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Update on the financial framework for PR18

Introduction and context

1. In January 2017, we published our first consultation on the financial framework for our periodic review 2018 (PR18)[1]. We received a range of responses from stakeholders, which we are taking into account in developing our proposals. However, there have been some significant developments since our first consultation that will affect the funding structure for Network Rail in CP6 (the five-year control period that begins on 1 April 2019).
2. In this letter we provide an update on these developments, provide our views on high-level strategic issues, and set out how we propose to determine the revenue requirement for each of Network Rail's routes, and for the System Operator, for each year of CP6. We refer to the information set out by the governments in their high level output specifications (HLOSs) and the financial information included in the Department for Transport's statement of funds available (SoFA). Transport Scotland has not yet published a SoFA, but we will take this into account when it becomes available. We also outline our next steps, including our plan to publish more detailed documents on our:
    a) approach for assessing Network Rail's efficiency and wider financial performance in CP6, to be published in January 2018; and
    b) proposals for the technical aspects of the financial framework for PR18, to be published in spring 2018.
3. The following key developments and issues are covered in this letter:
    a) Funding decisions, referred to in the Department for Transport (DfT) SoFA that:
        i. Network Rail will not be able to borrow in CP6 for the purposes of delivering HLOS outputs; and
        ii. some of Network Rail's costs and liabilities will be funded separately from the SoFAs and our determination of Network Rail's revenue requirements.

[1] http://orr.gov.uk/rail/consultations/pr18-consultations/consultation-on-the-financial-framework-for-pr18

b) There is some ring-fenced funding for enhancements in the DfT's SoFA, and any additional enhancements will be grant funded separately.

c) Our approach for calculating Network Rail's revenue requirement will be more straightforward than it was for CP5 – there will be no need for a cost of capital component, and we will replace amortisation allowances with funding for renewals expenditure.

d) The mix of business risks faced by Network Rail will change in CP6. Some risks, such as the level of interest rates on borrowing will be decreased or removed, whilst others, including exposure to changes in general inflation levels[2], will be introduced or increased.

e) The DfT's SoFA does not provide any funding for the risk that income and expenditure levels could be higher than expected. We will need to address this factor in our determination.

f) Some aspects of the funding structure for Network Rail are still to be finalised, in particular the extent to which it will be allowed to move expenditure between years and between revenue and capital spending categories. We set out the approach for providing the assurance the governments will need to support budgetary flexibility.

4. Work is underway to update the investment framework guidance that is published on our website and we refer to a letter we will be publishing to set out the guidance that is available on regulatory aspects of investment by third parties in the railway.

5. We would welcome any comments that stakeholders wish to make on the matters included in this letter.

The HLOSs and SoFAs for CP6

6. The DfT and Transport Scotland published their HLOSs for CP6 in July 2017[3] and the DfT also provided statutory guidance to ORR at that time[4]. The DfT published its SoFA on 13 October 2017 but Transport Scotland's SoFA has not yet been published. The purpose of the SoFAs is to set out the funding that the governments intend to make available to Network Rail to operate, maintain and renew the existing railway network through network grants and, indirectly, through the track access charges paid by franchised train operators[5]. The DfT's SoFA also sets out a total cash figure for expected expenditure on HLOS activities in CP6 and takes into

[2] Examples of general inflation indexes are RPI and CPI.

[3] DfT's HLOS is at: https://www.gov.uk/government/publications/high-level-output-specification-2017 and Transport Scotland's HLOS is at: https://www.transport.gov.scot/media/39496/high-level-output-specification-hlos-for-control-period-6-final.pdf

[4] DfT's statutory guidance to the ORR is at: https://www.gov.uk/government/publications/railways-guidance-to-the-office-of-rail-and-road

[5] DfT's SoFA is at: https://www.gov.uk/government/publications/railways-statement-of-funds-available-2017

account forecasts of the other income that Network Rail will receive during CP6, including from charges paid by freight and open access train operators.

7. Network Rail is preparing strategic business plans (SBPs) in light of the SoFAs to meet the output requirements and targets in the HLOSs. The SBPs will be compiled from the route strategic plans prepared by each of the routes and by the System Operator.

