OFFICE OF RAIL AND ROAD

PR18 explanatory note

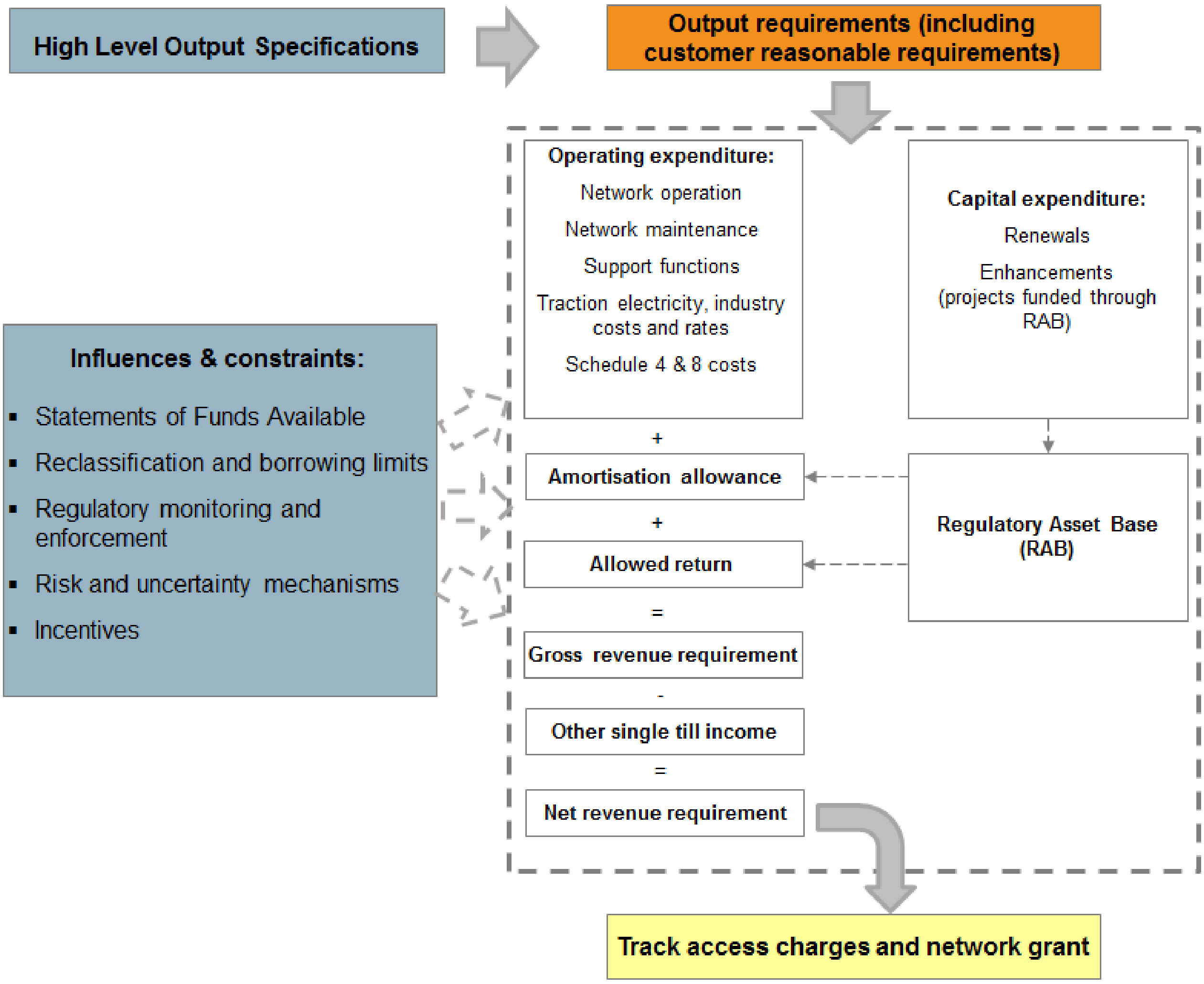
The 'building block' methodology

This note gives an overview of the building block methodology that we expect to use in the 2018 periodic review of Network Rail (PR18)

Version 1.0 – May 2016

1. Our approach to establishing Network Rail's required revenue will continue to use the 'building block' methodology widely used by economic regulators in the UK. Our periodic reviews for Network Rail in 2008 and 2013 used this broad approach, which is illustrated in Figure 1.

