Carl Hetherington
Head of Regulatory Finance
Telephone 020 7282 2110
Fax 020 7282 2041
E-mail carl.hetherington@orr.gsi.gov.uk

OFFICE OF RAIL REGULATION

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Dear consultee

Periodic Review 2008: Financial issues update and further consultation

1. The 2008 periodic review (PR08) will determine Network Rail's regulated outputs, revenue requirement and access charges for control period 4, which will run from 1 April 2009 to 31 March 2014. We intend to publish our final determinations on the overall revenue requirement and outputs in October 2008, with final levels of individual access charges and associated price lists approved by us in December 2008 following calculation by Network Rail.

2. Reviewing Network Rail's financial framework is a core part of PR08. Our conclusions on the financial framework need to be determined together with our decisions on the other aspects of the regulatory determination, such as the incentive framework.

3. The financial framework comprises three main elements: the allowed return; the definition and treatment of the regulatory asset base (RAB), including amortisation; and the way in which risks and uncertainties are treated. Other related issues, such as corporation tax, are also part of our review of the financial framework.

4. Since we started PR08 in August 2005, we have consulted on a range of financial issues. Attached to this letter is a general update and further consultation on progress with development of the financial framework, which builds on our previous consultations and other documents. The update covers the calculation of the allowed return and financeability; the roll-forward of the RAB; corporation tax; the balance between network grants and track access charges; and other financial issues.

5. We welcome comments on any issue raised in this update and further consultation and will take them into account in making our final decisions on the financial framework principles in our strategic business plan assessment and update on the framework for setting access charges' document in February 2008.

6. It would be helpful if your response is sent in electronic format by 16 November 2007. In addition, you should indicate clearly if you wish all or part of your response to remain confidential to the Office of Rail Regulation (ORR). Otherwise, we will make it available in our library, publish it on our website and we may quote from it. Where you make a response in confidence, you should attach a summary, excluding the confidential information, which can be treated as above. We may also publish the names of respondents in future documents or on our website, unless a respondent indicates that they wish their name to be withheld.

7. Copies of this document can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely

Carl Hetherington

Periodic Review 2008: Financial issues update and further consultation

Introduction

1. Reviewing Network Rail's financial framework is a core part of the 2008 periodic review (PR08). Our conclusions on the financial framework need to be determined together with our decisions on the other aspects of the regulatory determination, such as the incentive framework.

2. The financial framework comprises three main elements: the allowed return; the definition and treatment of the regulatory asset base (RAB), including amortisation; and the way in which risks and uncertainties are treated. Other related issues, such as corporation tax, are also part of our review of the financial framework.

3. Since we started PR08 in August 2005, we have consulted on a range of financial issues. These include: an initial consultation on the financial framework (in December 2005); our overall incentive framework, covering the allowed return (in July 2006); our approach to amortisation of the RAB (in September 2006); and the treatment of risk and uncertainty (also in September 2006). Following these consultations[1] we set out our decisions on the approach to establishing Network Rail's allowed rate of return; supported Network Rail's proposal to raise debt without a government guarantee; and confirmed the principles involved in determining the amortisation allowance in our February 2007 advice to ministers and framework for setting access charges document (February 2007 advice to ministers document)[2].

4. This document provides an update and further consultation on the development of the financial framework. It covers issues concerning:

(a) the allowed return and financeability;

(b) calculation of the opening control period 4 (CP4) RAB and how the RAB will be rolled forward during CP4;

(c) our approach to corporation tax;

(d) the balance between network grant and track access charges in CP4; and

(e) other financial issues (pensions, the treatment of inflation and re-openers).

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1 All of our PR08 consultations, including non-confidential responses, and other documents are available on the PR08 section of our website at http://www.rail-reg.gov.uk/server/show/nav.180.

2 *Periodic review 2008: Advice to Ministers and framework for setting access charges*, Office of Rail Regulation, February 2007. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/316.pdf.

5. Annex A contains the timetable for the remainder of PR08.

Allowed return and financeability

Introduction

6. This section describes the further work our consultants have undertaken in developing a view of the range for Network Rail's allowed return[3] and the approach we intend to use to ensure that our final determination allows an efficient Network Rail to finance its activities.

Background

7. In our February 2007 advice to ministers document we confirmed that we would be providing Network Rail with a risk-adjusted cost of capital. Although we had not at that time undertaken detailed work on the level of the cost of capital, for the purpose of that document, we set out a range for the real vanilla[4] weighted average cost of capital (WACC) of 4.0% to 4.7%.

8. Providing Network Rail with a risk-adjusted cost of capital will mean that the company, on an ex-ante basis, will receive an allowed return in excess of its financing costs. We said in our February 2007 advice to ministers document that the allowed return will cover the following components:

(a) financing costs (including a fee to government for the benefit Network Rail derives from lower interest costs resulting from the financial indemnity mechanism);

(b) a risk buffer to enable Network Rail to accommodate reasonable cost and revenue shocks; and

(c) a ring-fenced investment fund. This will be the residual amount once the financing costs and risk buffer have been established.

9. We will be establishing appropriate rules for allocating money between these components during the course of the year and will set these out in our strategic business plan assessment and update on the framework for setting access charges' document in February 2008 (February 2008 strategic business plan assessment document).

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[3] We apply the allowed return to the regulatory asset base as part of the calculation of the revenue requirement.

[4] A vanilla return is a pre-tax cost of debt and a post-tax cost of equity (i.e. it excludes any tax adjustment to the cost of debt or cost of equity).

Allowed return

10. We commissioned Cambridge Economic Policy Associates Ltd (CEPA) to give their view of an appropriate range for Network Rail's risk-adjusted cost of capital. Their report[5] involved determining estimates of the cost of debt, cost of equity and gearing that an efficient, conventionally financed business with comparable assets and risks as Network Rail would face. This approach reflects our conclusions on this aspect of the high-level financial framework set out in our February 2007 advice to ministers document and does not imply any change in Network Rail's corporate or financial structure. The approach is also consistent with how other regulators determine the allowed return for utilities. For example, the calculation is unaffected by a company's actual capital structure.