8. We will decide whether the funding required to deliver the HLOSs is available in the SoFAs or whether there is a ‘mismatch’ (meaning there is not enough money available in the SoFAs to fund the HLOSs).

Revised funding structure for Network Rail in CP6

9. Network Rail was reclassified as a public sector arm’s length body in September 2014, shortly after the start of the current five-year control period (CP5). Some changes to Network Rail’s funding structure resulting from reclassification came into effect during CP5 and some additional changes will apply for CP6, which we outline below. These changes are relevant to both England & Wales and Scotland.

No borrowing by Network Rail in CP6 to finance HLOS activities

10. Before reclassification, Network Rail raised debt in the financial markets. Since reclassification, Network Rail has only been allowed to borrow from the DfT[6]. Private sector debt is gradually being replaced with borrowing under the DfT facility as it matures.

11. In CP5, Network Rail borrowed primarily to finance enhancements, although the DfT loan facility has also been used to meet financing/refinancing costs and to manage other expenditure requirements. Network Rail received funding for the expected interest costs on its borrowing in our calculation of its revenue requirements in our last periodic review (PR13).

12. From the start of CP6, Network Rail will not be allowed to incur new borrowing to finance HLOS activities and enhancements will be grant funded as described in the next section. DfT will provide funding for existing debt liabilities covering servicing costs (including the financial indemnity fee on private sector debt), a collateral facility[7] and repayments of principal.

13. Both of these changes could have significant accounting and corporation tax implications. But this will not affect Network Rail’s underlying financial position.

[6] https://www.gov.uk/government/publications/network-rail-loan-agreement

[7] Prior to reclassification, Network Rail borrowed directly from the financial markets. To reduce its exposure to interest rate, currency and inflation fluctuations, Network Rail took out a range of financial instruments. Many of these require Network Rail to set cash aside in the form of collateral, and this amount varies as markets move.

Separate grant funding for enhancements under a pipeline approach

14. The HLOSs and DfT's statutory guidance specified that there would be a different process for the approval and funding of enhancement projects in CP6. This will involve a 'pipeline' approach to project decision making instead of a commitment to a portfolio of projects at the start of the period. Our present understanding is that Transport Scotland will use a similar pipeline approach to decision making on enhancements in CP6.

15. Going forward, enhancements will be funded by capital grants, separate from the SoFAs and our determination of Network Rail's revenue requirements. However, it should be noted that the DfT's SoFA includes ring-fenced funding for the completion of some enhancement projects.

16. The switch to grant funding of enhancements means that Transport Scotland will now have to pay for enhancement expenditure up-front, instead of just paying the interest costs on borrowing by Network Rail. There might also be interactions between enhancement funding decisions in England & Wales and in Scotland.

17. DfT has responsibility for assessing efficient costs levels for enhancements in England & Wales[8] and, accordingly, we will not assess enhancements costs for England & Wales in our PR18 determination. However, we will refer in our determination, to any available information on enhancement decisions and funding in CP6 in order to provide as complete a financial picture as possible. This is important because there are significant interactions between enhancements and operations, support, maintenance and renewals (OSMR) activities. In particular, the governments will need to consider the impact of enhancement decisions (under the pipeline approach) on OSMR expenditure requirements, whether relating to additional costs or savings.

Separate grant funding of corporation tax and British Transport Police costs

18. DfT has said it will provide separate funding (probably in the form of grants) for Network Rail's total corporation tax liabilities and for its share of British Transport Police (BTP) costs in England and Wales in CP6. This means that funding for these costs is not included in the DfT's SoFA and they will not be included in our revenue requirement determination for England and Wales. However, funding for transport police costs in Scotland is expected to be included in Transport Scotland's SoFA as the responsibility for it is being devolved to the Scottish government.

Budgetary flexibility during CP6

19. Our PR18 determination will specify a net revenue requirement for Network Rail for each year of CP6, which will be based on our assumptions on the levels of expenditure needed to deliver the HLOSs, taking into account Network Rail's other single till income.

