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Go-Ahead

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Office of Rail Regulation
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25 September 2012

Dear Richard,

Periodic Review 2013: ORR consultation on financial issues for Network Rail in CP5

Thank you for the opportunity to respond to the consultation on financial issues for Network Rail in CP5. This letter constitutes the Go-Ahead Group's response and also represents the views of London Midland, Southeastern and Southern Train Operating Companies.

I confirm no part of this response is confidential and can be published on your website.

The high level financial and incentive framework for CP5 has already been set out in an earlier published document by the ORR and this consultation is focused on some of the more detailed issues relating to Network Rail's financial framework. Nevertheless, our comments in response to the specific issues raised in this consultation are clearly very closely interrelated to the overall financial and incentive framework for Network Rail that will be put in place for CP5 and are difficult to treat in isolation.

As an operator of rail franchises, successful delivery of our services and meeting our obligations to our customers, industry funders and wider stakeholders is dependent also on the successful delivery of the required outputs for Network Rail established by the regulatory review process. The funding framework is a key element of the outputs that should be delivered, the incentives for delivery and the behaviours that these will create. Looking forward, potential future industry reform including alliances between operators and Network Rail routes and the REBS proposals, will further increase the relationship between franchises and Network Rail's financial performance and influence decisions relating to the allocation and management of risk.

We address each of the specific questions raised in the consultation below but there are a number of more general points we would wish to make which set the overall context for the specific issues raised.

Each of the specific financial issues raised in the consultation provide individual incentives to Network Rail that should ensure focus on meeting the required outputs and influencing behaviours. However, the overall CP5 determination will have a more significant impact than all the individual issues combined. That is not to say the issues raised are not relevant or the creation of individual incentives is not the right approach, but the overall delivery of CP5 outputs and the incentives and behaviours will be significantly greater influenced by the overall settlement. Therefore, where the overall CP5 final determination ends is of greater importance. As this determination has not yet been made it is difficult to judge the impact of individual elements. Furthermore, the impact and effectiveness of financial incentives must be set in the context of the unique corporate structure of Network Rail, which operates without the usual pressure exerted by external shareholders in holding the financial performance of the business to account.

Given that the overall CP5 settlement is the biggest influencer of outputs and behaviours, in considering the impact of specific elements we are of the opinion that each incentive needs to be considered in relation to:

- Is the incentive clear, focused and easy to understand, unless this is the case it will not drive behaviour and will become a mechanistic technical accounting procedure only;
- The relationship between all other elements and incentives, both those raised in this consultation and others proposed as part of the regulatory review, for example REBS, to ensure their interrelationships are understood and the avoidance of any conflicting or perverse outcomes though the impact of one upon another.

As this consultation is only one part of the overall process, it is difficult to comment further but we have some concerns that potentially unnecessary complexity is being introduced that will have at best marginal impacts, for example the inflation adjustment mechanism.

It is essential that the financial framework and incentives are fully aligned with the output framework (subject to a separate consultation).

We would like to highlight question 3.4 which relates to the treatment of electric traction (EC4T), this issue is also subject to a separate consultation that has recently been issued by Network Rail. We intend to submit a detailed response to the issues raised in that consultation therefore we do not go into detail in this submission, however we would iterate the importance of this issue.

Q3.1 The ex-ante assumption proposed would transfer financial risk to Network Rail as there will not be yearly adjustments in CP5 and the difference between assumed inflation and actual inflation would be logged in CP6 creating further risks in the next control period. It would be helpful to have sight of the study that will be commissioned to consider the inflation risk that is controllable by Network Rail and the assessment as to how it manages inflation risk before we comment further. Overall our initial view is that the proposal introduces a level of risk to Network Rail and TOCs without a commensurate benefit and the proposal is a departure from the standard regulatory approach. We would favour the continuation of index allowed revenue each year for movements in RPI as it is difficult to evaluate at this stage as to the incentive effects of an ex-ante approach.

Q3.2 If the expectation remains that Network Rail will not issue unsupported debt in CP5 it would seem unnecessary to provide them with an in-year risk buffer.

Q3.3 We are in agreement to the approach of removing specific re-openers and agree with the proposal in paragraph 3.49 of the consultation document.

Q3.4 The proposed treatment of traction electricity would be appropriate as it provides a greater incentive for Network Rail to manage aspects which it can control such as transmission losses. Network Rail presently does not have an incentive to encourage the creation of an efficient transmission network. It is important to include the transmission network with a view to growth in the RUS documents which do not have any plans in them on power usage.

We note that Network Rail have recently published a separate consultation on traction electricity and electrification asset usage charges in CP5. We intend to submit a detailed response to the issues raised by Network Rail in their consultation and this response should be considered in conjunction with the issues raised in this consultation.

We agree with the proposal on business rates.

We agree with the proposal on industry costs and agree with extending this to the licence fee.

Q3.5 We agree that the maximum level of financial indebtedness (as measured by the actual debt/RAB ratio) should at no point exceed a limit set between 70-75% in CP5 as it is necessary to provide a balance sheet buffer.

Q4.1 The handling of an industry reform initiative should take into account an adjustment of Network Rail's allowed revenue which either is taken into account in CP5 using a reopener. Less material changes can be made using an adjustment to the opening RAB for CP6.

Q4.2 We agree that the FIM fee should be set to reflect a long-run view of the credit enhancement that Network Rail is provided with as it is consistent with the way that the full cost of capital is calculated.

Q4.3 It would be appropriate to take account of the cost of embedded debt in the forecast of efficient financing costs as this provides a realistic overview of the capital cost and is consistent with the approach of WACC. We agree with the approach that only embedded debt that was efficiently incurred should be taken forward.

Q4.4 We have no comments to add to the proposal.

Q4.5 We agree with the proposal to keep the introduction of the WACC approach as it provides the full cost of capital against the efficient financing cost determining an indicator of the revenue requirement for Network Rail.

Q5.1 The treatment of reactive maintenance costs as operating and maintenance costs would be appropriate as it will provide transparency with Network Rail accounts and regulatory accounts. This alleviates the need for Network Rail to provide a reconciliation between the two sets of accounts. Given that railway infrastructure assets are long-life assets we agree with the period of 30 years for the amortisation calculation.

Q5.2 We have no comments on this proposal.

Q5.3 We view this as a discussion for the DfT and Network Rail.

Q5.4 For the purposes of transparency and consistency we agree with the proposal to keep using the opex memorandum account.

Q6.1 We have no comments on this proposal.

Q7.1 In driving incentives and behavioural change, we believe the balance of Network Rail's income should be routed via train operators rather than paid directly to Network Rail via Network Grant. This would create stronger incentives through reinforcing the role of train operators as the customers of Network Rail and would increase our ability to manage Network Rail in line with the normal commercial pressures faced by regulated industries, however we understand the reasons why the ORR has chosen to retain the Network Grant approach.

Q7.2 Providing Network Rail is delivering its core activities, and is not distracted from carrying out these activities, we have no strong views as to the activities that Network Rail should be allowed to carry out.

Q7.3 There needs to be more clarity between normal efficiency savings and outperformance, what those incentives might be and how you can realistically incentivise a company with Network Rail's corporate structure.

Please do not hesitate to contact me if you want to discuss any of the issues raised in the consultation in further detail.

Yours sincerely

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