11. For the cost of debt, CEPA considered regulatory precedent and market evidence looking at spot rates, longer-term averages and the potential for mean reversion. They also considered how an efficiently financed Network Rail might finance itself in terms of debt maturities, the mix of index-linked and nominal debt, and hedging. They then crosschecked the results against a forecast of Network Rail's cost of debt.

12. For the cost of equity, CEPA focussed on the overall return on equity, reflecting their concerns over the use of the capital asset pricing model. In particular, they considered:

(a) evidence of the returns actually required by equity investors in a range of market acquisitions of regulated utility businesses;

(b) recent evidence on other similar regulators' determinations of the cost of equity; and

(c) general market returns.

13. Their analysis of gearing considered recent regulatory precedent and market evidence of other similar regulated utilities.

14. In summary, CEPA's conclusions were that for a notional Network Rail (i.e. an efficient, conventionally financed business with comparable assets and risks as Network Rail):

(a) the real pre-tax cost of debt would lie in the range 2.7% - 3.25%;

(b) the real post-tax cost of equity would lie in the range 6.5% - 7.0%; and

(c) gearing would lie in the range 60% - 65%.

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[5] *Risk adjusted cost of capital for Network Rail*, a report by CEPA, June 2007. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/pr08-cepa-risk-jun07.pdf.

15. They have combined these estimates to give an estimated range for the real vanilla WACC of 4.1% - 4.7%.

16. The following table shows recent regulatory precedent.

Table 1: Recent regulatory decisions on the weighted average cost of capital

Regulator	Decisions	Cost of Debt	Cost of Equity	Gearing	WACC
Ofgem	GDPCR (2007)	3.55%	7.0%	62.5%	4.84%
CAA	Heathrow (2007)	3.00%	7.7%	60%	4.88%
CAA	Gatwick (2007)	3.00%	8.7%	60%	5.28%
Ofgem	TPCR (2006)	3.75%	7.0%	60%	5.05%
Ofwat	Water & sewerage (2004)	4.30%	7.7%	55%	5.83%
Ofgem	DPCR4 (2004)	4.10%	7.5%	57.5%	5.55%
CAA	Heathrow (2002)	3.675%	6.4%	25%	5.72%

Notes:

1. The table is sourced from CEPA.

2. The WACC is on a real vanilla basis.

3. GDPCR is an initial proposals document. The cost of equity number is the modelling assumption.

4. The CAA's 2007 Heathrow and Gatwick decisions are proposals to the Competition Commission.

5. Heathrow's 2002 cost of equity of 6.4% is consistent with the 7.75% pre-tax WACC, if the adjustments to the central values used by CAA, are assumed to relate wholly to the cost of equity. Detail of this calculation is set out in note 29 of CEPA's submission to the CAA, "Setting the Weighted Average Cost of Capital for BAA in Q5" (July 2006).

17. CEPA's range is lower than Ofgem's and Ofwat's most recent decisions on the cost of capital, and is also lower than the CAA's recent proposals to the Competition Commission for Heathrow and Gatwick for Q5. It is also interesting to note the general downward movement in the returns allowed by regulators since 2002, as shown in table 1.

18. CEPA's range reflects the evidence reviewed by them as part of their analysis, including an emphasis on market evidence of required returns to equity, and the relatively low spot and average costs of debt available across the yield curve, particularly for index-linked and long-dated maturities. The lower end of CEPA's range assumes that we introduce indexation for the cost of debt or that Network Rail has hedged a significant proportion of its future refinancing requirements at recent relatively low rates.

19. The cost of capital is one component of the regulatory determination and is dependent on the risk profile of the business. The appropriate cost of capital will therefore depend on how risks are allocated between the company, customers and funders. The greater the extent to which Network Rail is protected against risk, the lower the rate of return required to accommodate fluctuations in cash flow. We can therefore only take a final view on the cost of capital as part of the determination of the overall PR08 framework for Network Rail.

20. In addition to the external factors that determine the cost of capital, e.g. the risk free rate, the aspects of PR08 that affect Network Rail's risk profile that we will be considering in concluding on the allowed return include:

(a) the protections provided by re-opener provisions;

(b) treatment of non-controllable cost items;

(c) the treatment of capital expenditure (e.g. whether an adjustment is made for actual efficient expenditure being added to the RAB) and the extent to which it already contains contingency provisions;

(d) the treatment of input price inflation risk;

(e) the extent to which Network Rail is protected from cost overruns on large complex projects such as Thameslink;

(f) how challenging the efficiency assumptions are; and

(g) the incentives that we are putting in place.

21. In determining the allowed return, we will also take account of changes to market conditions since CEPA's report, to the extent that they have not already been allowed for in CEPA's analysis.

Indexing the cost of debt

22. In our September 2006 consultation on the treatment of risk and uncertainty,[6] we consulted on the possibility of indexing a part of the allowed return to a pre-determined benchmark[7], which received support from some respondents.[8] This could have the effect of reducing the level of interest rate risk facing Network Rail, and therefore enable us to take a less cautious approach to setting the allowed return. There has been general regulatory interest in this subject and so together

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[6] *Periodic review 2008: The treatment of risk and uncertainty*, Office of Rail Regulation, September 2006. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/pr08-risk-let-280906.pdf.

[7] For example, indexing against Government gilts.

[8] Responses can be accessed at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8512.

with Ofwat we jointly commissioned CEPA to explore the merits and practicalities of indexing elements of the allowed return to an appropriate benchmark.

23. The report is being finalised and we will be considering the findings before setting out our approach on this matter in our February 2008 strategic business plan assessment document.[9]

CP4 interest cost assumption

24. Paragraph 8 described the different components to which the allowed return will be allocated. In order that we can size the ring-fenced investment fund, we need to forecast Network Rail's interest costs based on a debt assumption. The three main options are to:

(a) use notional debt (i.e. reflecting an efficient gearing level as used to determine the risk-adjusted cost of capital);

(b) roll forward the access charges review 2003 (ACR2003) debt assumption; or

(c) use actual debt.

Notional debt

25. In the same way that we are using notional debt to determine Network Rail's cost of capital, we could also use it to determine the interest cost assumption. This has the advantage of being consistent with the cost of capital assumption.