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[8] At the moment it is not clear if we will be responsible for assessing efficient costs for enhancement projects in Scotland.

20. Under public sector spending rules, expenditure on operations, support and maintenance is classed as resource spending, whereas expenditure on renewals[9] is classed as capital spending. Public sector bodies are generally not allowed to carry forward budgetary underspends and funding, once allocated, cannot be transferred between resource and capital spending.

21. The governments are presently considering the degree of flexibility Network Rail should have in terms of moving money between financial years and between resource and capital spending in support of business efficiency and effective risk management. Network Rail should, in any case have some flexibility to manage resourcing and risks across its business (subject to arrangements for managing changes to route settlements that are included in our determination).

22. We will review Network Rail's planned expenditure profiles for CP6 from the standpoint of deliverability and financial risk management and take into account any views expressed by the governments in relation to expenditure profiles.

23. In support of route devolution and to assure the governments that budgetary flexibility for Network Rail will not lead to inefficient expenditure, we are increasing our monitoring of the business at route level by engaging more intensively with route managers and stakeholders to understand and challenge performance, efficiency, and budget management factors. We will be proposing a new approach to our efficiency and wider financial performance assessment of Network Rail for CP6 (see next steps below).

24. We also expect that the devolution of responsibilities to routes and the System Operator, and our route level regulatory approach for CP6, should make a significant contribution to strong business governance at route level. For example:

    a) Network Rail is improving local accountability through train operator alliances, scorecard measures and route supervisory boards.

    b) We are developing route level aspects of regulatory escalation and enforcement procedures.

    c) We are improving route level efficiency and financial performance metrics. This will allow better comparability of Network Rail's performance and allow operators to better understand how Network Rail's efficiency and financial performance can affect their own operational performance (because it can affect the amount of money available to carry out works).

25. These developments should, amongst other things, help routes to pursue third party funding and financing, including for incremental enhancements associated with asset renewal schemes. They should also allow routes to more effectively manage the impact of capital expenditure deferrals if these become necessary.

[9] For government reporting purposes, some renewals expenditure that is treated as capital expenditure in regulatory accounts may be classified as resource expenditure in government accounts.

Our approach for determining revenue requirements

26. Our PR18 determination will set out Network Rail's revenue requirements for each year of CP6 separately for England & Wales and Scotland using a building block approach. We will also use this approach to calculate the revenue requirement for each route, including the Freight and National Passenger Operator (FNPO) route, and for the System Operator for each year of CP6. The total of the route requirements will equal the overall revenue requirement for Network Rail[10]. Having reviewed each route's strategic plan (including the plans for the FNPO and System Operator), and Network Rail's overall strategic business plans, we will use our views of Network Rail's expenditure plans to calculate the revenue requirements using our financial model.

Building block approach

27. Economic regulators generally use the expression 'building block approach' to refer to a way of combining operating, asset financing (cost of capital) and asset depreciation costs to determine a revenue requirement to remunerate those costs. The more straightforward building block calculation that we are proposing to use to calculate the net revenue requirement for each route, for each year of CP6 will be the sum of[11]:

    - network operating expenditure;
    - support expenditure;
    - network maintenance expenditure;
    - traction electricity, cumulo (business) rates and industry costs;
    - schedule 4 and 8 costs[12];
    - renewals expenditure; and
    - risk funding;

    less:

    - other single till income.

    This is illustrated in the diagram in Appendix 2.

28. This calculation does not include debt financing costs because Network Rail's legacy debt costs will be separately funded by DfT and it will not be allowed to incur new borrowing in CP6 to finance HLOS activities. As Network Rail is a not for

[10] System Operator charges and central function recharges appear as costs in route expenditure requirements, and a share of geographical route costs are charged to the FNPO for the use of infrastructure.

[11] In our calculation we will assume that Network Rail's working capital level at the end of CP5 is the same as at the end of CP6. This is consistent with the DfT's SoFA.

[12] See the Glossary to our first consultation for an explanation of these terms.

dividend business no equity funding costs need to be included in our calculation of the revenue requirements.