Figure 1: Building block methodology



2. The building block diagram in Figure 1 is a high-level illustration of how we will calculate Network Rail's revenue requirements for control period 6 (CP6), which we expect to run from 2019-2024). The key features of the building block approach are that we assess:

   (a) the amount we think Network Rail needs to spend on **operating** and **maintaining** the railway for each year of the control period. We currently expect that Network Rail will receive income for this on a 'pay-as-you-go' (PAYG) basis. This means that for each pound it needs to spend each year it receives a pound in income; and

   (b) the capital expenditure on **renewals** and **enhancements** (where these are to be funded through the regulatory asset base (RAB)) that Network Rail needs to undertake in the control period. This expenditure is added to the RAB in the year in which it is incurred but the component of required revenue that we currently expect to determine for Network Rail for each year consists of:

      (i) an **amortisation** allowance; plus

      (ii) a calculated amount representing the **allowed return on the RAB**.

3. We have not yet decided our detailed approach to a number of the building blocks, including the amortisation allowance (see paragraph 4) and the allowed rate of return on the RAB (see paragraph 5).

Amortisation allowance

4. Amortisation is similar to depreciation in a company's accounts (in the sense that we deduct an amount from the RAB to reflect the reduction in the value of assets over their asset lives). We provide Network Rail with an amount of money (an 'amortisation allowance'), which largely funds expenditure to renew these assets (the value of these renewals is added to the RAB). The amortisation allowance may also include additional money to improve Network Rail's financial sustainability.

Allowed return on the RAB

5. Whereas expenditure on operating and maintaining the existing network is funded on a PAYG basis, Network Rail's renewal and enhancement expenditure is funded differently. Since its reclassification as a public sector body in 2014, Network Rail has financed its capital expenditure exclusively with debt, with all new borrowing being from the UK Government. The capital expenditure it incurs is added to the RAB balance.

6. While most large companies raise investment funding as a mixture of debt (borrowing) and equity (shareholder funds), Network Rail is a 'not for dividend' company and does not have any shareholder equity. Through the periodic review, we

allow Network Rail to recover a rate of return on the RAB. This allowed rate of return is expressed as a percentage value which, multiplied by the RAB balance, provides Network Rail with an amount to service the cash interest costs of its borrowing.

7. As well as determining the allowed rate of return referred to in paragraph 6, in PR18 we will also need to determine a notional weighted average cost of capital (WACC), which is expressed as a percentage value. This will represent the cost that Network Rail would be likely to bear if it were funded by a mix of private sector debt and equity. This value is important because, among other things, it is used as the basis for investment decisions to ensure that third parties funding rail investments pay the appropriate cost of finance.

Gross and net revenue requirements

8. As shown in Figure 1, adding up the operating expenditure, amortisation allowance and allowed return amounts gives the total income needed by Network Rail to carry out its activities. We refer to this amount as the '**gross revenue requirement**'.

9. In PR18, we expect that we will continue to use a 'single till' approach. This means that the income (which we call 'other single till income') that we expect Network Rail to earn on activities such as commercial property is deducted from the gross revenue requirement, leaving a '**net revenue requirement**' to be recovered through track access charges and network grant.

Recovery of the net revenue requirement – network grants and charges

10. We expect that the arrangements in PR18 will continue to allow governments to provide an element of Network Rail's net revenue requirement by the direct payment of 'network grants'. Network grants serve to reduce the amount of fixed track access charges that are currently only paid by franchised train operators.

11. Fixed track access charges are currently set at a level necessary to recover the amount of Network Rail's net revenue requirement that is not recovered through network grants and other access charges.