ACR2003 debt assumption

26. We used Network Rail's actual debt at 1 April 2004, as the starting point for our control period 3 (CP3) debt assumption, for the modelling of interest costs. We could roll forward the CP3 debt assumption, adjusting for approved additional expenditure (but not for under/over spending) to arrive at an assumed level of debt at the start of CP4.

27. This approach ought to have strong incentive properties because Network Rail would gain extra surplus cash if its actual interest costs were lower than those assumed by us.

Actual debt

28. Using actual debt[10] at 1 April 2009 as the starting point for our debt assumption is also a possibility. Using actual debt has the following implications:

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9 CEPA's report on indexation will be published on our website.

10 In practice, this will be a forecast of the actual level of debt at 1 April 2009. Any adjustments necessary as a result of a variance between the forecast and actual levels of

(a) if Network Rail's actual debt is lower than an assumed efficient level (e.g. Network Rail outperformed our efficiency assumptions), then using actual debt to estimate interest costs will result in a relatively higher ring-fenced investment fund and ensures that, everything else being equal, the company would not be receiving more cash than it needs to withstand reasonable cost and revenue shocks. This is a significant factor given the importance we place on the company facing a hard budget constraint;[11] and

(b) if Network Rail's actual debt is higher than an assumed efficient level (i.e. the company was less efficient than we had assumed in CP3), then using actual debt to estimate interest costs would give a relatively lower ring-fenced investment fund[12] and the risk buffer, everything else being equal, would still ensure that the company was receiving enough cash to withstand reasonable cost and revenue shocks.

29. All of these options have some merit and differing incentive properties. On balance, due to the importance of Network Rail facing a hard budget constraint in CP4, our current preference would be to use actual debt when forecasting interest costs for the purpose of sizing the ring-fenced investment fund. However, before making our final decision on this issue, we will consider further the effect on incentives in CP3 and beyond, although we recognise that incentives are only effective if they are signalled in advance and we will be almost four years through CP3 by the time we conclude on this issue.

30. We will conclude on this issue in our February 2008 strategic business plan assessment document.

Financeability

31. We need to ensure that the decisions we take on the incentive and financial frameworks for PR08 (e.g. providing a risk-adjusted cost of capital) would allow an efficient Network Rail to finance its activities. Regulators have tended to satisfy themselves that companies could finance their activities by assessing whether their determinations would allow an efficient company to secure a comfortable investment grade credit rating. We will adopt this approach for CP4.

32. Our assessment will examine a number of qualitative factors such as Network Rail's business risk and any regulatory protections against such risk. We will also

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debt at 1 April 2009, would be made at the next periodic review to take effect in control period 5.

11 This means that the overall revenue requirement should not provide Network Rail with surplus cash that it does not need, as this would reduce the incentives on them to manage their business efficiently.

12 This is akin to what happens in shareholder owned businesses in that, everything else being equal, higher debt and interest costs would reduce the size of dividend payments (the ring-fenced investment fund could be thought of as being equivalent to a dividend).

model the effects of the determination on the level and trend of certain financial indicators. This will allow us to take an appropriate, in the round, view of Network Rail's ability to finance its activities.

33. We will consult with the credit rating agencies before deciding which financial indicators to use in the assessment, how they are defined and the levels that we deem appropriate to achieve a comfortable investment grade credit rating. Our initial view of the main financial indicators we will consider is:

(a) funds from operations (cash flow from operations – corporation tax)/net interest;

(b) adjusted interest cover (cash flow from operations – corporation tax – capital expenditure to maintain the network in steady state)/net interest;

(c) retained cash flow (cash flow from operations – net interest – corporation tax – dividends)/net debt; and

(d) net debt/RAB.

34. These financial indicators enable us to consider long-term solvency issues by assessing both 'balance sheet' type measures and measures that examine the in-year relationship between revenue and interest costs.

35. Given the importance that the credit rating agencies place on the adjusted interest cover ratio, we are likely to take it into account in our analysis. However, there are a number of issues over the definition of the ratio and how it would apply to Network Rail, which we will discuss with the credit rating agencies.

36. In considering Network Rail's financeability, especially given present market conditions, it will also be important to ensure that we have taken appropriate account of inflation. For example, Moody's, in assessing financeability, give credit for the lower up-front cash costs of index-linked debt.

RAB roll forward

Introduction

37. The RAB[13] is a key building block in our methodology for determining access charges as it forms the basis for calculating the level of allowed return and impacts on the allowance for amortisation within Network Rail's revenue requirement.

38. This section describes our approach to the roll forward of the RAB in CP3 and CP4.

[13] Our calculation of the regulatory value of Network Rail's assets.

RAB roll forward in CP3

High-level principles

39. In ACR2003, we established a set of high-level principles for valuing the RAB.[14] These principles are:

(a) transparency: we will publish our assumptions and calculations in full. Network Rail's current and future lenders will have a clear and transparent basis on which to value the company. Looking ahead to CP4, this should assist Network Rail if it raises additional debt without a government guarantee;

(b) consistency: our methodology must be consistent with the policy statements made previously. This is because predictability and consistency over time in our approach serves to improve confidence in the regulatory regime and will enhance Network Rail's ability to finance its business in future; and

(c) simplicity: we will strive, where possible, to ensure that the calculation of the RAB remains as straightforward as possible.

40. We intend to retain these principles for CP4.

ACR2003 methodology

41. The calculation of the RAB at 31 March 2009 is given by subtracting the total forecast amortisation for each of the five years between 2004 and 2009 (as stated in the ACR2003 final conclusions) from the opening RAB at 1 April 2004, adding the ACR2003 forecast renewals and forecast enhancements expenditure for each of the five years between 2004 and 2009 (as stated in the ACR2003 final conclusions), adjusting for any further expenditure/adjustments approved by us (e.g. the revenue deferral) and making an appropriate adjustment for inflation. These additions to the RAB are subject to the required outputs being delivered. This process is explained in more detail in our regulatory accounting guidelines published on 3 April 2007.[15]

42. In addition to the ACR2003 forecast enhancement and renewals expenditure and amortisation, the following categories of expenditure and income will also affect the value of the RAB at 31 March 2009:[16]

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[14] *Access Charges Review: Final conclusions*. Office of Rail Regulation, December 2003. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/184.pdf.

