ATOC response to ORR financial framework consultation

ATOC welcomes the opportunity to respond to ORR's consultation on financial issues for Network Rail in CP5. We have set out our detailed response to the consultation questions in the attached appendix. Additionally, we consider there are three important points of principle that ORR should keep in mind as it develops its financial framework for Network Rail.

Firstly, in other regulated sectors the financial framework for infrastructure companies tends to be among the most hotly contested areas of debate in the periodic review process. This is because the financial framework establishes the level of profit the company should make, the speed with which investment should be remunerated and the allocation of risk between parties across the supply chain. In the rail sector, given Network Rail's status as a not for dividend company limited by guarantee as well as the protections provided to TOC's through clause 18.1 and Schedule 9 of the franchise agreements, debates around the financial framework have been much less prominent.

However, the DfT is currently considering options to change parts of this and, in particular, to let franchises which take a degree of regulatory risk. In addition, the advent of alliancing and a regional efficiency benefit sharing scheme that ORR has recently consulted on potentially will alter the existing structure and allocation of risks. Therefore the issues that ORR is consulting on in the current consultation are likely to become increasingly important to train operating companies. For that reason we think it is important to think ahead to how the financial framework may be viewed from the perspective of bidders and shareholders. In an industry which already has a quite complicated contractual matrix, there is value in keeping the financial framework clear, focussed and incremental in nature to make it easier for industry parties and stakeholders such as the financial community to anticipate the effect of the framework.

Secondly, the McNulty Rail Value for Money Study has set out an objective of delivering a 30% reduction in unit costs by 2018/19 and this has recently been endorsed by the Command Paper. This is a significant challenge and the PR13 process is a key mechanism for taking forward many of the recommendations made by the McNulty Review. Although the main focus of McNulty was on operational and capital expenditure efficiencies, the financial framework itself potentially has a role to play as well in reducing overall net subsidy for example by incentivising Network Rail to minimise the cost of borrowing and by optimising the allocation of risk to reduce total industry cost.

Thirdly, and related to the point above, the financial framework is clearly indelibly linked to the incentives framework and it is important for the ORR to bring these strands of the price review together in a cohesive way that is readily understandable for all industry stakeholders.

Within that general context, we look forward to working with ORR to develop these issues further.

Appendix to ATOC response - Questions for stakeholders from Consultation on financial issues for Network Rail in CP5

Risk and uncertainty
Q3.1: What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB for inflation. In particular, that we are proposing to set an ex-ante assumption for both general inflation and input price inflation in our determination of access charges for CP5?
ATOC response: Our understanding of the ORR's proposal is that it will effectively transfer inflation risk from customers and funders to Network Rail. While we note the ORR's view that this approach may sharpen incentives on Network Rail to control its costs, we also note that this is a very significant departure from the standard regulatory approach to compensating companies for inflation risk. Regulators in other sectors have taken the view that inflation is an exogenous factor and for that reason the standard RPI-X formula gives some protection from fluctuations in the level of inflation. It is not entirely clear to us what the justification for such a substantial change is: NR is already subject to considerable pressure to reduce its costs since they are not (within a control period) 'index-linked'. The periodic review ultimately sets charges that apply for five years, albeit those based on costs: even if the charges are 'index-linked', NR must pay the actual costs it incurs including the result of inflation and thereby has an incentive to manage them effectively. From a practical point of view, switching from an ex-post annual adjustment to an ex-ante estimating approach means that the ORR will need to take a long-run forward looking view of inflation rates. Given the level of volatility observed in both RPI and CPI in recent years (the debate on which we note still gets national attention given the difficulty that the Bank of England has faced in keeping CPI within mandated levels), this is likely to be a challenging exercise. Therefore, if ORR does proceed with its proposal, the ORR's proposed study to consider the inflation risk that is controllable by Network Rail will be a crucial input in this area.

