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Dear Carl,

ORR's Proprosal to Set a Pre-Determined Inflation Allowance for CP5

I am writing in advance of our full response to ORR's Financial Issues consultation. The reason for writing now is that ORR's policy proposal of setting a pre-determined inflation allowance for CP5 is of such significance that I wanted to give you early sight of our views.

As I am sure you are aware, this would be a virtually unique approach in the UK with almost no regulatory precedent. For this reason, we thought you might also find it helpful to have sight of OXERA's view on this, which is enclosed with this letter.

Network Rail's emerging view

We do not accept the suggestion that this policy would somehow improve Network Rail's incentive to manage its costs. We, like all other regulated companies, have a natural incentive to beat our efficiency targets by controlling our costs. If we are able to keep any of our input cost changes below the UK general inflation level this will contribute to us meeting and hopefully beating the regulatory efficiency challenge that we have been set.

Even if one did accept the premise that there are incentive properties from setting a fixed level of indexation, the following discussion might be instructive. It seems to us that any incentive properties from this proposal could depend greatly on the level of price indexation that ORR sets. Clearly if ORR’s indexation assessment turned out to exactly match outturn inflation, there would be no effect from this policy. If ORR’s indexation level turns out to be above outturn inflation, it could be argued that the policy will have weakened NR’s incentive to manage its costs down. Conversely, if

ORR set an indexation level that turned out to be below outturn inflation, it could be argued that this would represent an additional efficiency challenge.

This demonstrates the importance of ORR setting a broadly accurate indexation level if it wishes to be ‘in charge’ of the efficiency challenge that it sets NR. It is a tough task to accurately predict inflation, especially 6 or 7 years out. The best way for ORR to set a consistent and foreseeably appropriate efficiency challenge would be to link its efficiency target to inflation by way of an RPI-X approach. It is for this reason that virtually all price controls in the UK have adopted just this approach.

This issue was discussed at ORR’s 5th September workshop. There was a suggestion from one delegate that unregulated organisations would cut costs rather than pass inflation onto their customers by way of higher prices. It appears to me that this is a *non sequitur*. If this were the case there could, surely, be no inflation in the UK.

Risk Allocation

As a matter of principle, we consider that HMG is best placed to manage inflation risk. It seems improbable that Network Rail could significantly influence inflation levels that it faces. We consider that the issue is purely one of appropriately apportioning risk between NR and our funders.

We do understand that DfT has difficulty dealing with inflation in its annual budgets as it has a cash settlement from HMT. For this reason, we do not object to the concept that ORR proposes, for practical reasons. We consider that it would be more appropriate to rationalise any such move for this reason solely, rather than as a new cost management incentive. If ORR wanted to represent NR's efficiency targets in a way that is linked to inflation, the more conventional way of doing so would be to set an RPI minus price control.

Practical Implications of this Policy

If ORR does set this policy, it is clear that we would need to have sufficient debt/RAB buffer to be able to withstand the difference between ORR's *ex ante* assessment of inflation and any adverse outturn.

You will note from OXERA's initial analysis that this policy could necessitate an additional 1 to 6% of additional debt/RAB headroom, above that which would otherwise be required. In addition, our income statement profit would need to be able to ‘withstand’ such a policy. Our analysis of the profit impact is still being considered. We will have a more developed view of this impact when we respond fully to your consultation.

Any variation in ORR's forecast and actual inflation should, we consider, be automatically adjusted at the start of CP6. We think the deadband idea set out in the consultation is likely to be too complex and would risk confusing an already intricate charging framework.

Next Steps

Given the unusual nature of this policy proposal and its potentially very significant impact on the charging framework, I would strongly urge that we meet to discuss this further over the next week or two. I would be happy to meet at a convenient time.

Yours Sincerely

Peter Swattridge
Head of regulatory Economics