[15] *Regulatory Accounting Guidelines*. Office of Rail Regulation, April 2007. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/323.pdf.

[16] All of these items, with the exception of (c), will have capitalised financing costs included.

(a) variance on emerging cost enhancements: these are enhancements where we did not set a fixed price for the enhancement in ACR2003; instead we agreed to add actual expenditure to the RAB in the year concerned;

(b) enhancements not funded by ACR2003: these are new enhancements, that are approved by us by applying the criteria set out in our investment framework;[17]

(c) the amounts earned by Network Rail through the volume incentive and the asset stewardship incentive, which will be added to the RAB;

(d) the increase following our review of signalling renewals expenditure, which concluded in December 2005.[18] The RAB additions are subject to the delivery of the signalling renewals schemes;

(e) the effect of the difference between actual outturn 2003-04 renewals and enhancement expenditure and the assumption made for our ACR2003 final conclusions in December 2003;

(f) the effect of the revenue deferral that we approved following the ACR2003 final conclusions, whereby a proportion of government network grant payments to Network Rail in the first two years of CP3 was deferred, with a compensating RAB addition on 1 April 2009; and

(g) the effect of a minor error in the forecast for traction electricity income in 2004-05 and 2005-06 that was used to calculate charges in the ACR2003 final conclusions document.

Probity check of Network Rail's information

43. The audit of the 2007-08 and 2008-09 regulatory accounts will confirm that the boundary between renewals/enhancements and maintenance is the same as we used in ACR2003 and the capitalisation of overheads is on the same basis as in ACR2003.

44. The actual outturn figures for renewals and enhancements expenditure in 2008-09 will not be available until the publication of the 2008-09 regulatory accounts in July 2009. We therefore intend, where appropriate (e.g. in relation to emerging cost

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[17] The criteria are included in: *Policy framework for investments: Guidelines on implementation arrangements & processes,* Office of Rail Regulation, London, March 2006, available at http://www.rail-reg.gov.uk/upload/pdf/277.pdf; and *Policy framework for investments – update on implementation guidelines,* Office of Rail Regulation, London, March 2007, available at http://www.rail-reg.gov.uk/upload/pdf/invest-guide-let-020307.pdf.

[18] *Signalling Review: final conclusions of the medium term review*, Office of Rail Regulation, December 2005. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/269.pdf.

enhancements), to make an adjustment as part of the next access charges review, to the control period 5 (CP5) opening RAB at 1 April 2014. The adjustment (including where relevant the associated capitalised financing) will take account, where appropriate, of the difference between the final outturn figures for CP3 shown in the 2008-09 regulatory accounts and the forecast 2008-09 RAB additions used in our October 2008 final determinations document.

Outputs

45. As part of our on-going regulation of Network Rail, we will ensure that if it fails to deliver any required outputs in CP3, then it will not retain the associated financial benefit. We will do this by either making an appropriate deduction from the RAB or not funding the company for any deferred work that it will be doing in CP4.

RAB roll forward in CP4

Expenditure to be added to the RAB

46. As discussed above, generally, ex-ante forecast renewals and enhancement expenditure is added to the RAB in CP3 and adjustments are not made for actual efficiently incurred expenditure. This provides Network Rail with a strong incentive and correspondingly higher risk as it retains all the benefits of outperformance and bears the costs of underperformance. We considered that this policy provided an appropriate balance between risk and reward in CP3, in the wider context of the other financial protections for Network Rail in the regulatory framework. However, some other sectoral regulators in the UK adjust the RAB for actual efficient expenditure.[19] This adjustment can diminish the incentive to outperform but also reduces the risk faced by the company and, all other things being equal, reduces the required return.

47. As part of our overall work on incentives, the financial framework and the approach to risk and uncertainty, we are considering whether to change our approach to rolling forward the RAB and for CP4 adjust the RAB for actual efficient expenditure. This may give a more appropriate balance between incentives and risk in the context of the new incentive and financial frameworks for CP4, which will include providing Network Rail with a risk-adjusted cost capital.

Timing issues

48. Network Rail's capex incentives in CP3 vary slightly for each year of CP3, as the earlier in the control period they outperform our assumptions the lower their financing costs will be.

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[19] An example of this would be: if forecast capital expenditure was 100 in year five of the control period but actual expenditure was 90, then as part of rolling the RAB forward to the start of the next control period, 90 would be the addition to the RAB for that year.

49. The approach outlined above that adjusts the RAB for actual capital expenditure does not resolve this timing issue and can make it worse as it would mean, in simple terms,[20] that the reward for outperforming in year 1 of a control period is five year's amortisation and allowed return on that saving. If the company outperforms in year 5 they gain one year's amortisation and allowed return on that saving. In this situation, the company would make a greater reward from a saving in year 1 than in year 5, hence the incentives to make savings decline over the life of the control period.

50. As part of our overall work on incentives, the financial framework and the approach to risk and uncertainty, we are considering whether to equalise capex incentives, so that Network Rail has (as far as possible) the same capex incentive in each year of CP4.

51. One of the ways of equalising incentives is to introduce a smoothing mechanism that equalises the reward/penalty for an underspend/overspend for each of the five years of the review period. Some other regulators use such incentive smoothing mechanisms. We will consider the advantages and disadvantages of their mechanisms, other alternative approaches, and how each could apply to Network Rail in CP4.

52. In particular, we want to avoid using a mechanism that is overly complicated and reduces transparency, as ensuring that the incentive and financial frameworks are transparent and provide the right incentives for Network Rail, given its financial structure, is an important consideration for us. We will set out our proposal in our February 2008 strategic business plan assessment document, in the context of our decisions on the incentive and financial frameworks for CP4.

Non-capex additions to the RAB

53. We have previously added, or agreed to add, non-capex items to the RAB. These principally relate to three main types of issue: overspend incurred by Railtrack and Network Rail in the aftermath of the Hatfield accident; revenue deferral; and incentive payments.

54. The Hatfield related overspend is a historic issue. This overspend was included in the RAB as part of ACR2003 and is being amortised from 1 April 2004. This is not an issue that affects CP4 RAB additions. Similarly, the revenue re-profiling was a one-off adjustment reflecting an issue with government finances following ACR2003. Now that the government's funding available for the railways for the review period is clear and formalised under the statement of public financial resources available (SoFA), we do not expect this to be an issue in the future.

