Department for Transport

Nick Bisson
Director – Rail Policy
Great Minster House
33 Horseferry Road
London
SW1P 4DR
Direct Line: 020 7944 4250
Email: nick.bisson@dft.gsi.gov.uk

Web Site: www.dft.gov.uk

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Richard Fitter
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

**Dear Richard,**

**This letter is the Department for Transport's response to the Office of Rail Regulation's (ORR) consultation on financial issues for Network Rail in CP5**, published in August 2012. The points contained in our response have been the subject of discussion with the ORR.

***Q3.1: What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB for inflation. In particular, that we are proposing to set an ex-ante assumption for both general inflation and input price inflation in our determination of access charges for CP5?***

DfT supports ORR's proposals on the treatment of inflation and sees the benefit they offer in reducing uncertainty in Government's budgeting for Network Rail's costs and incentivising Network Rail to manage cost inflation. DfT recognises though that in determining on this issue ORR will need to consider any consequential effect on Network Rail's financing costs and required level of financial headroom.

***Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?***

DfT supports ORR's proposals to do away with the annual risk buffer. We agree with ORR's analysis of why this is no longer required.

***Q3.3: What are your views on our proposal to simplify the mechanism to re-open Network Rail's access charges review by removing some of the specific re-openers?***

We support ORR's proposal to simplify the current re-opener arrangements. DfT considers that the proposal to retain a separate re-opener for Scotland is a practical arrangement that Transport Scotland are likely to find of benefit, whilst providing the equivalent mechanism for England and Wales, though strictly logical, should be unnecessary given the relativity of expenditure between the two Government funders of the network.

***Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?***

DfT supports ORR's proposals for the treatment of these costs. Recognising that other parts of the industry also have directors on the RSSB Board and British Transport Police

Authority, it may be more appropriate to calibrate incentives based on Network Rail's share of the cost, rather than the total industry position.

***Q3.5: What are your views on our current thinking that the maximum level of financial indebtedness that Network Rail can incur should at no point exceed a limit set between 70-75% in CP5?***

DfT considers this licence condition to be an important discipline on Network Rail and limiter of funding risk for Government. We consider that the limit needs to be set sufficiently high to provide Network Rail with an adequate balance sheet buffer for accommodating overspend risk but at a low enough level to provide DfT and Transport Scotland with protection against excessive funding liabilities. Establishing such a level requires quantitative analysis and risk modelling of the type proposed by ORR. We consider that it is also important to understand the practical relationship between the level of the indebtedness limit and the point at which a reopener would likely occur.

***Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?***

DfT considers it impossible to anticipate adequately such an initiative *ex ante* within a structure of the price control. It agrees with ORR's suggestion that the effect of such an initiative could be evaluated between the parties if and when it were to arise. The consequences, if material, could then be dealt with through the reopener arrangements.

***Q4.2: What are your views on our proposal to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail is provided with?***

DfT is content that the FIM fee should be set at a long run level. We understand that ORR's proposals ensure that Network Rail is funded for the rate of FIM fee that it will actually pay within a period. We are clear that this must be the right principle. Since this was not the case in CP4, DfT would like to understand whether the benefit received by Network Rail from being over-funded for the FIM fee in the prior period should be returned to funders to ensure that this value is not left stranded in Network Rail.

***Q4.3: What are your views on our proposal to take account of the cost of embedded debt in our forecast of efficient financing costs?***

DfT supports ORR's proposal to allow for efficiently incurred embedded debt costs. We also consider it important that ORR allows for forward looking interest costs that are based on Network Rail financing itself as efficiently as possible.

***Q4.4 What are your views on how we are proposing to assess financial sustainability?***

We agree with ORR on the importance of financial sustainability. However, given Network Rail's current financing arrangements and how these are being addressed through the 'Adjusted WACC' approach, we would like to understand further how credit ratings agencies' financial ratios tests can be meaningfully applied to inform this assessment.

***Q4.5 What are your views on our proposal to keep the introduction of the adjusted WACC approach as simple and transparent as possible by calculating efficient***

***financing costs on a cash basis and by taking the normal regulatory approach to indexing the whole of the RAB?***

Whilst we agree that the approach adopted should not be excessively complicated, we have concerns that the approach proposed by ORR may risk double counting the effect of inflation and may leave Network Rail with significant surplus value. It may also cause an unjustified divergence between debt and RAB with adverse long term consequences for the credibility of the latter and for the meaningfulness of the indebtedness limit. We would ask ORR to consider this issue further and explore whether a relatively simple adjustment to the RAB should be implemented that would ensure that Network Rail were not funded twice for the inflation on its nominal debt.

***Q5.1: What are your views on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation?***

DfT agrees with ORR's proposal.

***Q5.2: What are your views on our proposal not to index renewals for changes in input prices and how should we take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient?***

We agree with ORR's proposals to move away from the use of IOPI to index renewals costs.
We recognise the difficulty in determining the efficiency of renewals underspend. We would, however, advocate caution in removing the distinction between efficient and inefficient underspend, due to the effect this could have on Network Rail's incentives to defer renewals spend.

***Q5.3: What are your views about legacy debt and RAB?***

DfT does not see the case for adjusting Network Rail's actual debt levels to achieve some notional position, nor for paying down Network Rail's debt in such a way. If in future such a requirement were to arise as a result of an industry reform initiative, it should be evaluated at that time and in that context.

***Q5.4: What are your views on our proposal to keep using the opex memorandum account?***

DfT is supportive of ORR retaining this mechanism.

***Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?***

On balance, DfT considers that ORR should retain its current approach to allowing for corporation tax.

***Q7.1: What are your views on our proposal to allow part of Network Rail's income to be provided directly by the governments through a network grant, which will be set ex-ante for each year of CP5?***

DfT is strongly supportive of ORR's proposals for the reasons the consultation paper sets out.

***Q7.2: What are your views on the activities that Network Rail should be allowed to carry out?***

DfT intends to engage separately with ORR and other parties on this issue, in light of any proposals which emerge from Network Rail.

***Q7.3: What are your views on increasing the strengths of the incentives on Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination and should we consider more heavily incentivising genuine 'game changing' initiatives?***

DfT looks to ORR to take the lead on the correct structures of management incentives, and how these should be balanced against corporate incentives. To maximise the efficiency improvements achieved, DfT considers it essential that the rail industry collectively is strongly incentivised to out-perform the regulatory efficiency target. For Network Rail, ORR may wish to consider how far this is best achieved through the corporate incentives on the company, and how far through the company's management incentives, the structure of which are themselves subject to ORR oversight.

**Nick Bisson**
**Director – Rail Policy**
**Department for Transport**