railfuture

Campaigning by the
Railway Development Society Ltd

please reply to:
'Clara Vale'
Thibet Road
Sandhurst
Berkshire
GU47 9AR

chris.page@railfuture.org.uk

Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

For the attention of Richard Fitter

richard.fitter@orr.gsi.gov.uk

26th September 2012

Consultation on financial issues for Network Rail in CP5

Dear Sir,

We are pleased to submit this consolidated national response on behalf of ***rail**future*, which has been prepared by the Policy Group, with contributions from individual branches and groups. The document has been reviewed and approved by the Group.

Railfuture is a national voluntary organisation structured in England as twelve regional branches, and two national branches in Wales and Scotland.

We support the concept of simplifying regulation, aligning incentives and focussing on customers to move Network Rail toward the long-term goal of operating as a self-financing commercial business.

If you require any more detail or clarification please do not hesitate to get in touch.

Yours faithfully

Chris Page

Chris Page
Railfuture
Policy Group

Response to the Consultation on financial issues for Network Rail in CP5.

Risk and uncertainty

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?

The deadband set around the ex-ante assumption used for indexing inflation should be assymetric to encourage Network Rail to use its purchasing power to drive down costs, rather than accept input costs (prices, salaries and interest) increasing at the prevailing rate of inflation. The RAB should be indexed by actual inflation, but since the RAB represents the value of Network Rail's physical assets (which are the products of construction not retail purchase), this calculation should use the IOPI or COPI measure of inflation, not RPI, to more accurately reflect the effective rate of inflation on their value.

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

An in-year risk buffer would effectively duplicate contingencies held in project and operational budgets and so would encourage Network Rail to use the contingencies rather than working more efficiently, so we agree that it should not be provided.

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?

Removing the specific re-openers move Network Rail closer to operating as a normal commercial business, so we agree. The proposal should recognize that Network Rail is at risk of political changes and massive capacity demand changes, which could trigger a reopener as a material change in Network Rail's circumstances.

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

We would question whether Network Rail has sufficient control over BT Police and RSSB costs to justify Network Rail taking the financial risk for them.

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?

This is equivalent to a debt/equity ratio of 3:1, which would be a high level of gearing for a normal commercial business and is only justified by the relative stability of the business and the government backing for the debt.

Cost of capital issues

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

A reform which had a significant impact on Network Rail's scope or financial position would be handled by a reopener. For simplicity, any other reform should proceed without any change to the financial controls.

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?

If a long-term view were not taken, the FIM fee would potentially need to be reviewed each year to reflect changes in commercial interest rates.

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?

If the interest rates which apply to embedded debt were determined before regulation based on efficient financing costs was introduced, then Network Rail did not have the opportunity to manage this debt efficiently and so the full cost of this debt should be included in the calculation of efficient financing costs.

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

The proposals for assessing financial sustainability do not recognize the need for sustainability through future control periods. If gearing continues to increase, then in future control periods either the 75% limit will have to be reset, alternative means of funding (eg equity or unsecured debt) will be required, or financial performance will have to be improved. The assessment of financial sustainability should also measure the trend and identify when further financial performance improvement initiatives are required.

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?

The use of the full cost of capital for investment appraisal of non-HLOS proposals puts the business case of non-HLOS rail development opportunities at a disadvantage when compared to road developments which would benefit from the interest rate advantage of direct government borrowing. We believe all transport developments should be appraised on a level playing field.

If Network Rail were operating as a normal commercial business without receiving the network grant, it would be operating at a loss. In that scenario it would not be paying a dividend on its 'equity surplus', and would be unlikely to be able to borrow commercially to fund its deficit – so it would require a capital injection from its equity stakeholders. Therefore a fairer WACC calculation would be to treat the network grant to NR as a capital injection at a zero cost of capital, and not to deduct the equity surplus from the allowed return, until improvements in efficiency paid for by the investment from NR's equity stakeholder (the government) has moved Network Rail into profitable operation.

Amortisation and RAB related issues

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?

Maintenance should be treated as opex not capex.

The approach of keeping amortization in line with long run renewals does not take account of growth in the network – it effect, the cost of enhancements is not depreciated over time. Taking account of expected future renewals efficiency effectively assumes that current renewals will last longer, as the cost of previous renewals is depreciated more slowly. Both factors have the effect of making the RAB higher than it should be, ie higher than the real value of the network, which over time will threaten financial sustainability.

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?

A method of quantifying the life extension of assets achieved by renewals is necessary. The efficiency of renewals can then be calculated as the ratio of life extension to cost of renewal.

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

Non capex legacy debt should form part of debt but not part of RAB, as it does not form part of the value of the network.

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

Non-capex spend should not form part of RAB so we support this approach.

Corporation tax

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

Regulation should move toward treating Network Rail as a normal commercial business, so where NR is taking the risk or opportunity on cost or revenue, it should take the related corporation tax liability or gain.

Whilst we would like to see Network Rail moving towards operating as and being treated as a commercial business, we would like the extent of taxes and loan guarantee fees paid by Network Rail to government to be made public. We understand that this figure is substantial, approaching £1bn per year and set to increase as Industrial Buildings tax is resumed and as rebates on past corporation tax losses run out. Public awareness of this figure would help to allay concerns about the extent of public support for the railway industry.

Other financial issues

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?

The network grant provided to TOCs should equate to the subsidy required for the TOCs to operate profitably and pay a fair rate for access charges. The network grant provided directly to Network Rail should equate to the capital investment required to improve NR's financial performance so that at some point in the future it can operate as a commercial business on a self-financed basis, plus the subsidy required to offset the inefficiencies in its current financial performance.

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

Changes to achieve a level playing field should not have the effect of making projects more expensive, either in financing or resource costs.

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?

Initiatives which will significantly and profitably increase demand for rail transport and provide the capacity to meet that demand should be incentivised, and investment assessed on a level playing field with other modes of transport.