[20] Where the revenue settlement is based on forecast expenditure, we provide amortisation and an allowed return from the year of forecast expenditure, adjust the RAB at the next review for actual expenditure and assume that the saving is made at the start of the year.

55. In ACR2003, we stated that we would make additions to the RAB at the start of CP4 to reflect the company's performance in respect of the volume and asset stewardship incentives. We do not intend to add any incentive payments to the RAB in relation to incentive schemes that may be developed for CP4. If there are incentive payments for CP4, we can either adjust revenue in the year concerned, which would have budgetary implications for the governments or we could include the adjustment in an opex style memorandum account that adjusts revenue in the subsequent control period.

56. This opex style memorandum account would work by "logging up" the payment to the account during the control period. Monies could then be released from this account over an appropriate period of time. In normal circumstances, this would either be in the first year of the subsequent control period or spread across the control period. In exceptional circumstances, a longer period of time could be used. Both Ofgem and Ofwat employ these opex style memorandum accounts and we intend to implement this approach for CP4.

57. In CP3, with the exception of reactive maintenance that we discuss below, we largely used Network Rail's accounting policies as the basis for defining what can be added to the RAB as renewals and enhancements. This is a transparent and easy to understand approach and we intend to retain it for CP4.

58. Network Rail in the past used to account for certain reactive maintenance costs[21] as capital expenditure. The calculation of the revenue requirement reflected this treatment. Since 2002-03, Network Rail has accounted for these costs in its statutory accounts as an operating cost. In order to improve transparency we are now proposing to remunerate these reactive maintenance costs in the year concerned (i.e. for the purpose of calculating the revenue requirement, treat them in the same way as operating and other maintenance costs).

59. Everything else being equal, the increase in maintenance costs (and hence the revenue requirement) would largely be offset by a reduction in amortisation (and hence the revenue requirement), as we would expect the long-run steady state renewals to be lower by an equivalent amount. This means that a change in this policy should not have a material impact on the revenue requirement in CP4.

60. The Department for Transport (DfT) and Network Rail have proposed a specific approach for the treatment of enhancement expenditure on the Thameslink programme. This would involve a target cost estimate being added to the RAB in CP4, with an adjustment being made to the opening CP5 RAB in accordance with a pain/gain share mechanism. By adopting this approach we would effectively be ring-fencing that project, so that the normal rules for the roll forward of renewals and enhancement spend in CP4, would be replaced for that project by specific rules. We are continuing our discussions on this issue with DfT and Network Rail.

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[21] In 2006-07, reactive maintenance costs were £102m.

61. DfT or Transport Scotland may want to adopt a similar approach for other major projects. We will consider any proposals they make. Our main priority is to ensure that Network Rail has the right incentives to carry out major projects efficiently and is taking an appropriate amount of risk consistent with the proposed new financial framework.

Amortisation

62. We have already established the key principles we will use to derive the level of the amortisation charge. Amortisation in CP4 will be based on long-run steady state renewals, as we set out in September 2006.[22] The February 2007 advice to ministers document also clarified that we will be amortising the non-capex element of the RAB and said that the main issues to be addressed in determining the level of long-run steady state renewals were:

(a) the period of time that should be used as a proxy for the long-run period;

(b) the starting point for the cycle – i.e. should we take account of historical expenditure;

(c) the forecasts that we should use for Network Rail's renewals activity levels – an issue here is how reliable the long term forecasts are; and

(d) the efficiency assumptions we should use.

63. Network Rail's strategic business plan will contain the company's projections for renewals. We will review this projection in conjunction with our assessment of the scope for future efficiency improvement in order to determine a reasonable level of long-run steady-state renewals to use as the basis for the CP4 amortisation charge.

Corporation tax

64. This section describes our proposed approach to the treatment of Network Rail's corporation tax liabilities. Corporation tax is a normal business cost and as such is one of the building blocks of the revenue requirement.

65. Corporation tax can either be provided for, by including an uplift in the allowed return calculation (the so called "tax wedge" approach where a pre-tax cost of capital is provided) or by allowing a vanilla cost of capital and providing a specific allowance for our forecast of Network Rail's efficient corporation tax costs.

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[22] *Approach to the amortisation of Network Rail's regulatory asset base*, Office of Rail Regulation, September 2006. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/pr08-amortisation-let-290906.pdf.

66. At ACR2003, we determined Network Rail's allowed return on a pre-tax basis. The calculation was done at a high-level and one of the key factors involved was comparable pre-tax returns being allowed by other similar regulators.[23]

67. We are proposing to move to a specific approach to corporation tax in CP4. This is because:

(a) Network Rail is only forecasting to pay very small amounts of corporation tax during CP4 so providing for corporation tax through the allowed return would give Network Rail significantly more revenue, everything else being equal, than it needs to finance its activities. This would weaken the hard budget constraint that is an important part of the proposed new financial framework and hence the resulting incentives; and

(b) to improve consistency with other parts of the regulatory framework, where changes in the efficient level of costs are passed through to customers/funders at the next periodic review.

68. A specific approach to corporation tax can provide either an ex-ante allowance or an estimated allowance combined with a pass-through mechanism. Our normal approach to issues of this nature would be to provide an ex-ante allowance as that has better incentive properties. Given that, in our view, there are no specific issues that would need additional protection beyond the normal re-opener arrangements, we are proposing to provide an ex-ante allowance.

69. Using a specific approach will mean we need to forecast Network Rail's efficient corporation tax costs in CP4, which will also require us to determine a starting position at 1 April 2009 for the opening balances for corporation tax losses brought forward and capital allowances. We are proposing to base the starting position on our view of Network Rail's forecast corporation tax position at 1 April 2009.

Implications of a change of corporation tax policy

70. Allowing for corporation tax through a tax wedge approach does not necessarily align the corporation tax allowance with corporation tax payments in any one year or in any one control period. However, over time the cumulative allowances for corporation tax provided by a tax wedge in the cost of capital should, in simple terms, broadly equal corporation tax payments.

