SETTING THE RULES FOR RING-FENCED FUND IN CP4

DISCUSSION NOTE

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CONTENTS

1. INTRODUCTION

1.1. Purpose and structure of paper

This short discussion note has been prepared to support the ORR's thinking in the development of rules for the operation of the ring-fence fund. As a discussion note, it does not provide firm recommendations or seek to consider wider issues associated with, for example, communication with Network Rail and its investors.

We note that the options and issues discussed in the paper may not be where the ORR ends up either in the publication of its interim or final determinations.

Section 2 sets out the position at the beginning of CP4. Section 3 then provides our initial thoughts on the rules for the ring-fenced fund. Section 4 discusses other key implementation issues.

1.2. Context

The context is as follows. It is proposed:

- To restrict the FIM such that, from CP4, it is only available to refinance existing debt. All incremental debt will be unsupported.
- To provide NR with revenues incorporating a WACC-based rate of return.
- To charge NR a guarantee fee for the FIM that reflects the credit enhancement resulting from its availability.
- To allow NR a risk buffer, over which it will have full discretion in-year, to enable it to manage normal fluctuations in cash flow, and
- To require the additional surplus to be channelled into a virtual 'ring fenced investment fund' (RFF) to deliver HLOS outputs. These funds would be available in extremis to service debt by deferring the 'bottom part' of the HLOS.

2. STARTING POSITION

At the time the CP4 determination is made (i.e. before commencement of the first year of CP4) the starting position will be as follows:

- ORR will have set the allowed revenues for CP4 based on its judgments about the 'efficient' opex, maintenance and renewals (hereafter repex) expenditures and HLOS capex that an efficient NR would incur over the period and the appropriate WACC and depreciation profile.
- The amount of required expenditure on HLOS investments (both the 'top' and 'bottom' parts) will be set such that an efficient NR can maintain an appropriate,

solid investment grade rating. This will require that NR, if operating efficiently is able to show that the projected values of key cash flow financial ratios are consistent with what is required by the debt markets (ratings agencies) for a credit with that rating - absent any implicit support from the FIM (the 'halo' effect). The financeable amount of HLOS expenditure over the period will be determined in large measure by the allowed WACC and achievable opex and capex efficiency gains.

- The key financial ratios will be Funds from Operations (FFO)/net interest (or Adjusted Interest Cover) and net debt/RCV. The precise definition of ratios will need to be considered in the context of the ratios used by the different ratings agencies differs and the expectation is that NR would track ratio values using the definitions used by the two major agencies. Here the term FFO means cash from operations less repex expenditure (as defined above).

- The starting position prior to commencement of CP4 will be financial projections of NR earnings, cash flow and balance sheet using the regulatory assumptions. From these it is simple to derive projected ratio values for key financial ratios (eg FFO/net interest, net debt/RCV) for each year of CP4 assuming the mandatory HLOS programme ('top' and 'bottom' parts) is implemented in full. These ratio values are referred to here as the 'projected ratio values'.

- The 'projected ratio values' will be set to allow 'headroom' between the projected ratio values and the ratio values which NR must maintain if it is to retain an investment grade rating. (These will be minimum ratio values for FFO/net interest and maximum values for net debt/RCV). These ratio values are referred to here as 'minimum ratio values'. Were these minimum ratio values to be breached then NR's rating (or ability to finance itself efficiently) would be expected to come under strong pressure (rating watch in the absence of a 'halo' effect).

- The amount of headroom between the 'projected ratio values' and the 'minimum ratio values' will determine the amount of the risk buffer available to NR to absorb unplanned expenditure during CP4[1]. Additional unplanned capital expenditure will have to be financed with extra borrowing which will increase net interest and net debt. Unplanned additional repex will reduce FFO. Either way the 'actual financial ratios' (i.e. the ratios that result after unplanned expenditure) will diverge from the 'projected ratio values'. When they equal the 'minimum ratio values' then the risk buffer is fully used up.

- Provided that ORR gets its determinations correct, if the actual performance of NR over CP4 accords with the regulatory assumptions then cash flow from operations should be sufficient to maintain 'projected financial ratios' (FFO/interest,

[1] Or put the other way would be expected to be the headroom in cash flows that result from the 'risk buffer' referred to in ORR's published material.

debt/RCV) comfortably above 'minimum ratio values'. NR will continue to have unused debt capacity to finance its way through cost shocks while retaining its rating.

