First
transforming travel

26 September 2012

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Dear Richard,

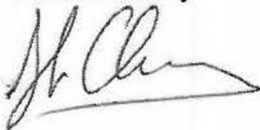
Consultation on Financial Issues for Network Rail in CP5

Thank you for the opportunity to comment upon the consultation on financial issues for Network Rail in CP5.

Please find attached FirstGroup's response which represents all FirstGroup's rail organisations, First Great Western, First Capital Connect, First TransPennine Express, First ScotRail, and Hull Trains.

Should you require clarification on any of the comments please do not hesitate to contact me.

Yours sincerely



Hugh Clancy
Commercial Director, Rail

FirstGroup Response to ORR Consultation on Financial Issues for Network Rail in CP5

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?

While we understand that the government funders have fixed funds available and it is therefore desirable for them to have the proposed regime, it does not fit in with the normal income drivers of a TOC. Fares in the industry, due to the regulation of certain fares, tend to rise with RPI inflation. Payments from/to government funders under Franchise Agreements continue to be linked to RPI. Thus the incomes of TOCs are generally driven by the movement in RPI.

The number of passengers wishing to travel is also affected by the level of economic activity in the UK and to a certain extent inflation pressures are higher when economic activity rises. As passenger numbers rise TOCs tend to put greater demands on Network Rail putting an upward pressure on its costs above the rate of inflation, where inflation is driven by UK demand.

While a known annual price increase is attractive the threat of a need for an interim review, due to the re-opener, makes it difficult to reliably plan on that basis.

Since TOCs income and expenditure also tends to increase with RPI, any move away from RPI will tend to make the compensation payments for restricted access under schedule 4 and performance under Schedule 8 less reflective of the actual losses.

We therefore feel that the payments that TOCs make to Network Rail should generally rise in line with RPI. We have considered whether an RPI minus figure would be appropriate. We do not believe that RPI minus is appropriate. Much work will have gone into evaluating the potential efficiency improvements Network Rail can make without affecting its ability to deliver outputs. Thus it would seem odd to add a further fairly blunt additional efficiency objective.

The proposed post-ante inflation measure does seem appropriate for the Direct Grant element of Network Rail funding with the assurance of recovery for unavoidable additional inflation pressures via the memorandum account. This always providing that the Government funders are prepared to accept that the account will, in the end, be settled by them. This settlement being made either directly via increases in the Direct Grant, or indirectly through the payments by Franchised TOCs, which they underwrite, in CP6.

This restriction of the post ante inflation measure to the Government funders who need it, has the merit of reducing the number of interested parties if the reopener becomes a possibility and greatly simplifying what needs to be done to correct the problem.

Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?

The logic for not providing the in-year risk buffer, explained in your consultation document, appears sound. Also the level of the current in-year risk buffer, compared with the balance sheet buffer and the annual turnover of Network Rail, appears relatively insignificant.

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?

The global re-opener seems generally a pragmatic approach. We are not convinced that the Scottish specific re-opener is the best way to resolve issues which are material in a Scottish context but not to Network Rail as a whole. We believe it would be better to clarify that the meaning of "material" includes issues which are material to the Scottish Ministers.

We are surprised that you mention the possibility of adding further specific re-openers, but not specific exclusions from the global re-opener. Does this imply that you will consider using re-openers to defend Network Rail from material changes in its financial position in all circumstances?

Potentially re-openers increase Network Rail's certainty and increase the uncertainty for its customers and stakeholders. There has to be an understanding that Network Rail, and those who manage it, will not be fully bailed out where they either fail to react properly to events or actually create the problem in the first place.

A further re-opener that allows ORR to reopen the funding issues when it is necessary to promote changes which are included within the stated objectives of the industry seems sensible. Limiting it to current initiatives means we may be unable to respond to funding issues that arise in the future. The RDG, if its status is made formal, could consider when changes to funding are desirable. It could then recommend use of a more widely drafted re-opener.

Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?

Traction Electricity

We agree that Network Rail should be exposed to any costs of transmission losses above the efficient rate. Losses are dependent on the following issues; the consumption by the end user, the design of the supply system and the way network is maintained and operated. Train Operators are exposed through EC4T charges to the overall traction electricity consumption cost and the introduction of metered trains increases the strength of the link between the TOCs behaviours and the bill it receives. At the moment Network Rail is not exposed to and has little knowledge of the effects of its behaviours on the losses.

The likely increase in electrification projects means it is vital that designs optimise efficiency based on the likely future cost of energy. Also maintenance regimes, in particular the outages of supply points, which reduce losses need to be encouraged. Maintenance issues are particularly important in the DC network where losses are particularly high and there are significantly more supply points to be maintained.

Industry Costs, i.e.BTP and other costs.

We agree with your approach. Those industry bodies which have a cost recovery arrangement in place clearly are not heavily incentivised to be efficient. TOCs and NR tend to share these costs. It is therefore important to TOCs that everyone and, given its size, in particular Network Rail is incentivised to put pressure on these bodies to reduce costs.

Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?

It seems inevitable that there will be some reforms to the structure of the industry in CP5. It is though impossible with any certainty, given the initiatives currently taking place, to be sure what will emerge. We therefore suggest that our proposed change to the proposed re-opener for concessions (see question 3.3) be more widely drafted to cover industry reform should be considered. If its use were overseen by the RDG it would provide a flexible and transparent solution.

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?

Your proposal sets the fee based on the value of the FIM to Network Rail and therefore represents a reasonable price for them to pay.

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?

To not take account of embedded debt which has been sensibly acquired by Network Rail (and we have no evidence that Network Rail's treasury decisions are not well founded) would create a strong incentive on Network Rail to not acquire such debt. Thus any other decision than the one you propose would create an incentive to sub-optimal decision making by NR and would be counter productive.

Q4.4: What are your views on how we are proposing to assess financial sustainability?

As you state in your opening statement, this is a statutory duty on ORR. We therefore believe it is for ORR to decide how best to meet this obligation. We can though confirm that we do not generally find any reason to question the logic of the proposal.

The only issue we observe is that the "investments" that have been included in the RAB have not always been as rigorously controlled as they are now. It is essential therefore that, where a ratio is founded on the RAB, any target allows for a sensible margin of error in the value of the RAB. Otherwise the financial sustainability calculation may give a false impression.

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 approach to calculating the efficient financing costs seems likely to produce a result which is accurate enough for the purpose and certainly as accurate as the available inputs.

It is clear that the value of the RAB needs to be reviewed annually and that index linked debts need to be accounted for. Indexing the RAB seems the most straight forward way of achieving this objective.

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?

Given that many of the assets in the rail industry have a high average age the long run steady state renewals cost seems a sensible approach for these assets. This is always providing that inappropriate assets, in particular the increasing number of such assets being replaced by modern equivalents dependent on modern electronics and software, are not treated in this way.

We support the view that reactive maintenance should not be put on the RAB. For train operators reactive maintenance has very negative consequences and allowing it to go on the RAB and earn a return sends out the wrong message to Network Rail. Having the cost of such undesirable activities impact on Network Rail's bottom line is the correct approach. Network Rail should be incentivised towards planned preventative maintenance.

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?

We cannot claim to have exact details of the change in renewal activity at the beginning of CP4. However we saw cancellation of possession plans, high profile redundancies among suppliers, some suppliers merging or closing down and a reduction in facilities on the network associated with renewals. It appeared that faced with funding for renewals at efficiency levels which NR could not at that time achieve Network Rail reduced the activity dramatically. The effect of this on a supplier base dependent on Network Rail and the capacity of the industry coupled with the discouraging signals it sent to those who may have been thinking of entering the market has not been assessed but it is likely to have dramatically reduced the capacity of that supplier base. In the long run as demand increases to deal with the deferred work that is bound to increase input prices. Where input prices are so badly affected by these negative behaviours it would be wrong to use this increase in prices to inflate the value of the RAB.