71. In Network Rail's case, it had large brought forward corporation tax losses at the start of CP3 and is forecasting to pay a very small amount of corporation tax in CP3. In effect, in CP3 Network Rail has probably been funded for corporation tax liabilities in future control periods and has used this money to pay down debt or invest in the network. By moving to an approach whereby Network Rail is paid for its expected

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[23] These returns would have included an allowance for tax.

corporation tax liabilities, it could be argued that the company will have been paid twice for some of its future corporation tax liabilities.

72. There are a number of ways of dealing with this issue:

(a) make no adjustment for any CP3 potential over-funding – this would be consistent with Ofgem's approach on a similar issue;

(b) make an adjustment for the over-funding in relation to the period from 1 April 2004 to 31 March 2009 but make no adjustment for earlier years, as it would be difficult to calculate what the adjustment should be. This could be implemented in three ways:

   (i) an adjustment to the RAB;

   (ii) an immediate revenue deduction; or

   (iii) hold the amount on account and only start funding Network Rail for corporation tax when this account has been exhausted by actual corporation tax payments.

73. There are a number of problems with making an adjustment including:

(a) any over-payment for corporation tax liabilities, even from 1 April 2004, is difficult to calculate with certainty;

(b) the tax wedge probably included in the allowed return for CP3 is not explicit, (although an estimate could be derived from comparisons with the cost of capital provided by other regulators); and

(c) an adjustment could be perceived as being a retrospective clawback by the regulator.

74. If we did make an adjustment, there could be an effect on Network Rail's cash flows in CP4 and it could result in a lower ring-fenced investment fund. Given our duty that we should not make it unduly difficult for Network Rail to finance its activities, if we adversely affect the company's cash flows in this way, it could also mean having to make an offsetting upwards financeability adjustment to its cash flows (i.e. provide Network with more cash).

75. We will set out our approach on this issue in the February 2008 strategic business plan assessment document.

The balance between network grant and track access charges in CP4

Introduction

76. Network Rail's income currently comes from a number of sources: access charges from passenger and freight train operating companies, other income (e.g. from property) and network grants paid by the governments to Network Rail. One of our tasks in PR08 is to determine the balance of Network Rail's income between access charges and network grants. This section sets out and explains our proposals on this issue.

Background

77. Between publication of the ACR2003 final conclusions[24] and the start of CP3, the rail regulator approved changes to the balance of Network Rail's income between network grants and track access charges. The balance was altered so that a higher share of funding would be paid in network grants than envisaged in the ACR2003 final conclusions. A reduction in the level of fixed track access charges was made that was equal to the higher level of network grant payments. The request to alter the level of network grants was made and approved by the former regulator in order to meet government accounting rules, taking into account his section 4 duties and considering Network Rail's key accountabilities to its train operator customers and the regulator. More detail on the reasons for these changes and the planned level of CP3 network grants and track access charges is set out in the statement made by the regulator on 10 March 2004.[25]

78. The government accounting rules say that direct grants paid to Network Rail are accounted for as capital expenditure in the government's accounts, whereas the equivalent money paid as government subsidies to train operating companies (TOCs) (who in turn pay Network Rail track access charges) are accounted for as resource (current) expenditure.

79. Government accounting rules impose constraints on the level of grants by way of two financial tests:

(a) **investment test**. This states that network grants that are accounted for as capital expenditure in the government's accounts, cannot exceed Network Rail's capital investment (i.e. renewals and enhancements). Any network grants paid in excess of capital investment are accounted for as resource

[24] *Access Charges Review: Final conclusions*. Office of Rail Regulation, December 2003. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/184.pdf.

[25] *Access Charges Review 2003: Regulator's approval of Network Rail's proposed financing arrangements*, Office of Rail Regulation, March 2004. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/188.pdf.

expenditure. This test applies in respect of the governments in England & Wales and Scotland separately; and

(b) **market body test**. This test requires that Network Rail's annual income from sales (equal to access charges plus other single till income) covers at least half of the company's production costs (equal to operating and maintenance expenditure and depreciation). Meeting the market body test is an important (but not the only) factor in Network Rail's continued classification as a private sector entity in the government's accounts. This test applies to Network Rail as a whole and separate calculations do not need to be made for England & Wales and Scotland.

80. In practice, the application of these rules means that the "resource" funding that is available to government and used for its funding of TOCs is more constrained than "capital" funding.

81. At the start of CP3, the level of network grant payments was set to satisfy the two tests, including a significant level of headroom. In both 2004-05 and 2005-06, the headroom was unnecessary. DfT asked us to consent to £250m of additional network grant payments to Network Rail in each year and a corresponding rebate in track access charges by Network Rail to TOCs (which in turn were passed back to DfT through the franchise arrangements). We agreed to these requests. For 2006-07,[26] following a request by DfT, we agreed to additional network grants of £600m (and a corresponding rebate of track access charges) and signalled our likely approval of similar switches in 2007-08 and 2008-09 (although consent must be sought and provided for in each individual year).

82. Whilst we have been content to make these adjustments in CP3, we made it clear that those decisions did not fetter our discretion for the future in respect of our policy towards network grants.

CP4 considerations

83. There are three questions we have considered in order to develop our proposed policy for CP4, these are:

(a) Do we allow network grants at all?

(b) If so, do we let the investment and market body tests determine the ceiling?

(c) Do we allow adjustments during CP4?

[26] Transport Scotland/Scottish Executive started paying network grants in respect of Scotland from 1 April 2006.

Do we allow network grants in CP4?

84. The governments in England & Wales and Scotland have made two arguments to us to justify the continuation of network grants, these are:

(a) **industry structure**. We recognise the governments arguments that the emergence of the new industry structure and procedures through the Railways Act 2005 clarify the roles and responsibilities of the governments and other parties. In particular, the high level output specifications (HLOSs) give a clear role for the governments in respect of their relationship to Network Rail, and hence this justifies direct network grant payments; and

(b) **government accounting rules**. The accounting rules that governments throughout the European Union must adhere to, do not allow grants to the private sector to be accounted for as capital formation, unless paid directly to the private sector entity undertaking the capital formation. Therefore, such grants cannot be routed through the TOCs.