3. RULES FOR THE RING FENCED FUND

3.1. Introduction

The aim of the RFF mechanism is:

(i) to maximise the size of the planned HLOS investment programme over CP4 (assuming the regulatory assumptions are fully achieved);

(ii) to retain financial flexibility for NR in the event that unplanned increases in costs during CP4 exceed the amounts that can be absorbed by the 'headroom' referred to above.

In reality the RFF is not a fund at all. It is a mechanism for deferring part of the HLOS investment portfolio to generate more net cash flow in the event that unplanned expenditure is greater than can be absorbed by the risk buffers.

The note sets out two approaches to setting rules for the RFF:

- Option (i) is a prescribed rules-based mechanism.
- Option (ii) is a less structured mechanism for triggering an intra-period review in specified circumstances. Both options are described below and a short analysis of the pros and cons provided.

The rules for the RFF mechanism need to:

- Identify how investments will be deferred.
- Specify a trigger for the mechanism (which starts deferrals).
- Specify the circumstances in which the mechanism will (and will not) be applied e.g. whether it applies to 'efficient' and 'inefficient' overspend).
- Specify the consequences of the mechanism being triggered (e.g. consequences for NR and management and future price reviews).
- Specify the 'recovery' mechanism i.e. if part of the HLOS is deferred, when and how is the deferred expenditure re-instated?
- Clarify how the RFF and price re-openers interact if there is either 'efficient' or 'inefficient' overspend within the period.

3.2. Identify the investments that will be deferred

The first stage is to designate within the total HLOS expenditures for E&W and Scotland, separately, that <u>proportion of expenditure</u> or <u>specific programmes</u> (see discussion below) that are designated as in the 'top' and 'bottom' parts of the HLOS. Expenditure / Programmes within the 'top' part of the HLOS are mandatory. Expenditure / Programmes in the 'bottom' part of the HLOS for E&W and Scotland are mandatory except that part of them may be deferred in accordance with the rules of the RFF mechanism (as below).

A key decision concerns the proportion of the total HLOS designated as in the 'bottom' part of the HLOS because this determines who bears the risk in the event of major unplanned expenditure by NR. Essentially the position is as in Table 1 below, namely, that the greater the proportion of the total HLOS in the 'bottom' part, the greater the risk of deferral of HLOS enhancements and the lower the risks to NR's creditworthiness.

Table 1

'Bottom' part of HLOS (or RFF) as % of total	Risk of HLOS deferral	Risk of NR de-rating
The smaller the % of the HLOS in the RFF	Lowest risk of HLOS deferral	Greatest risk of NR de-rating
The larger the % of the HLOS in the RFF	Greatest risk of HLOS deferral	Lowest risk of NR de-rating

There are two options for making this work. The **first approach** would involve DfT/TS specifying in advance (or 'ex ante') the 'bottom' part of the HLOS as:

- A series of discrete enhancement programmes, each of which involves expenditure in each year that is only a relatively small proportion of the total expenditures in the 'bottom' part of the HLOS in that year. This is to enable NR to defer the minimum number of enhancement programmes when the RFF mechanism is triggered.
- A series of discrete work packages some of which can be undertaken over relatively short periods e.g. 1, 2 and 3 years. This is necessary if flexibility is to be retained to defer, and subsequently restore, enhancement programmes relatively quickly as the financial prospects of NR evolve. (If all programmes were, say, 5 years then, if all of the 'bottom' part of the HLOS was committed early in CP4 it would be very difficult to retain flexibility to defer expenditure if there were major overspends later in CP4).
- Department of Transport ('DfT')/ Transport for Scotland ('TS') will also need to indicate relative priority of the enhancement programmes so that, if NR does defer part of the HLOS, it defers so far as possible those programmes designated by DfT and TS as lowest priority.

The **second approach** would be for DfT / TS to define the projects in the bottom part of the HLOS at the point that NR gives notice that the RFF mechanism is to be triggered (and elements of the HLOS deferred.) The advantage of this approach is that DfT would not be obliged to specify projects in advance in detail – which may not be particularly easy.

However, the risk is that HLOS projects with a higher priority may be deferred if expenditure on lower priority projects (from DfT's perspective) is already committed in whole or in part.

3.3. Options for RFF triggers and re-openers

In the starting position (described above) NR will have 'headroom' and any overspend (whether efficient or inefficient) will initially be absorbed by NR through additional net borrowing. This will 'use up' its risk buffer and erode the 'projected ratio values'. If overspend exceeds that can be absorbed by the risk buffers, the point may be reached where, if the whole of the HLOS were undertaken, the actual financial ratio values fall to, or below, the 'minimum ratio values' in which case the creditworthiness of NR would come under pressure.

