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OFFICE OF RAIL REGULATION

6 August 2008

Ron Henderson
Group Finance Director
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Dear Ron

Periodic Review 2008: Corporation tax issues

Introduction

1. The 2008 periodic review (PR08) will determine Network Rail's regulated outputs, revenue requirement and access charges for control period 4 (CP4), 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. The June 2008 draft determinations document published on 5 June 2008 and previous consultation documents[1] outlined our approach to corporation tax and in particular explained that we will provide Network Rail with a specific ex-ante corporation tax allowance. We explained that this will represent a change in our corporation tax policy from the policy used in the access charges review 2003 (ACR2003)[2] which, in our view, would lead to Network Rail being paid twice for future corporation tax liabilities unless we make an adjustment to account for this double count.

3. This letter provides details of our calculation of the adjustment for the double count, the methodology for calculating the corporation tax allowances in CP4 and our approach to the roll forward of corporation tax balances into control period 5 (CP5).

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1 For example, *Periodic review 2008: Financial issues update and further consultation*, Office of Rail Regulation, September 2007. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/pr08-financial-issues-let-060907.pdf.

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

Adjustment for the change in tax policy

4. The level of the allowed pre-tax return is clear for each year of control period 3 (CP3) but not all of the individual components of the weighted average cost of capital (WACC) used to determine the allowed pre-tax return were explicitly identified by us in ACR2003. Therefore, the CP3 allowance for corporation tax needs to be estimated and we appointed First Economics to calculate the estimate.

5. First Economics has derived a central estimate and a range for the estimated allowance for corporation tax. Annex A includes First Economics' methodology and Annex B includes First Economics' detailed calculations. In summary, they estimated the allowance for corporation tax by rearranging the standard WACC formula and using the ACR2003 assumptions for the allowed return and estimates of gearing and the cost of debt. In simple terms, that is equivalent to:

(a) First, taking the allowed pre-tax return (i.e. the WACC) in each year of CP3. This is 7.0% for the first two years of CP3 and 6.5% for the remainder of the control period.[3] The allowed pre-tax return will include a grossed up cost of equity that includes an implied "tax wedge" i.e. an allowance for corporation tax.

(b) Then, assuming a level of gearing of on average 71% for the central estimate. This assumption is the one used in the ACR2003 joint financial model for ACR2003 and is based on Network Rail's actual level of debt instead of a notional level of debt that is typically used by other regulators in determining the WACC of price controlled companies.[4]

(c) Then, making an assumption of the cost of debt. In the central case, First Economics assume that the real pre-tax cost of debt is 3.25% which was Network Rail's assumed financing cost used in the ACR2003 joint financial model.[5]

(d) Then, deducting the assumed cost of debt from the pre-tax cost of capital to derive an estimated pre-tax cost of equity. The resulting pre-tax cost of equity in real terms for the central estimate is on average 14.6%.

(e) Then, multiplying the estimated pre-tax cost of equity by an assumed corporation tax rate of 30%, which was the corporation tax rate used in the

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[3] These rates are on an annual basis. In their calculation, First Economics use the semi-annual rates used to determine Network Rail's revenue requirement in ACR2003.

[4] If you assume a lower gearing level then the estimated corporation tax allowance would be higher. Notional gearing levels used by other regulators at the time were typically lower than First Economics' central assumption.

[5] See paragraph 13.4 and 13.9 of *Access Charges Review 2003: Final conclusions,* Office of Rail Regulation, December 2003. This document can be accessed at http://www.rail-reg.gov.uk/upload/pdf/184.pdf.

ACR2003 joint financial model. The resulting estimated corporation tax allowance in total for CP3 is a range of £1,235m to £1,760m, with a central estimate of £1,570m.[6]

6. After calculating the estimated corporation tax allowance, the corporation tax payments forecast for CP3 should be deducted to obtain the estimated corporation tax double count, but no corporation tax payments were forecast in the ACR2003 joint financial model, so we have not made an adjustment.

7. We think that First Economics' estimate of £1,570m for the estimated corporation tax allowance is a robust estimate. However, given that the estimate is based on a number of assumptions and that ultimately the corporation tax allowance for CP3 was not explicit, it is appropriate for us to be cautious. Therefore, we have assumed that the double count is £1,300m, which is at the low end of First Economics' range.[7]

8. This amount will be held on account and will reduce every year by the amount of corporation tax that we estimate would be payable by Network Rail, until the balance on the account reaches zero. After that, we will fund Network Rail's efficient corporation tax payments through the regulatory tax allowance.

The methodology for calculating the corporation tax allowances in CP4

Overall approach

9. We have reviewed Network Rail's forecast corporation tax payments and had a number of discussions with the company. In summary, our approach to forecasting Network Rail's corporation tax payments is to forecast Network Rail's income and its profits chargeable to corporation tax and therefore corporation tax payable. This involves using a conventional approach for the calculation of the adjustments to convert profits for accounting purposes to profits subject to corporation tax, such as substituting capital allowances for amortisation, etc.

10. We have largely used Network rail's forecast for 2008-09 to obtain the opening position at 1 April 2009. We will review this forecast for our final determinations in October 2008 and ensure it is consistent with any other changes we make, after reviewing Network Rail's latest forecast for 2008-09.