85. Our preferred method of funding Network Rail is for all its income to come from TOCs, freight operating companies and other customers. However, we must have regard to the funds available to the Secretary of State and Scottish Ministers' in exercising our duties. The governments have told us that it is not possible to make changes to government accounting rules.

86. Given these considerations, we consider that we should continue to allow the governments to pay network grants to Network Rail in CP4.

Calculation of the level of network grant

87. Although government accounting rules are a matter for government, we consider that it is appropriate to be consistent and retain the approach used in CP3, where both the investment and the market body tests are used to determine the ex-ante level of network grants.

88. We recognise the need to allow sufficient headroom above the level of network grants set to meet the investment test to accommodate cost and income fluctuations. These fluctuations could include changes to the level of variable charges, changes to planned expenditure due to out/underperformance of our determination or re-phasing of engineering work, and also for any fine-tuning in the delivery of outputs set out in the HLOSs, e.g. Network Rail and the TOCs make adjustments to the outputs each is undertaking in CP4 to achieve the HLOSs. This would be associated with financial transfers between Network Rail and TOCs, which could have an effect on either the investment or market body tests. Similarly, passenger transport executives (or other bodies) may make increments/decrements to the level of train service provision with impacts on Network Rail's income and expenditure levels that would affect the two tests. We consider that headroom of around 10-15% on average in CP4 would be appropriate.

89. From our initial calculations, this would mean that network grants as a proportion of Network Rail's total revenue could be between 50% and 60% of its revenue requirement. This is a similar level to CP3. This level will also still ensure we can maintain a charging framework which provides appropriate price signals and incentives.

90. We will, for the purposes of transparency, indicate what the appropriate level of fixed track access charges for each train operator would be in the absence of direct grant payments. If these charges were faced by train operators, they would be reflected in franchise bids, thereby increasing the subsidy requirements or reducing premium payments.[27]

Do we allow adjustments in CP4?

91. Once we have set out the schedule of network grant payments for CP4 as part of PR08, we do not consider that it is appropriate or necessary to allow adjustments during CP4, for a number of reasons:

(a) **presentational and accountability issues**. Notwithstanding the new industry structure and relationships, direct payments from the governments can, or at least appear to, blur the accountabilities and status of Network Rail, and accountability of it to train operators. Setting out an ex-ante schedule of network grants for all of CP4 should minimise concerns about accountability compared to a situation where there are regular changes;

(b) **clarity and stability**. We, and we think the industry, prefer stability, without making adjustments from year to year. Following from the previous point, continual adjustments could call into question the accountability of Network Rail. In addition to this, the administrative work required to make the changes to network grants and track access charges creates bureaucracy for all parties; and

(c) **section 4 duties**. We must have regard to the funds available to the Secretary of State and Scottish Ministers' in exercising our duties. From initial discussions with the governments, we are content that setting out an ex-ante fixed schedule of network grant payments, would not be in conflict with this duty.

92. We consider that the governments should be able to know their ex-ante position on the levels of CP4 network grant payments, in the context of a reasonably firm understanding of Network Rail's CP4 expenditure and income forecasts determined through PR08 (taking into account a prudent level of headroom). We consider that the benefits to the governments of having the facility to make adjustments to this

[27] If there were no direct grants, and if access charges were based on a fair allocation of fixed and common costs, we estimate that at present, all TOCs would be receiving government subsidy (there would be no premium paying TOCs).

position are outweighed by the administrative burden and presentational/accountability issues.

Grant dilution

93. Current track access contracts include a provision that automatically increases track access charges, if the governments do not pay network grants according to a pre-determined schedule, to ensure that Network Rail recovers its required revenue.[28]

94. In order to ensure that Network Rail can finance its activities in the unlikely situation where the governments were not meeting their funding obligations, our intention is to include the same, or a similar, provision in track access contracts for CP4.

95. Following consideration of any responses we receive, we intend to confirm our approach in our February 2008 strategic business plan assessment document. We will also include an indicative schedule of network grants in that document.

Other financial issues

Introduction

96. This section describes the development of our approach to three other areas of Network Rail's financial framework: pensions; the treatment of inflation; and re-openers.

Pensions

97. Network Rail is part of the railway pension scheme (RPS), which is a shared cost defined benefit scheme and it also operates a defined contribution pension scheme. Overall, pension costs are a relatively small part of Network Rail's total cost base.[29]

98. In contrast to other comparable companies such as National Grid, Network Rail's share of the deficit in the RPS is relatively small. There are also some important differences between Network Rail's scheme and other schemes. For instance, the RPS is shared cost (employees are responsible for 40% of the deficit) and it has no pre-privatisation pensioners or deferred pensioners, as they are included in a government funded scheme. Network Rail has also closed the RPS to new members until they have five years service.

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[28] Part 3A of Schedule 7 of the track access contracts also includes provisions that automatically increase track access charges when conditions are placed on the payment of network grants.

[29] Network Rail's pension costs of £121 million in 2006-07 represented approximately 2% of their total cost base.

99. In response to the large deficits faced by the companies they regulate in the energy and water sectors, Ofgem and Ofwat have examined pension issues recently and developed ways of treating these costs on a specific basis, i.e. by looking at how much of the deficit in a pension scheme customers should fund.

100. Given the difference in Network Rail's pension arrangements and liabilities compared with other comparable companies, there is less of a need for us to have a specific set of policies for the treatment of pension costs. Therefore, instead of using a specific approach, we are proposing to treat pensions in the same way as any other operating cost.

101. As our determination will include efficient assumptions for all costs, we will review Network Rail's overall employment costs against appropriate benchmarks and we will include an assumption of Network Rail's total efficient employment costs in the determination of the revenue requirement.

102. We will be considering total employment costs because examining one part of an employee's remuneration (e.g. salaries) without looking at all the other elements can provide a partial, distorted picture and it is for Network Rail to decide on the appropriate balance between the different components of an employee's remuneration.

Treatment of inflation

103. In our February 2007 advice to ministers document we proposed to continue to use RPI to adjust Network Rail's allowed revenue. This is in line with standard regulatory practice and is the way Network Rail's allowed revenue is presently adjusted.