29. For PR13 we included an asset amortisation allowance instead of a renewals allowance. This was based on Network Rail's long-run average renewals costs. However, as noted above, in the calculation of the revenue requirements for PR18 we are proposing to include a renewals allowance, based on the forecast cash cost of renewal activities each year, rather than an amortisation allowance. This is primarily because Network Rail will not be able to borrow in CP6 to finance HLOS activities and, consequently, would find it harder to manage fluctuations between actual expenditure requirements and amortisation allowances based on long-run average cost levels[13].

RAB and cost of capital

30. We used an 'adjusted WACC' approach to Network Rail's cost of capital in PR13. This consisted of an allowance to cover the cash interest costs on Network Rail's debt balance. We explained this approach in chapter 3 of our January 2017 consultation.

31. As explained above, our more straightforward building block calculation for PR18 will not include a cost of capital component or the use of a regulatory asset base (RAB) value. However, we are proposing to:

    a) determine a notional weighted average cost of capital (WACC)[14] for Network Rail; and

    b) maintain a RAB value for each route[15].

32. In the two paragraphs below we explain why we think this approach is appropriate. We will set out proposals in the further paper we will publish on the financial framework in spring 2018.

33. We will determine a notional WACC for Network Rail to allow the calculation of the finance cost component of facility charges payable by third parties who have promoted enhancements financed by the governments through Network Rail. For example, Transport for London pays a facility charge to Network Rail in respect of infrastructure associated with Crossrail (although in this particular case, only the cost of debt component of Network Rail's WACC is used in charge calculations). A WACC value can also provide a benchmark discount rate for investment projects (and other) decisions by Network Rail.

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[13] ORR's calculation of track charges may still use the PR13 approach that considers the long-run average cost of renewals because volatility in charges is not helpful to train operators.

[14] This is the cost of capital Network Rail would face if financed by private sector debt/equity without UK Government support and is expressed as a percentage value - see the Glossary to our first consultation for an explanation of this term. The adjusted WACC referred to in paragraph 30 is the monetary portion of the WACC x RAB value which equated to our forecast of Network Rail's cash interest costs in CP5.

[15] We will discuss in our technical financial document to be published in spring 2018 how we will take account of future grant funded enhancements in the RAB.

34. Maintaining RAB values is an effective way to value railway assets and the RAB is currently used as part of the basis for valuing the railway network in Network Rail's statutory accounts (£61.8bn at 31 March 2017)[16]. RAB values provide a degree of comparability with other regulated network businesses and could also be relevant to the valuation of any assets transferred to another network operator. For example, Network Rail, DfT, the Welsh Government and HM Treasury are planning on referring to the value of the Wales route RAB when they consider the value of assets that may be transferred by Network Rail to Transport for Wales as part of the process of devolving responsibility for the core valley lines.

Third party investment in the railway

35. The DfT's statutory guidance to us says that:

"The Secretary of State wishes ORR to ensure that the regulatory framework creates certainty for the supply chain and investors and fosters investment in whatever form. This includes taking all appropriate steps to facilitate a greater level of private investment, including through ensuring that third party investors (both public and private sector) are afforded appropriate protection through the regulatory framework."

36. The DfT is reviewing how third party investment can be facilitated and we will assist the review by publishing a letter setting out answers to questions that have been asked recently by potential investors on issues such as safety requirements, access, whether a licence would be required and what form regulation would take etc.

37. The 'investment framework'[17] has helped to facilitate third party investments by:

a) providing a framework for capital investment decisions to be made outside of a periodic review;

b) setting out how those investments are paid for by either allowing third-parties to pay:

i. up-front; or

ii. through facility charges where Network Rail has financed the investment using its borrowing facility;

c) explaining the basis for facility charges;

d) calculating the facility charges;

e) setting out Network Rail's role in:

i. planning, facilitating and delivering enhancements and accelerated/upgraded renewals; and

ii. contestable/non-contestable works;

[16] https://www.networkrail.co.uk/who-we-are/publications-resources/regulatory-and-licensing/annual-report/

[17] http://orr.gov.uk/__data/assets/pdf_file/0014/5720/investment_framework_guidelines_october_2010.pdf

and

f) providing a range of template agreements and setting out change control and dispute resolution processes.