Risk and uncertainty
Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?
ATOC response: We consider that in previous control periods, and particularly when Network Rail

was a relatively new organisation and was fully focussed on the financial problems that beset Railtrack, the provision of an in-year risk buffer and other financial protections may have been helpful to enable Network Rail to manage business risk and normal fluctuations in cash flow. However, as we reach CP5 and NR's control of financial risks is now so much better than was the case under Railtrack we consider that this is less clear cut. Provided that Network Rail has sufficient headroom in the overall financial and regulatory framework to respond to reasonably foreseeable shocks, we would tend to agree with the ORR's assessment that an in-year buffer is less important.

Risk and uncertainty
Q3.3: What are your views on our proposal to simplify the mechanism to re-open Network Rail's access charges review by removing some of the specific re-openers?
ATOC response: We believe that there is general agreement that re-openers should only be used sparingly to cover genuinely exceptional events that have a material effect on Network Rail and therefore the current approach might be streamlined somewhat. However, in light of the move towards greater disaggregation and the devolution of rail in Scotland, we agree that there needs to be a specific re-opener for Scotland.

Risk and uncertainty
Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?
The treatment of 'non controllable' costs has always been a controversial area but we support the general approach that NR should be exposed to some of the costs involved in areas that it has influence over. We would value a broader discussion with ORR about EC4T in the light of the various changes that NR and ORR are proposing and of the implications of the new wholesale supply contract expected to apply for electricity delivered from October 2014. This is a very complicated area and a broader viewpoint would probably be helpful to all parties. In the meantime, we record our support for NR being subject to some degree of risk over transmission losses and reiterate our view that the move to metering trains should be phased and not be unduly distorted by non- cost reflective allowances and mark-ups in the charging system.

Risk and uncertainty

Q3.5: What are your views on our current thinking that the maximum level of financial indebtedness that Network Rail can incur should at no point exceed a limit set between 70-75% in CP5?
ATOC response: In our view, there are likely to be important incentive implications associated with the maximum level of financial indebtedness. On the one hand, a tightly binding cap may strengthen the incentives on Network Rail to meet ORR's efficiency targets. But, on the other, a cap which is set too tightly may not provide sufficient headroom for Network Rail to deal with unanticipated fluctuations and day-to-day cash flow management. Within that context we consider that the absolute level of the cap should be informed by detailed financial modelling undertaken by ORR, Network Rail and funders.

Cost of capital issues
Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?
ATOC response: In our view, ORR needs to anticipate industry reform initiatives such as further alliances or concessions that may be proposed in CP5 and begin considering their implications whilst noting that we are not yet at a stage in which these should high priorities. For example, a useful first step has been ORR's production of disaggregated profit and loss information, by route, which has given an indication of how some of NR's HQ expenditure might be allocated. In turn, this facilitates some degree of benchmarking between routes. Eventually, this could lead on to separate price controls for each route area. However, this is clearly some way off and is by no means a certainty, so the focus that ORR applies to this should remain proportionate.

Cost of capital issues
Q4.2: What are your views on our proposal to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail is provided with?
We have no comment on this point.

Cost of capital issues
Q4.3: What are your views on our proposal to take account of the cost of embedded debt in our forecast of efficient financing costs?
ATOC response: In our view, an important long-term principle is that Network Rail should only be remunerated for costs that are efficiently incurred. This should, in principle, apply to past decisions about financing as well as on operating and capital expenditure. However, the size and financing of NR's RAB and associated debt are considerable and reflect a whole range of decisions by successive Governments, regulators and managements on these matters. These decisions cannot readily be unscrambled even if that was thought to be a sensible step and therefore, to a very considerable extent, we are where we are. We would therefore suggest considering whether any change from the approach in previous control periods is warranted, given the need for transparency and simplicity of the regulatory system.

Cost of capital issues
Q4.4: What are your views on how we are proposing to assess financial sustainability?
ATOC response: Financial sustainability is crucial, particularly in an industry where the regulated asset base (and the underlying level of debt) of the infrastructure company has grown (albeit by design) at a faster rate than in other regulated sectors. Therefore, a longer term view of the future revenue requirement of Network Rail would provide stakeholders with greater visibility of the long term implications of decisions that are being made as part of this price review. We note that the ORR has asked Network Rail to provide longer term forecast of costs and revenues in its future business plans. We support this approach and are aware that long term revenue requirement scenarios are being planned by NR as part of the SBP process. With respect to financial indicators, we consider that these may be useful for examining short term '*financeability*'. However, we consider that long term '*affordability*' should also be a key consideration for the ORR.