104. Indexing Network Rail's revenues in this way does leave the governments in England & Wales and Scotland with budgetary uncertainty for each year of CP4. This is because the governments do not know in advance exactly what the level of inflation, and therefore the required level of funding, will be for each year of CP4.

105. One way of reducing the governments budgetary uncertainty would be to include an ex-ante inflation assumption in allowed revenue and then log up/down any differences between this assumption and actual inflation. These differences could then be taken into consideration at the next periodic review. However, because of the way in which the governments protect franchised train operating companies from changes in the real level of charges during the life of their franchises, such an approach is only likely to provide greater overall budgetary certainty for the governments in relation to the element of Network Rail revenues paid through direct government network grants. The governments would still be exposed to any changes in franchised train operators' charges.

106. Since February 2007, we have had further discussions with Network Rail, DfT and Transport Scotland about this issue and considered our statutory duties, which include requiring us not to make it unduly difficult for Network Rail to finance its activities and also to have regard to the governments' available funds.

107. Network Rail supports retaining the current approach of adjusting for inflation in the year concerned, as it does not increase its financial risk within CP4. DfT and Transport Scotland would prefer us to use a logging up/down mechanism as their SoFAs are set in nominal terms, which means that they are exposed to any differences between the inflation forecast they assumed in setting the SoFAs and actual inflation.

108. On balance, we consider that it is more appropriate to make an adjustment for inflation in the year concerned. We consider that the additional financial risk that would be imposed on Network Rail by including an ex-ante estimate of inflation in our determination of the required revenue and logging up/down any variation between actual inflation and the ex-ante assumption (even if only for the direct government network grants) outweighs the benefits to the governments of increased budgetary certainty. This policy is in line with regulatory best practice and is the way Network Rail's allowed revenue is presently adjusted.

Re-openers

109. There are currently a number of re-openers in franchised train operators' access contracts with Network Rail. These re-openers enable us, under particular circumstances, or for particular specified purposes, to consider carrying out an access charges review where changes made in that review could have effect before the end of the current control period.[30]

110. The current re-openers are applicable in the following situations:

(a) where there is a material change in the circumstances of Network Rail or in relevant financial markets and in consequence there are compelling reasons to initiate an access charges review;

(b) when Network Rail's cumulative expenditure is higher or lower by more than 15% than the previous access charge review's determination;

(c) for reviewing elements of charges in relation to specific policy areas e.g. to facilitate the introduction of on-train metering;

(d) for reviewing specific activities where there remained some uncertainty at the most recent access charges review e.g. signalling; and

(e) in relation to the West Coast project.

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[30] In franchised passenger operators' contracts these provisions are set out in Part 7 of Schedule 7. Freight operators and some non-franchised passenger operators have different arrangements in Schedule 7 of their track access contracts.

111. We consulted on the first two re-openers described in paragraph 110[31] above in our September 2006 letter on the treatment of risk and uncertainty and most respondents favoured retaining them. In our February 2007 advice to ministers document, we discussed the advantages and disadvantages of retaining both these re-openers. We said that in reaching a conclusion on this issue we would have regard to other developments in the financial framework, for instance the level of 'risk buffer' that is built into the rate of return.

112. We intend to retain the first two re-openers described in paragraph 110. This provides Network Rail with protection for a material change in circumstances and it also provides it with certainty that we would consider an access charges review when a certain change in expenditure took place.

113. The re-openers only provide us with the opportunity to consider whether to carry out an access charges review. In addition, even if we carried out a review we would only expect to determine additional revenues for the company where its additional expenditure was efficient. These features of the re-opener should mean that we avoid the possible perverse incentive on the company to increase its expenditure if it approaches the required trigger level.

114. We intend to alter the definition of the quantified re-opener, to widen its scope and include changes in access charges income, other single till income, corporation tax and financing costs in addition to the current definition covering expenditure on the operation, maintenance and renewal of the network and expenditure on allowed enhancement projects. This is because changes in other single till income, corporation tax or financing costs could also have a significant impact on the company. By including access charges income, we take account of changes in access charge income offsetting cost changes.

115. We will set out the specific level of the quantified re-opener in our draft determinations in June 2008, as it needs to be considered in conjunction with all the other elements of the revenue requirement and the PR08 framework, e.g. the size of the risk buffer. As we said in the February 2007 advice to ministers document, the financial framework will be disaggregated between England & Wales and Scotland. This will mean that specific levels for the quantified re-openers in England & Wales and Scotland will need to be determined.

116. As they are no longer relevant, we propose to remove the current specific CP3 re-openers from franchised passenger operators' contracts, with the exception of a specific re-opener related to the introduction of on-train metering or the

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[31] These re-openers are: where there is a material change in the circumstances of Network Rail or in relevant financial markets and in consequence there are compelling reasons to initiate an access charges review; and when Network Rail's cumulative expenditure is higher or lower by more than 15% than the previous access charge review's determination.

introduction of competing suppliers of electricity for traction as these changes would alter the way that traction electricity is charged.

117. The development of policy elsewhere in PR08 might require the introduction of a specific re-opener. This will be discussed further in PR08, e.g. through the work on the structure of charges or on the Schedule 4 possessions regime.

118. We will set out for consultation all the re-openers in our draft determinations in June 2008.

Annex A: Periodic Review 2008 timetable

Date	Milestone
31 October 2007	Network Rail publishes its strategic business plan (SBP), including indicative levels of individual access charges.
6 November 2007	We publicly consult on Network Rail's SBP.
20 December 2007	We publish letters on our initial assessment of whether the high level output specifications can be delivered for the available public financial resources.
14 February 2008	We publish our assessment of Network Rail's SBP, including decisions on the financial framework following the September 2007 consultation and decisions on the early start programme for 2009-10.
By 3 April 2008	Network Rail provides revisions to the SBP if necessary.
5 June 2008	We publish our draft determinations for CP4.
30 October 2008	We publish our final determinations for CP4.
18 December 2008	Final access charges (price lists/charge schedules) are audited and approved. The review notice is served starting implementation of PR08.
5 February 2009	Final point by which objections could be made to our review notice starting implementation, leading to a revised notice or possible Competition Commission reference.
By 31 March 2009	Network Rail publishes CP4 delivery plan.