38. We will work with Network Rail, the Rail Delivery Group, and other industry stakeholders to update the existing investment framework to align it with the developments referred to in this letter. In particular we will need to review references to the use of Network Rail's borrowing facility to provide finance. Given the restriction on Network Rail's borrowing, use of the investment framework will be constrained in future, unless third party investors have access to their own funding. However, the investment framework is still available to be used where funding solutions can be identified. Funding from devolved authorities, local authority initiatives and local enterprise partnership programmes could be examples of funding sources.

39. Traditionally the investment framework has been used to calculate the charge a third party would pay Network Rail for constructing an asset. But in the future it could also be used to calculate the charge Network Rail could pay a third party who has constructed an asset for Network Rail.

40. Working with Network Rail, we have commissioned a review of the industry risk fund and Network Rail fee fund requirements in the investment framework to make sure they do not present an undue barrier to investment.

Financial risk management for CP6

41. DfT is not providing funding specifically to cover financial risks in CP6 as it thinks this would not be appropriate for an arm's length public sector body[18]. However, because Network Rail, like any other company, faces the risk that actual income and expenditure levels could be different from those forecast, the assumptions in our determination will take account of financial risk. This is very important because Network Rail needs to develop a workbank that is deliverable after taking account of supply chain issues and our view of efficiency and financial risk.

42. Our assumptions on financial risk will be based on an analysis of the risks that Network Rail faces and how it can efficiently manage them. We will need to ensure that we do not double-count financial risk funding with the cost assumptions Network Rail has included in its baselines.

43. Financial risks to income and expenditure levels include:

a) higher than expected general or input price inflation;

b) poor coordination of enhancements with network operation and renewals;

c) high impact low probability events (including severe weather events);

d) lower than expected other single till income;

[18] Transport Scotland's position on this issue is not yet clear.

e) macroeconomic events; and

f) performance penalties[19].

44. As noted above, Network Rail's ability to manage financial risks will be affected in CP6 as it will now have more exposure to changes in general inflation levels. It might also be affected if its flexibility to carry forward underspending from one year into another is limited, in particular because it will not be able to borrow to manage cash flows relating to HLOS activities in CP6. However, it should have some capacity to manage budgets across its whole business, subject to any arrangements for managing changes to route settlements included in our determination.

45. On the other hand, the revised funding structure for CP6 should mean that some financial risks Network Rail faces are reduced in comparison to CP5 because:

   a) Network Rail will no longer be exposed to interest cost variations on borrowing;

   b) enhancement project costs and budget planning will be separate from OSMR funding; and

   c) corporation tax and BTP costs will be separately funded by DfT.

46. We presently consider that the re-opener provisions, included in track access contracts, that allow changes to the revenue Network Rail can recover in certain circumstances, should be retained. We will also consider in our further publication on the financial framework in spring 2018, whether any changes to Network Rail's financial licence conditions are required.

<u>Inflation</u>

47. We expect that the post-efficient expenditure assumptions set out in Network Rail's SBPs will:

   a) be expressed in real (constant 2017-18) prices; and

   b) reflect:

      i. efficiencies Network Rail thinks it can achieve (versus cost levels at the end of CP5); and

      ii. forecasts of input price effects[20] and other cost 'tailwinds/headwinds' applicable to its business.

48. The DfT's SoFA for CP6 set out the funding available from network grants as a fixed cash total. It also set out the amount of expenditure expected to be met from Network Rail's other income, primarily from track access charges, but also from

[19] Under Schedule 8 or as a result of enforcement action.

[20] In this context, input price effects refers to the difference between the forecast of total input price inflation that may be experienced by the business and the forecast level of general inflation.

other sources (also in cash terms). We have duly noted these points and need to take them into account in making our determination of revenue requirements. We presently expect that Transport Scotland's SoFA may be expressed in similar terms.