Disaggregation

11. For the purposes of calculating Network Rail's allowance for corporation tax, we have calculated corporation tax separately for England & Wales and Scotland. This is consistent with our approach to disagregation as explained in our work to support

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6 These estimates are in nominal prices. ACR2003 used 2002-03 prices. First Economics converted 2002-03 prices into nominal prices for each year of CP3.

7 This amount is in nominal prices.

devolving responsibility for rail strategy and funding in Scotland to Scottish Ministers.[8]

12. The opening corporation tax balances at 1 April 2009 have been derived for England & Wales and Scotland by splitting the corporation tax balances at 1 April 2006, based on the 1 April 2006 RAB split between the geographic areas. These balances are then rolled forward using the latest income and expenditure forecasts for England & Wales and Scotland. This is consistent with our disaggregation of the RAB and net debt between England & Wales and Scotland.

13. The metrics we have used to allocate corporation tax balances/adjustments between England & Wales and Scotland for the period after 1 April 2006 are similar to those used to derive the opening CP4 RAB position and also used for the allocation of operating, maintenance, renewal and enhancements costs.

14. The table below shows the regulatory tax allowances for Great Britain per our June 2008 draft determination document. We will update these numbers in our final determinations in October 2008.

Table 1: June 2008 draft determinations - regulatory tax allowances for Great Britain

Year	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**Total**
Regulatory corporation tax payable	**9**	**0**	**12**	**11**	**9**	**41**
Adjustment for corporation tax double count	(9)	(0)	(12)	(11)	(9)	(41)
CP4 corporation tax allowance	**0**	**0**	**0**	**0**	**0**	**0**
Corporation tax double count account carried forward	1,291	1,291	1,279	1,267	1,259	

Roll forward of corporation tax balances into CP5

15. We have said in previous documents that the corporation tax allowance we provide for Network Rail will be on an ex-ante basis. This means that we will

8 *ORR's approach to regulation in Scotland: Conclusions*, Office of Rail Regulation, December 2005. http://www.rail-reg.gov.uk/upload/pdf/267.pdf.

calculate ex-ante as part of PR08 what the corporation tax allowance will be for CP4, and we will not change the allowance for CP4 if Network Rail's actual position during CP4 is different. We also need to decide what the approach will be for determining the opening corporation tax balances for CP5.

16. In deciding on our approach, we need to consider the balance between risk and incentives. For example, if a company outperforms the determination by £100 and an ex-ante approach has been adopted then the corporation tax the company will pay on the outperformance will not be reimbursed by the regulator so the net benefit to the company is say £72.[9] If a company underperforms the determination by £100 and an ex-ante approach has been adopted then the reduction in corporation tax, as a result of the underperformance, will not be clawed back by the regulator so the net cost is say £72. Using an ex-ante approach therefore reduces the net incentive to outperform but is less risky as the company's downside is reduced.

17. If we adjusted the opening corporation tax balances at the next control period for actual income and expenditure, then in the above example the taxation effects of the outperformance or underperformance would be adjusted for, so the company would retain all £100 of the outperformance and lose all £100 of the underperformance. Therefore, the overall incentive is higher when the corporation tax opening balances at the next control period are adjusted for actual income and expenditure but also risk is higher.

18. Network Rail, given its forecast brought forward corporation tax losses at the start of CP4, is not forecasting to make significant corporation tax payments until well into CP5 or control period 6. Also, the impact of our policy on the CP3 double count of corporation tax means that we are not providing any funding for corporation tax in CP4. Therefore, the incentive effect on Network Rail of our corporation tax policy could be significantly diluted in the short to medium term but we still need to determine an appropriate policy, consistent with our overall approach to risk and incentives in our draft determinations.

19. The allowances for income, operating costs, maintenance costs, interest costs and corporation tax[10] were set on an ex-ante basis in our June 2008 draft determinations, and so Network Rail will bear the costs of an overspend and benefit from outperformance. Consistent with this approach, we are proposing that we will not adjust the roll forward of corporation tax balances for variances from our determination in income, operating costs, maintenance costs, interest costs and corporation tax.

20. For renewals and enhancements, the June 2008 draft determinations document outlines the various protections we are planning to introduce to protect Network Rail

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[9] This assumes a corporation tax rate of 28%.

[10] This means changes in corporation tax excluding the underlying differences in income and expenditure e.g. if a capital allowance rate changed.

from efficiently incurred overspend. We are proposing to adjust the roll forward of corporation tax balances for those variances against the determination in renewals and enhancements spend which we have agreed to log up to the RAB. This will mean that our approach to the roll forward of corporation tax balances for variances in renewals and enhancements spend will be consistent with the approach taken to the roll forward of the RAB.

21. We welcome comments on any issue raised in this letter. We will take them into account in determining our final conclusions on the Periodic Review 2008 in October 2008. If you would like to discuss any of the issues in this letter, please contact Carl Hetherington (Head of Regulatory Finance) on 0207 282 2110.

22. Please can you send your views on the issues we have raised in electronic format (or if not possible, in hard-copy format) by Thursday 4 September 2008 to:

Linda Smith
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London WC2B 4AN
Tel: 020 7282 2066
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23. It would be helpful if your response is sent in electronic format. 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.

24. 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

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