Given that the driver for these changes appears to be the 5 year cycle of regulatory reviews we do not believe the right question is "how should we take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient." But "How can we avoid this cycle of change in expenditure and create a settled supply market for Network Rail in which supply and demand are balanced, prices are stable and renewals are occurring at the level required to maintain the value of the Network?". We believe that the regulatory review process needs to become a rolling process with greater focus on bottom up analysis of Network Rail's efficiency and less reliance on high level comparisons. The fact that Network Rail is inefficient is well proven, the reasons for that are less well defined. Constantly adjusting the finances of Network Rail on a 5 yearly cycle will not get Network Rail to adopt best practice. Identifying what best practice is and creating the environment that allows and encourages Network Rail to adopt it is the correct answer.

Q5.3: What are your views about legacy debt and RAB?

The detail set out in the consultation document provides an interesting insight into the long term effects of the correction that took place after Hatfield. Given the underlying issues with Government debt in the Eurozone and its effect on the ability of the economy to grow and possible adverse changes in the cost of financing that debt, it is a very significant issue. However how to deal with that problem is very much an issue for the Governments, as you rightly say.

Q5.4: What are your views on our proposal to keep using the opex memorandum account?

This seems an essential tool to ensure that the RAB is truly reflective of the value of the assets put into the base.

Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?

We are slightly concerned that Network Rail has no tax capacity to claim capital allowances. It is notable that Network Rail funding agreements with TOCs requires the TOCs to ensure that the capital allowances are, where possible, made available to Network Rail. For any third party funder wishing to invest in the rail industry it is not tax efficient to invest in capital projects where the value is retained on Network Rail's

balance sheet and the benefits of capital allowances on investment cannot be passed back to the investor through the charge for the project.

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?

Given the sensible reasons set out by both Governments for retention of the current funding arrangement for Network Rail's capital expenditure we believe this is the right approach.

Despite both ORR and Sir Roy McNulty's views we remain to be convinced that recovering the full costs of Network Rail through the Fixed Access Charge, levied only on Franchised TOCs, would create any significant benefit. TOCs have little knowledge of the way these charges are derived and are generally held harmless from them by the funders. Franchised TOCs already have very small balance sheets compared to turnover. TOCs are businesses that are very differently financed from their open access competitors, who pay none of these costs at all. It is notable that many potential fines on companies for infringement of various types of legislation are based on turnover rather than balance sheet value. By artificially increasing turnover through a charge which does not relate directly to the activity of the company and, through indemnities, is a virtual pass through, TOCs could be placed in the situation where a fine, which legislation intended to be painful but affordable, would result in the failure of the business.

Q7.2: What are your views on the activities that Network Rail should be allowed to carry out?

While it appears superficially attractive that Network Rail should as far as possible seek to gain additional revenue from under utilised assets to offset industry costs, it is potentially risky for train operators. Train Operators are customers buying from a monopoly supplier who has no fear of losing their business as long as they survive. If Network Rail uses the resources funded to supply this captive market to also supply to markets where there is much greater competition then there is a strong risk of Network Rail focusing on its customers who do have a choice ahead of those that do not.

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?

We do not believe it is desirable to increase the incentives on Network Rail to outperform or indeed increase the penalties should it under perform. The dangers of creating perverse incentives and unpredictable behaviours are too great. We look to ORR to set Network Rail realistic objectives for the managers to keep the business a going concern. It is the responsibility of the shareholder to determine the incentives it places on the managers of the company to outperform within the environment set for them by the ORR.

Unfortunately the 5 year control period has the danger of dis-incentivising Network Rail by creating the view that all over achievement does is make the next period harder. That view is best removed by intelligent debate and giving greater weight to longer term thinking and planning which is mutually agreed.