49. Our PR13 determination for CP5 set out revenue requirements for Network Rail in constant 2012-13 prices, but the network grant and access charge arrangements both included RPI indexation. This process meant that Network Rail was protected, in most respects, from variances between forecast and actual levels of general inflation during CP5 (but it was exposed to variances in input prices).

50. As noted above, the funding available from DfT for network grants in CP6 is fixed in cash terms[21], and these limits will not be subject to adjustment for general inflation. However, track access charges may be subject to an adjustment for general inflation (and some of Network Rail's other single till income streams might also have index linking provisions).

51. If the revenue required from track access charges is subject to indexation and expressed in constant 2017-18 prices, then expressing the revenue required from network grants only in cash prices could be confusing for stakeholders. We think that one way of dealing with this issue would be to express the revenue requirement relating to network grants in cash prices *and* in 2017-18 prices after adjusting for our forecast of general inflation.

52. In order to express the revenue required from network grants in 2017-18 prices, we would need to deduct a forecast inflation factor from the amounts determined in cash prices. However, the determined amount of revenue would remain as the cash prices amount. The additional presentation in 2017-18 prices would be for ease of understanding only. An illustration of this presentation is shown in Appendix 3.

53. Because the revenue available under network grants would be fixed in cash terms, Network Rail would only be protected to a limited extent (through the indexation of track access charges) if general inflation turned out to be higher than forecast.

54. We considered the index we could use to update charges for general inflation (RPI or CPI) in our first consultation. We will set out our proposal on this issue in our further publication on the financial framework in spring 2018.

<u>Next steps</u>

55. Network Rail submitted the first parts of its route strategic plans and overall strategic business plans to ORR on 8 December 2017, and the submission should be completed by 9 February 2018.

56. We plan to publish a further paper in spring 2018 that will set out our proposals for the financial framework and details on the more technical aspects[22]. We will take responses to that publication into account in our draft determination for PR18.

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[21] The approach for Transport Scotland has not yet been confirmed.

[22] For example, the way we would roll forward the value of the RAB from year to year.

57. We will also publish a consultation on assessing Network Rail's efficiency and wider financial performance in CP6 in January 2018 that will, in particular, consider how financial performance information can be made more transparent for stakeholders. This will build on the content in our first financial framework consultation and on the work we are already doing to improve the financial performance information we include in our half yearly monitor publications and our annual efficiency and financial assessments. We will also consider the metrics that Network Rail's routes propose to include on their own scorecards for CP6 and how these relate to our wider financial performance assessment. This consultation will also discuss how Network Rail's statutory accounts can be reconciled to its regulatory and government accounts.

58. We presently expect that ORR's draft determination for PR18 will be published in June 2018, as shown in the summary timetable in Appendix 1.

59. We would be interested to receive any comments that stakeholders have on the issues we have set out in this letter. The deadline for responses is 18 January 2018. Information about the publication and confidentiality of responses we receive is set out on our website and in chapter 8 of our January 2017 consultation.