There will need to be a rule specifying the circumstances in which NR may defer part of the 'bottom' part of the HLOS. In what follows, we present one option and a number of potential variants. There are clearly other options.

3.3.1. A possible approach

The RFF trigger

In this approach, the 'RFF trigger' would be when NR becomes aware that its actual financial ratios over CP4, if the whole of the HLOS is undertaken, will breach defined **'threshold ratio values'**.

The 'threshold ratio values' would be set by ORR at the time that the CP4 determination is made in the knowledge of the 'projected ratio values' (as defined above) and the 'minimum ratio values' (set by markets/ratings agencies at the time).

In principle, the threshold ratio values could be set equal to the 'minimum ratio values', the 'projected ratio values' or somewhere 'in between'. If they were set equal to the minimum ratio values then this would place greatest risk on NR's creditworthiness (because HLOS deferral could not start until ratios were projected to fall to minimum values consistent with maintenance of its rating). If they were set equal to the 'projected ratio values' then this would place greatest risk on DfT (because HLOS deferrals could start as soon as ratios fell below the levels projected with no overspend). The values selected for the ratios will determine the likelihood that the RFF mechanism will be triggered.

Consequence of RFF trigger

NR might be required by the licence to give notice to ORR:

- That, if the entire HLOS is implemented, actual financial ratios are expected to breach the 'threshold ratio values' giving reasons for how this has come about and indicating whether the overspend in its view is 'efficient' or 'inefficient' overspend and giving reasons (see below).

- That it intends to defer some of the 'bottom' part of the HLOS stating which programmes it proposes to defer giving reasons and demonstrating that the actions are in accordance with the RFF rules set out in a schedule to the licence.
- Stating what actions it has taken, and is taking, to deal with unplanned overspend and any claim to log-up efficient overspend.
- Providing NR's estimates of the actual ratio values that will result after deferral of part of the HLOS and remedial actions to deal with unplanned overspend.
- Indicating when, on current indications, the deferred parts of the HLOS are likely to be re-instated.

If DfT/TS had specified 'ex ante' the parts of the HLOS that could be deferred then NR would act in accordance with the agreement. If this has not been specified ex ante, DfT/TS would review NR's proposed deferrals and decide to approve or amend their proposals – in the light of their priorities.

NR might be required to give notice in respect of E&W and Scotland, separately. The allocation of deferrals between E&W and Scotland would need to be decided – see Section 4.2 below.

Intra-period price reopener

If NR judges that, even after deferral of RFF projects its ratios would breach the pre-defined 'minimum ratio values', an intra-period price re-opener would be triggered[2].

(Note that if the % of HLOS projects in the RFF is low overspends could result in an intra-period price re-opener immediately. This is also more likely if the threshold ratios are defined to be the same as the minimum ratios.)

NR may incur overspend for reasons that may be 'efficient' or 'inefficient'.

Efficient overspend may come about because of an unplanned increase in required repex or capex e.g. because of a change in safety regime or other regulatory standards, or for other reasons beyond NR's control. There is already a mechanism for identifying efficient overspend and a process of logging-up with these costs taken account of in the next price review. However, within the control period, these costs must be financed and they would be expected to use up the risk buffer and erode financial ratios to the threshold values first; and then result in deferrals in HLOS projects before the re-opener is triggered[3].

Inefficient overspend is defined here to be all overspend that is not deemed by ORR to be efficient overspend. This too must be financed in CP4 but there will be no adjustment to prices in CP5 for 'inefficient' overspend incurred in CP4. As now, we see NR giving notice

[2] Although note also the discussion in relation re-opener provisions for Scotland in Section 4.2

