Richard Owen (cc Cathryn Ross)
Office of Rail and Regulation
One Kemble Street
London
WC2B 4AN

Kings Place
90 York Way
London
N1 9AG
T 020 7557 8000

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Dear Richard

Network Rail's Response to ORR's 'Incentives' Consultation

ORR's 14th December 'Incentives' consultation discusses how to finance Network Rail in CP5. This is a very important issue for Network Rail and we recognise the affordability issues for our funders.

In CP4 Network Rail was financed in the same way that almost all other regulated companies are in the UK. This traditional method involves funding the company for the full risks that it faces.

In practice this means that the cost of capital used to calculate the allowed return for CP4 for Network assumed an equity component of c.40% even though we are currently 100% debt financed. Reflecting the fact that the company does not pay dividends, equity returns in CP4 are then used to fund part of the company's capital investment program (through the ring-fenced fund). This device has considerable merit as it maintains the appropriate financing approach for the company whilst at the same time using equity returns to reduce the cost of investments in the network. It also means that different ways of financing the company are left open, such as raising unsupported debt.

As we state in our response to ORR's consultation we consider that it is very important that the risks that Network Rail faces are fully reflected in its allowed return (i.e. in its cost of capital). In addition to this being consistent with regulatory practice, it should also mean that the cost of financing the company is consistent and stable across control periods. In its consultation, ORR discusses changing the financing of the company (temporarily) to our cost of debt i.e. excluding and imputed equity

component. We consider that this would create a temporarily cheaper way of financing the company but purely at the cost of higher debt and longer term increased financing costs.

We recognise that funders may wish to consider other ways of using the company's equity returns, for example by way of a dividend or rebate mechanism. We would be open to discussing these. However, the cost of this option would be very similar to the current approach of using equity returns to pay for capital investments.

Our response to ORR's consultation noted that we would be submitting a separate paper written by Oxera discussing allowed returns for other regulated companies, including those with similar ownership structures to Network Rail. That report is attached to this letter.

The paper takes quite a thorough look at how other regulators address the issue of the cost of finance.

We hope that this note is helpful for ORR in its consideration of this issue. We would be very happy to discuss this matter further.

We are content for this letter and the OXERA note to be published in full on your website.

Yours sincerely

Peter Swattridge
Head of Regulatory Economics