Yours sincerely

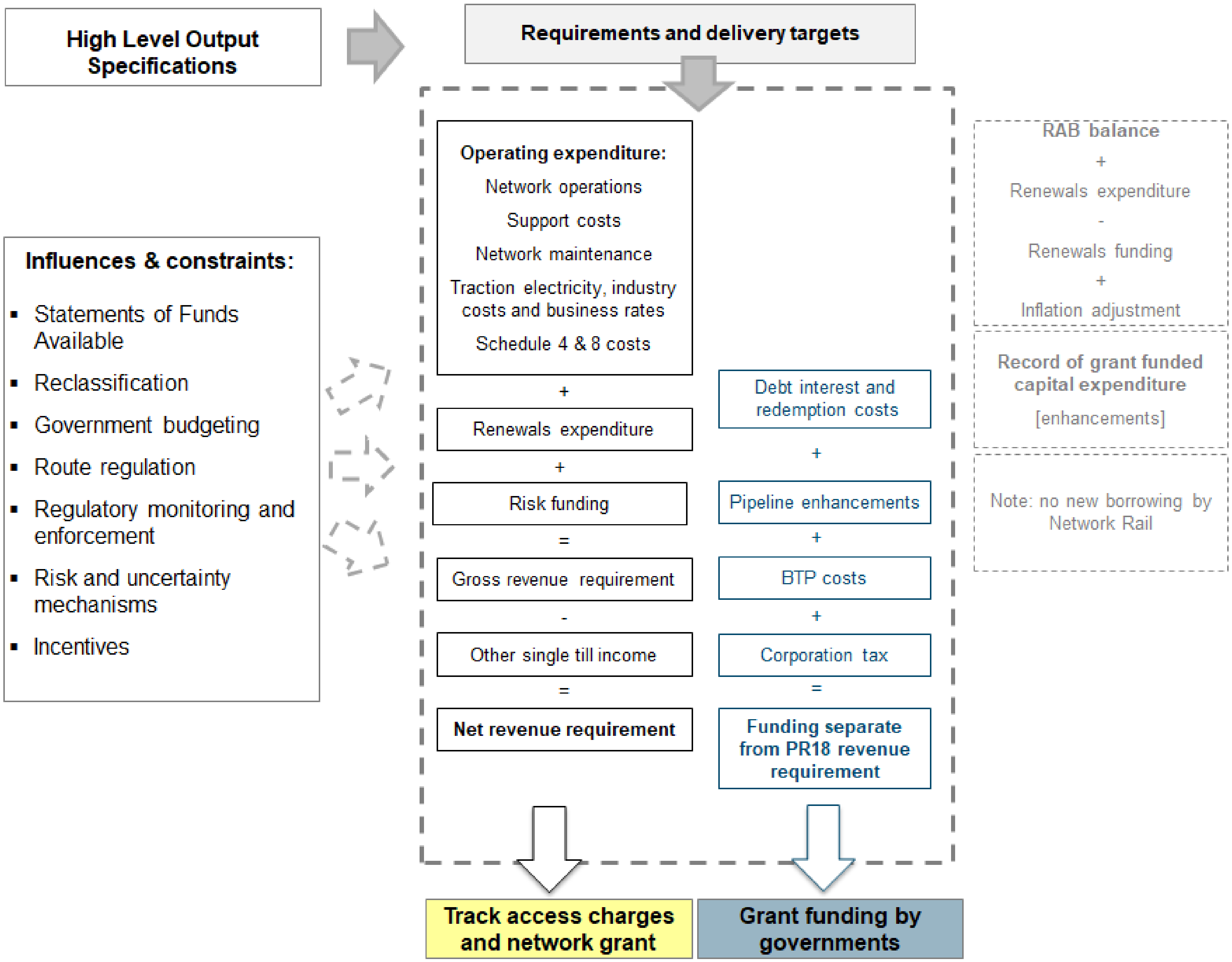
John Larkinson

Appendix 1: Current PR18 timetable

- December 2017 – Network Rail provides ORR with its provisional route and overall strategic business plans.
- January 2018 – ORR publishes approach for assessing Network Rail's efficiency and wider financial performance in CP6.
- February 2018 – Network Rail finalises and publishes its route and overall strategic business plans.
- Spring 2018 – ORR publication on the technical aspects of the financial framework for PR18.
- June 2018 – ORR draft determination published for consultation.
- July 2018 – ORR consultation on approach to implementation drafting (changes to access contracts and licence conditions if necessary).
- October 2018 – ORR final determination published.
- December 2018 – ORR issues review notices setting out changes to access contracts and the network licence.

  Governments issue network grant documentation (if applicable).
- March 2019 – Network Rail delivery plans.
- April 2019 – CP6 commences.

Appendix 2: Updated building blocks illustration



Appendix 3: Illustration of a possible approach to general inflation for network grants

Presenting network grant revenue in 2017-18 prices[23]

(see paragraphs 50 to 52)

Table 1: Network grant in cash prices

£bn	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**Total**
Total	7.00	7.00	7.00	7.00	7.00	**35.00**

Table 2: Network grants in 2017-18 prices
(using a forecast of 2% per annum inflation)

£bn	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**	**Total**
Total	6.72	6.57	6.43	6.27	6.12	**32.11**

[23] Figures for illustration only.