financial framework and are reproduced below.

7.19 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 control period spend, prior to the finalisation of its grant agreements, and is reflected in the profile of funding Transport Scotland agreed with HMT.

7.20 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

7.21 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.

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

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