Cost of capital issues
Q4.5 What are your views on our proposal to keep the introduction of the adjusted WACC approach as simple and transparent as possible by calculating efficient financing costs on a Cash basis and by taking the normal regulatory approach to indexing the whole of the RAB?
The RAB, its amortisation and its financing are already complicated areas. We believe that continuity of treatment with previous control periods is of value in itself and that ORR would be wise to retain the current approach.

Amortisation and RAB related issues
Q5.1: What are your views on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation?
ATOC response: We have no comment on this point.

Amortisation and RAB related issues
Q5.2: What are your views on our proposal not to index renewals for changes in input prices and how should we take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient?
ATOC response: As noted above in response to question 3.1, the effect of ORR's proposed approach is to transfer inflation risk from customers and funders to Network Rail. We are unsure that this would be an important a reform as ORR indicate. The broader issue from a TOC perspective is that we are aware that, during CP4, ORR has encountered a number of difficulties in confirming whether renewals underspend has been efficient. These issues relate to a lack of volume information and problems resolving the link between inputs, outputs and the serviceability and sustainability of the network. We consider that ORR should continue to develop its framework for assessing efficiency particularly in light of

the steps that Network Rail is taking to improve its unit cost reporting. As we have previously noted, it will obviously be essential to resolve these issues in the context of the ORR’s proposals to develop route level efficiency benefit sharing.

Amortisation and RAB related issues
Q5.3: What are your views about legacy debt and RAB?
No comment

Amortisation and RAB related issues
Q5.4: What are your views on our proposal to keep using the opex memorandum account?
No comment

Corporation tax
Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?
No comment. It is not immediately clear to us what the high-level differences between the two approaches that ORR set out are, particularly in a context of expected capital investment by the company which makes it unlikely that NR will be liable for corporation tax for some time.

Other financial issues
Q7.1: What are your views on our proposal to allow part of Network Rail's income to be provided directly by the governments through a network grant, which will be set ex-ante for each year of CP5?
ATOC response: In terms of the balance of Network Rail's income, all other things being equal we would have a preference for this to be routed via TOCs rather than paid directly to Network Rail in the form of Network Grant. This would reinforce the role of TOCs as Network Rail's customers and would also be consistent with the findings of the Rail value For Money study which recommended stopping the payment of network grants to Network Rail as a means of improving customer focus. Nevertheless, we do recognise that there are a number of broader factors at work and, in particular, that the need to distinguish capital from revenue expenditure remains an important principle to Government. The Government in its SOFA has provided a clear indication that it is expecting the Network Grant structure to remain in place for CP5 and ORR will clearly want to take note of this.

Other financial issues
Q7.2: What are your views on the activities that Network Rail should be allowed to carry out
ATOC response: In our view, it is important that Network Rail sticks to the knitting and is not distracted from carrying out its core functions. However, we can see a case for Network Rail to have some incentive to pursue modest, relatively small scale, value-enhancing revenue opportunities such as car parking and some station and retail development. This would require that protections remain in place through a binding ring-fence and to that extent we consider that Network Rail's paper on these issues, referred to in ORR's document, should be made available to industry stakeholders.

Other financial issues

Q7.3: What are your views on increasing the strengths of the incentives on Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination and should we consider more heavily incentivising genuine 'game changing' initiatives?
ATOC response: The existing approach to incentivising Network Rail is broadly comparable to that observed in other regulated sectors. The key distinguishing feature of rail is that Network Rail has no equity shareholders and, therefore, the usual incentives are unlikely to function in the way that they do for traditionally financed companies. For that reason, we think there could exceptionally be cases for considering further improving or strengthening the power of incentives where necessary. However, in the context of 'game changing' initiatives, we think that if further consideration is given to this option it is important for ORR to provide clarity quickly around how it would view and deal with such issues in practice, particularly if there are 'flow throughs' to actions that TOC might take to facilitate efficiency (for example, on possessions), given the range of work now being undertaken by RDG in this area.

ATOC
28 September 2012