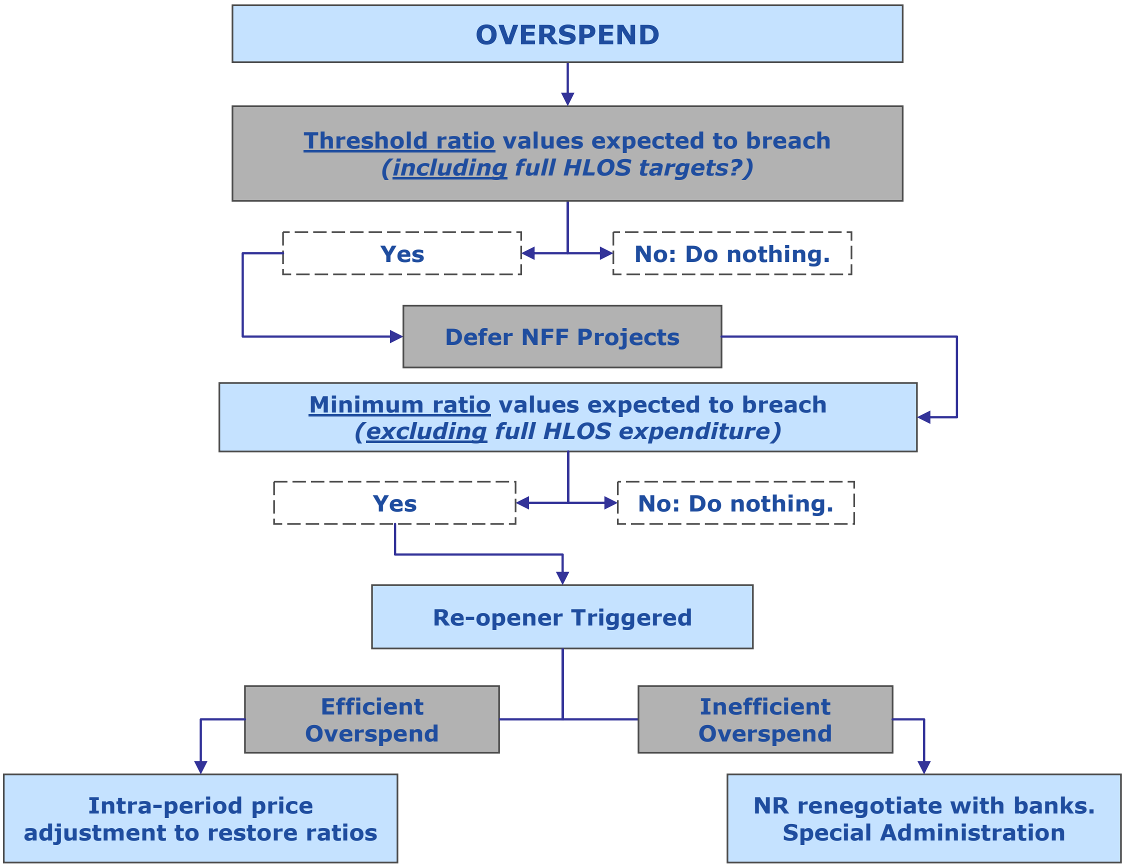
[3] We think that this has better incentive properties than the alternatives – but we recognise that it may or may not be appropriate.

to ORR that it is has incurred 'efficient' overspend and ORR will determine whether or not it is efficient and should be logged-up. Any overspend not deemed to be efficient by ORR is inefficient overspend.

As set out in Table 2 the ORR's presumptions in relation to the outcome of the price re-opener would be as follows:

- If the overspend is inefficient, when the entire 'bottom' part of the HLOS has been deferred NR would be expected to renegotiate the repayment schedule of its debt with its lenders and failing an accommodation (*in extremis*), the provisions of Special Administration would apply.
- If the overspend is efficient, an intra-period price re-opener might result in ORR adjusting prices to restore threshold ratio values. Subject to discussion with DfT/TS it might also be possible to restore deferred projects.

Figure 1: Possible process operation of RFF



3.3.2. Variants

Possible variants of the above approach that ORR may wish to consider include:

- Variant (i): To combine the RFF deferral notification and the re-opener stages outlined in 3.2.1 above. In this case NR would still be required to provide notice to ORR that it expects unplanned expenditure (whether efficient or inefficient) to cause it to breach threshold ratio values. However, in the event that the mechanism was triggered, ORR would go straight to an intra-period price control review (i.e. missing out the separate RFF deferral stage). Based on its review ORR would still determine: (i) whether the overspend was judged by it to be 'efficient' or inefficient' (as defined earlier); (ii) whether there should be an adjustment to allowed revenues. But once NR had notified ORR that it was likely to breach threshold values it would be free to defer projects as envisaged above at its discretion.
- Variant (ii): In principle, it might be possible to reduce the flexibility that NR has to defer projects. For example, the right to deferral of RFF projects could be subject to ORR approval. However, greater flexibility for ORR goes hand-in-hand with greater uncertainty for NR and lenders to NR. In order to minimise this it would be essential that ORR provides clear guidance at the outset of the control period as to how it might be expected to respond to a request to defer projects. (We would recommend against this option since it significantly reduces the likelihood that banks and rating agencies would give credit for the flexibility that the mechanism is intended to provide.)
- Variant (iii): In principle it would also be possible to reduce the extent of prescription further by removing any agreed 'ex ante' threshold financial ratios. In this case, the trigger would need to be defined with reference to NR's credit rating or a judgement by NR that it was likely to be unable to finance itself.
    - The credit rating trigger could be either (a) a defined change in the credit rating (e.g. a reduction by a notch); or (b) a defined level (e.g. BBB) – which is expected to pose problems for NR's financing. The difficulty with both of these approaches is the 'halo' effect of the government guarantee – which means that it is possible that the credit rating might be held up by the perceived government support even when financial ratios become very stretched[4].

