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Dear Richard

ORR's Industry Letter: Indexing access charges in CP5 to take account of inflation

I am writing in response to the industry letter that ORR published on 13 June, which discussed a potential new approach to indexing access charges in CP5 to take account of the inflation that Network Rail is exposed to in its cost base.

Network Rail welcomes ORR's letter and the opportunity to provide some initial comments prior to the formal consultation on the matter in ORR's CP5 implementation consultation, which we understand will be published on 12th July 2013. We also welcome ORR's fresh thinking on this important policy issue.

The comments, set out below, should be taken as initial observations by Network Rail. Because of the relatively short period afforded stakeholders to respond to the letter, we reserve the right to revise our views when ORR formally consults on the matter.

Background

Inflation over the five years of a control period is a very significant issue for Network Rail, given the size of our cost base. By way of illustration, ORR's consultants CREDO estimate, in its PR13 study, the impact of cumulative general price inflation accounts for c.£1bn of Network Rail's total CP4 expenditure.

As ORR notes in its Draft Determinations, Network Rail like all other companies cannot significantly control the impact of general inflation on its cost base. It is, therefore, very important that the chosen annual charges uplift mechanism accurately reflects the general inflationary pressures we face on our input costs when calculating the prices that are charged to our customers.

Historically, outturn inflation is impossible to forecast accurately. Therefore, in setting access charges each year, a lagged approach has been used to uplift charges to reflect cost inflation, as ORR notes in its letter.

Initial feedback on ORR's proposals

Accurately forecasting inflation is never easy, and with the current heightened financial uncertainty it appears even more challenging than normal. We consider that if inflation is 'lumpy' during CP5, ORR's proposed 'true-up' approach could, therefore, have merit in providing a more appropriate level of charges to match our cost base during the control period.

We also note the feedback that ORR reports receiving from freight and passenger train operators. ORR considers that this feedback suggests that train operators may prefer the annual average approach discussed in ORR's letter, as it smoothes the effects of inflation. We are, of course, mindful to the preferences of our customers.

We also see the potential logic in ORR considering bringing the freight and passenger charges regimes into line. This would be a small step in simplifying the railway charging regime, which should be welcomed.

Points for ORR to consider

The illustrative examples in ORR's note are very useful. However, we consider that ORR should be clearer (for example in Table 2) about the methodology for uplifting the cost base from its Final Determination into opening year access charges (to get from 2012/13 prices to 2014/15 prices). The proposed 'true up' approach could start in this opening year adjustment with a forecast of outturn cost inflation for the two years to December 2014 (i.e. from 2012/13 to 2014/15) – both of which will not be 'known' at the time that ORR is likely to require final price lists to be published for the first year of CP5.

We note that ORR is proposing applying its 'true up' approach to all access charges, including FTAC. The current methodology for uplifting FTAC annually for the impact of inflation in our cost base (in Track Access Agreements) is different to that used for passenger and freight variable charges (instead of using year-on-year changes in RPI, it is based on the difference in RPI in the previous year and 2008). It would be helpful if ORR recognises that this approach could also be addressed if ORR decides to make changes to adopt a different approach in CP5.

Network Rail is concerned about the impact of any change-over of approach from that used in CP4 for passenger access charges annual uplifts, to that proposed by ORR. The fact that the current regime applies actual inflation 'November to November' whereas the proposed approach uses an annual average could lead to a mismatch at the start and end of the control period. As ORR notes in its letter there is a risk that the December 2013 inflation could factor in any mismatch resulting from any change-over.

It appears to Network Rail that there could be a methodological error in the 'true up' approach proposed by ORR (in Table 4). In practice each year's uplift for cost inflation will be applied multiplicatively, so it appears to us that the 'true up' approach should take this into account. To illustrate the multiplicative issue, consider the simple example of prices rising by 5% in year 1 and 4% in year 2. If a charge started at 100 units, prices in year 2 should be 109.2 and not 109.0. We consider that it should be possible to tweak ORR's 'true up' approach so that it takes account of this multiplicative effect (which if left uncorrected appears equally likely to slightly 'over' or 'under' apply inflation from any mismatch between forecast and outturn inflation).

In addition, the example of the 'true up' approach, set out in ORR's note, models the impact of inaccurate forecasts of inflation by considering relatively smooth revenue streams. It could be that Network Rail's FTAC/grant is profiled to be 'lumpy' over the control period. In this case it seems possible that the 'true up' approach could lead to higher revenue discrepancies than ORR's example suggests. ORR may wish to consider this further prior to its formal consultation on the matter.

Furthermore, we consider that it would be helpful if ORR clarified how its 'true up' approach would apply at the end of CP5. We believe that ORR should be clear that the 'true up' approach would apply to the final year of CP5 with any adjustment 'flowing' into the opening year uplift for CP6.

Conclusion

We welcome ORR setting out its proposals on this issue in its industry letter. We have provided some initial observations in response, but reserve the right to add to or revise these when we respond to ORR's formal CP5 implementation letter, later in the summer. In particular, we intend to perform some analysis on the 'true up' approach during the consultation period, given the materiality of the issue for Network Rail.

We are content for this letter to be published in full.

If you have any questions regarding this response I would be happy to discuss it with you or one of your colleagues. I understand that you will shortly be leaving ORR to return to Australia. I would like to take this opportunity of thanking you for your contribution whilst at ORR and wishing you every success in your future career.

Yours sincerely

Peter Swattridge
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