RBC Capital Markets

Corporate Finance Advice on Proposals for Network Rail to raise Risk Capital

Paper 4: Approach to Cost of Capital and Financing Arrangements

30th March 2012

OFFICE OF RAIL REGULATION

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1. Introduction

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Introduction

- RBC has been appointed by the Office of Rail Regulation (“ORR”) under Tender Reference ORR/CT/10-53 to advise on implications of current proposals to introduce risk capital to Network Rail
- As part of the ORR’s consultation on the next Periodic Review of Network Rail’s charges (“PR 13”), ORR has been considering approaches to the calculation of Network Rail’s cost of capital and has exchanged views with both Network Rail and DfT on the subject
- In March 2012 ORR requested RBC to provide advice on likely market reaction to such changes to Network Rail’s financing structure
- This paper (“Paper 4”) sets out RBC’s advice
- RBC’s work has been principally based on the following materials provided by the ORR:
  - ORR’s Periodic Review 2013: Consultation on incentives, issued in December 2011
  - Network Rail’s response to the December 2011 consultation document and covering letter dated 8 February 2012
  - Note from Network Rail entitled ‘Network Rail cost of capital in CP5’
  - Letter from Network Rail dated 13 February 2012 and note from Oxera on ‘Allowed return for regulated companies with unconventional ownership structures’
  - Draft note from DfT dated 24 January 2012 and e-mail extract on ‘Adjusted WACC Approach’ received 9 March 2012

2. Background

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Background – Consultation Document

December 2011 Consultation

- In the December 2011 consultation document ORR discusses methods for incentivising Network Rail and in particular the approach to Network Rail's cost of capital, which forms a large part of the calculation of the company's allowed return
- The consultation document considers a number of issues, including
  - how the cost of capital is calculated
  - how any surplus should be treated
  - Network Rail's financing arrangements, including the potential to raise unsupported debt
- To date, when ORR has reviewed Network Rail's allowed return, it has calculated a cost of capital that was designed to reflect all of the risks that Network Rail is exposed to as a business. This assumes that Network Rail is a conventionally financed company. This approach is similar to that adopted by regulators of most other UK utilities
- As Network Rail's ultimate parent company is a Company Limited by Guarantee and Network Rail is financed solely by debt, which benefits from the Financial Indemnity Mechanism ("FIM") from Government, its actual cost of finance is substantially lower than its cost of capital. This means that surplus cash is generated, which is currently re-invested in the network via the Ring Fenced Fund
- In the 2008 Periodic Review ("PR 08"), ORR also aimed to regulate Network Rail in a way that would facilitate the introduction of unsupported debt (i.e. issuance of non indemnified debt ("NID")). PR 08 saw the establishment of the Ring Fenced Fund
- For the current Periodic Review ("PR 13"), ORR has been prompted to reconsider its approach to the cost of capital in the light of changes since PR 08. These changes include:
  - A worse economic climate that may affect affordability for Governments of the PR 08 approach to cost of capital, an issue that the ORR's duties require it to consider
  - Current and prospective industry reforms, including Network Rail devolution, concessions and cost/revenue sharing mechanisms. ORR needs to consider whether these changes should take place ahead of any introduction of risk capital

Background – ORR Options

ORR Options

- As a consequence of the foregoing, ORR has analysed five principal options:
  - IIP – Network Rail's proposal which uses the PR 08 assumptions on cost of capital but does not include the issuance of any NID
  - Gradualist – Also uses Network Rail's base approach, but assumes a gradual increase in NID
  - Rebate – Uses the gradualist approach, but any surplus achieved is remitted back to Government rather than be used for additional enhancements through the Ring Fenced Fund
  - Cost of Debt – Allowed return is based on Network Rail's efficient interest costs (including FIM fee) with no Ring Fenced Fund and only FIM debt is issued during CP 5
  - Balance sheet buffer – Network Rail's balance sheet is used as the constraint with a target gearing ratio of 70%. Again, no NID is issued during CP 5
- Following further discussions, the above options have been refined to two:
  - Conventional cost of capital – Essentially continuing the PR 08 approach, with surplus being treated as a Ring Fenced Fund for enhancements and including options for the gradual introduction of NID
  - Adjusted WACC – Cost of capital calculated on a conventional basis, but with the surplus (i.e. the 'equity' return element) immediately deducted from the income requirement prior to being paid to Network Rail