[4] One further alternative would be for the trigger to be based on notice given by NR to the effect that it is unable to finance itself. However, given the possibility that NR could finance itself even at sub-investment grade ratings, the RFF or price re-opener might not be triggered until NR was already close to special administration. There is also a 'value for money' concern associated with raising debt at sub-investment grade ratings.

- Leaving the trigger to be at the sole discretion of NR, in our view, places risks on DfT / TS in particular that they would only be made aware of significant problems at the point where options for tackling them were significantly narrowed.

4. OTHER ISSUES

4.1. Consequences of HLOS deferral

If NR is to subject to meaningful pressure to avoid deferring part of the HLOS then there needs to be adverse consequences for the company and the management team should there be any deferral of the HLOS because of inefficient overspend. Possible adverse consequences include:

- Official notice by ORR to NR governors that the company has failed to comply with its licence conditions and requirement for them to explain what they are doing to address the shortcomings, with reputational consequences (though whether this would have a major impact is debatable).
- Official notice that, as a result of the breach, ORR will take account of poor performance when setting the next price control review (although whether this works when there are no shareholders at risk is debatable).
- An increase in the FIM fee reflecting the increased risk incurred by the public purse.
- Provisions in the MIP which directly link remuneration to whether there has been any deferral of the HLOS. (This would have to be agreed with NR as ORR does not have direct locus over the terms of the MIP).

Of these options the one with the strongest 'teeth' is the last one.

4.2. Allocation of HLOS Deferrals between England and Wales and Scotland

The 'bottom' part of the HLOS will be set separately for E&W and Scotland. If the whole of the risk buffer were used up by NR then there needs to be a rule about whether deferrals of HLOS enhancements fall in E&W or in Scotland. The starting position is that by far the largest amount of investment will be in E&W.

TS may be concerned that:

- Overspend in E&W will cause disproportionate deferral of Scottish HLOS investments; and / or
- About affordability of major overspends – because they are small compared with overall NR balance sheet buffer – they do not trigger any deferrals.

An equitable rule is needed. The simplest rule is that, when the 'threshold ratio values' for NR are breached that deferrals of HLOS will fall in E&W if the cause of the overspend is in E&W and in Scotland if the cause of the overspend is in Scotland. NR should be required to allocate HLOS deferrals between E&W and Scotland in accordance with the agreed allocation rule and to explain how they have done this (and provide supporting evidence).

The only approach to deal with the second issue would be to introduce a second condition for a re-opener that related specifically to a % overspend in Scotland.

4.3. Reporting Requirements

There would be no obligation on NR to report its financial position (including financial ratios) to ORR unless and until the notice provisions referred to above were triggered[5].

If the notice provisions were triggered there should be pre-agreed reporting requirements on NR. These reporting requirements will oblige them to provide ex ante and ex post financial information. The ex ante information will include financial projections for the whole of CP4 setting out, inter alia, the projected financial ratios if the entire HLOS is implemented and the projected financial ratios after proposed HLOS deferrals have taken place. The ex post reporting will include actual financial ratios and a comparison with expected values in previous years.

Once the provisions are triggered NR will be obliged to provide this information annually to ORR for so long as there is an outstanding deferral of HLOS programmes.

4.4. Licence Conditions

- The delivery of the whole of the HLOS would be a regulatory commitment enforceable under the licence.
- The licence would make implementation of the 'bottom' part of the HLOS subject to the provisions of the RFF mechanism.
- There would be notice provisions set out in the licence along the lines noted above.
- The licence would set out the reporting obligations noted above and the circumstances in which they would apply.
- The price reopener provisions in the licence would be amended to operate in the way envisaged above.

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[5] However, if ORR deemed it necessary they could require NR to make a statement each year to the effect that the notice provisions were not currently or expected to be triggered.