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Dear Jon

Policy Framework For Investments

Firstly I apologise that this response to your letter of 2 March is issued slightly later than your 27 April deadline. Nonetheless there are a number of areas upon which we would like to comment; these are set out below.

We welcome the fact that ORR seeks to facilitate investment in the railway by addressing barriers to the delivery of efficient investment. One of the most significant such barriers relates to the residual value risk associated with investment in assets whose useful economic life is considerably longer than the remaining length of a TOC's current franchise. This can be true notwithstanding that pay back is achieved within the franchise term.

This barrier to investment is removed if, and to the extent that, charges payable to Network Rail are lower in present-value terms than the cost to the TOC were it to bear the full capital and OM&R expenditure itself. If this is not the case, then the TOC would incur lower costs by avoiding addition to the RAB and accepting the residual value risk.

"Self-Financing" Schemes and Use of the RAB

In this regard, there are a number of features of the RAB financing model that may mitigate against delivery of ORR's objectives:

- Payment of the capital costs, together with Network Rail's cost of capital and OM&R expenditure inherently results in higher cash outflows from TOCs over the life of the asset.
- The 6.5% financing charge, applied to the reducing capital balance outstanding, implies payments to Network Rail that are high in the early years of an asset's life, gradually reducing over time. The result is that the TOC sponsoring a scheme will pay a disproportionate share of the overall cost relative to future franchise operators for similar benefits. It is unclear to us how this will incentivise the sponsoring TOC from making the investment.
- Section 29(d) of your document could be read as requiring Network Rail to recover the capital costs over a maximum of 15 years. If this is the intention, then it is inconsistent with the sample spreadsheet at Annex C, which uses a period of 30 years.

- Moreover, the use of a standard number of years is not appropriate to the wide variety of assets that could be added to the RAB. Certain buildings, for example, may well have a life in excess of 50 years, and it would be inappropriate to charge sponsoring TOCs on the basis of depreciating over 30, 15 or a shorter number of years.
- We note also Network Rail's suggestion that the relevant period should be the payback period if this is shorter than 15 years. Self-evidently this destroys a financial business case for the TOC, which exists on the presumption that the payback period will indeed be shorter than the useful life of the asset concerned.
- Finally the model in Annex C suggests that the future sums payable from the TOC to Network Rail will attract RPI indexation. This we find difficult to understand recognising the underlying nature of the financial amounts involved, namely depreciation and financing of an initial capital investment.

Other Policy Issues

Incremental OM&R

We note the proposal in section 52 that the TOC should pay additional OM&R charges for the life of the enhanced asset. We assume the intention is that the TOC will only incur the annual charges for the duration of its present franchise.

Accelerated Renewals

We welcome the recognition that accelerated renewals should be taken into account in setting future Network Rail charges. We would only comment that in practice, our experience has been that agreeing this element with Network Rail has not been straightforward.

We would be happy to clarify any part of this response if this would be helpful.

Kind regards

Yours sincerely



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Business Planning Manager