Background – Evaluation Criteria

Evaluation Criteria

- ORR has assessed the effect of these options on a number of criteria:
  - Incentives, now and in the longer term
  - Transparency
  - Flexibility to change Network Rail's financing structure
  - Long term financial sustainability
  - Affordability
  - Consistency[1]
- ORR is also required to consider its duties, including:
  - Having regard to funds available to the Secretary of State and Scottish Ministers
  - Promoting efficiency and economy
  - Securing value for money
  - Enabling railway businesses to plan for the future with a reasonable degree of assurance
- RBC has been asked to provide its views on the potential impact of the proposals in terms of flexibility to change Network Rail's financing structure in the future

[1] This criteria was added following responses from the December Consultation

3. Market Issues

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Market Issues

- RBC's Paper 1, issued on 31st March 2011 discussed the proposals for raising NID and identified a number of the key issues which we believed potential investors would focus on, such as:
  - Structure of NID, including covenants and relationship to FIM debt
  - Size and timing of any issuance programme
  - Network Rail business, including operational and financial risks and performance
  - UK rail industry structure, regulation and government involvement
  - Financial market conditions and how the Network Rail investment opportunity compares to other utilities or similar credits
- We noted that in respect of rail regulation, we considered that investors saw the system as 'proven' and 'consistent with other utilities'
- The current proposal to consider an 'Adjusted WACC' approach to Network Rail's cost of capital would obviously mark a departure both from the approach adopted in PR 08 and most other utilities (as discussed in the OXERA paper). However, this may be viewed in the context of the UK utilities sector that comprises a range of industry and corporate structures and where regulation has also evolved over time
- Obviously, until such time as any NID or equity issuance is proposed, the regulatory approach to cost of capital is largely academic for investors, as they are reliant on the FIM
- At the point when Network Rail does approach the market for NID or equity, investors will clearly be interested in how Network Rail's allowed return is to be calculated, but this will be alongside the variety of other factors identified above. We would expect investors' prime interest to be on the present and future. They will be interested in the past to the extent that it assists in analysing and pricing risk on the new debt or equity instruments
  - Network Rail's performance, both financially/operationally
  - How the regulatory regime has worked
- All other things being equal, a consistent regulatory approach (both over time and in relation to other UK utilities) will be easier for investors to assess

Market Issues (cont'd)

- To the extent that there have been changes in previous Control Periods, whether from, for example, the regulatory approach to allowed return, the form of Government support or industry structure, then it will be important that ORR, Department for Transport, Transport Scotland and Network Rail are able to communicate effectively and consistently to the market the rationale for the regulatory approach:
  - The obvious concern of investors is that Network Rail is vulnerable to political pressures given the dependence on subsidy and that the Adjusted WACC approach is an example of this
  - Even if the change in approach is presented as a temporary reaction to specific circumstances of a particular periodic review, investors may be inclined to seek more explicit assurances regarding any future revision to regulatory approach
- It will also be important that Network Rail is able to show historic performance on a consistent basis – i.e. headline metrics normalised to remove distortions that arise solely from changes to regulatory approach
- Consideration will also need to be given to how Rating Agencies are brought into this process. Key issues are likely to include:
  - Appropriate credit metrics to measure Network Rail's performance, given that the Adjusted WACC approach in the relevant CP will result in lower headline interest cover ratios and that the risk buffer has been set at an appropriate level for Network Rail to manage performance within its financing structure
  - Confirmation that they understand the rationale of any changes in regulatory approach and that such changes do not adversely affect their overall view of the regulatory principles such as duty to consider financeability etc

4. Conclusions

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Conclusions

- We understand that ORR's thinking on cost of capital is now focussed on two options, namely maintaining the PR 08 approach or adopting an Adjusted WACC approach
- We do not believe the PR 08 approach raises any new issues from the perspective of the flexibility to change Network Rail's financing structure
- To the extent that no issuance of NID or equity is envisaged in CP 5, then either approach to cost of capital is only of academic interest to investors, as their only concern will be in the FIM
- If ORR were to adopt an Adjusted WACC approach for PR 13, then a number of matters require further consideration:
  - Strategy for communicating with the market on the details and rationale of the Adjusted WACC approach and presentation of historic performance
  - Approach to Rating Agencies and establishment of credit metrics
- When investors are presented with an opportunity to invest in Network Rail, the past performance of the company and the regulatory approach will be just one of a number of factors to be considered
- It would therefore seem likely that if there is a negative impact on issuing NID in the future as a result of a change to ORR's approach it is unlikely to be material, especially if ORR are able to effectively communicate the rationale for the Adjusted WACC approach to the market