**John Thomas**
**Director, railway markets & economics**
Telephone 020 7282 2025
Fax 020 7282 2041
E-mail john.thomas@orr.gsi.gov.uk

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Patrick Butcher
Group Finance Director
Network Rail Infrastructure Limited
Kings Place
90 York Way
London
N1 9AG

**Copied to: See attached list of consultees**

Dear Patrick

# Network licence review - consultation on the level of financial indebtedness licence condition

## Introduction

1. The 2008 periodic review (PR08) determined Network Rail's regulated outputs, revenue requirement and access charges for control period 4 (CP4), which runs from 1 April 2009 to 31 March 2014. Throughout PR08, we supported Network Rail's commitment to start to raise unsupported debt in CP4 and as such said that we would introduce a restriction on the financial indemnity mechanism (FIM) – the government guarantee of Network Rail's debts.

2. However, we concluded in the April 2009 review of the Network Rail licence[1] that we agree with you that conditions are not yet favourable for Network Rail to begin issuing corporate debt without the FIM. Therefore, at present, we do not propose to consult on the introduction of a licence modification to restrict Network Rail's use of the FIM. We continue to support Network Rail's commitment to raising unsupported debt when conditions are more favourable.

3. We have previously said that if we concluded it was not appropriate to restrict the FIM at this time, we would consult on whether the current financial indebtedness limits in the network licence remain appropriate. This letter represents the initial round of consultation.

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[1] *Review of the Network Rail licence,* Office of Rail Regulation, April 2009. This may be accessed at http://www.rail-reg.gov.uk/upload/pdf/network_licence_review_apr09.pdf.

## Purpose of the licence condition

4. The financial indebtedness licence condition was introduced in 2004[2] in response to Network Rail receiving the benefit of the FIM. The FIM means that Network Rail does not face normal market constraints on its ability to raise finance – it effectively faces no hard budget constraint. The financial indebtedness licence condition introduced some constraints on Network Rail's borrowing capacity and is therefore, to some extent, a proxy for the market constraints that the company would face in the absence of the FIM. The original indebtedness limits were set in the access charges review 2003[3] and it is now appropriate for us to review whether these limits remain appropriate.

5. The licence condition currently includes two types of limits. The first is a threshold – debt of Network Rail Infrastructure Finance being 85% of the value of the regulatory asset base (RAB) – which requires Network Rail to use reasonable endeavours to keep below this threshold and if it is exceeded, to provide to ORR details of the steps it intends to take to reduce the amount to 85% or below, to take those steps, and to provide to ORR evidence that it has taken those steps. There are then two absolute limits which Network Rail is prohibited from breaching. These are as follows:

- the total amount of financial indebtedness of Network Rail Infrastructure Finance (NRIF)[4] and any subsidiaries of NRIF shall not exceed 90% of the RAB; and
- the total amount of financial indebtedness of Network Rail Infrastructure Limited (NRIL),[5] any subsidiaries of NRIL, NRIF and any subsidiaries of NRIF shall not exceed 100% of the RAB.

6. We believe that this structure broadly reflects what would happen if market mechanisms were to apply. If Network Rail's financial position deteriorated, the first likely step would be for investors to increase their scrutiny of the business, requiring more information and a plan to remedy the worsening financial position. Ultimately, the financial position could deteriorate to such an extent that Network Rail's borrowing capacity would be exhausted.

## Issues to be addressed

7. We are consulting on the following issues in relation to the financial indebtedness licence condition:

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[2] See Annex B for the current licence condition.

[3] *Access Charges Review 2003: final conclusions*, Office of Rail Regulation, December 2003. This may be accessed at www.rail-reg.gov.uk/upload/pdf/184.pdf.

[4] Network Rail Infrastructure Finance is the special purpose vehicle that Network Rail has established to facilitate the licence holder's long-term debt issuance programme.

[5] Network Rail Infrastructure Limited is the holder of the network licence.

(a) the definition of net debt and RAB;

(b) the body corporate that the limit should apply to;

(c) the different types of limits; and

(d) the level of the limits.

**Definition of net debt and RAB**

8. The definitions of net debt and RAB need to be considered alongside the appropriate financial indebtedness limit.

*Net debt*

9. There are two main questions in relation to the definition of net debt.

10. First, what balances should be included in net debt? Given that this licence condition aims broadly to replicate market constraints, we believe that it is important that definitions are used which are broadly consistent with how lenders and credit rating agencies consider Network Rail's financial position but that they also take account of how we determined Network Rail's revenue requirement and considered its financeability. The main issues include:

(a) Should debt be gross or net of cash and cash equivalents (i.e. investments that are similar to cash)? It would seem to be appropriate to include cash and cash equivalents as long as they are sufficiently liquid so that they can be used to pay down debt if necessary without undue delay or loss. This is likely to be in accordance with the approach of lenders and credit rating agencies.

   Elsewhere in the network licence, in relation to considering the investments that Network Rail can hold, we refer to "… investments acquired in the usual and ordinary course of the treasury management operations …". This definition is likely to be inappropriate for the level of financial indebtedness licence condition as it may include investments which are not sufficiently liquid. It would seem to be more appropriate to use an accounting based definition of cash and cash based equivalents. This is likely to be in accordance with the approach of lenders and credit rating agencies;

(b) Should balances on financial instruments such as finance leases be included in the definition of net debt? As the obligations under these financial instruments have similar financial effects as debt obligations, in that there is an obligation to pay an amount to another party, then they should be included in the definition of net debt. This is likely to be in accordance with the approach of lenders and credit rating agencies;

(c) Should the balance include net debt held in other companies that are in Network Rail's group such as those in Network Rail's insurance company and balances in relation to de-minimis, as well as net debt held in NRIL? Ultimately, these balances are at the discretion of NRIL to use as it sees fit and reflect activities that have been included in the determination of NRIL's revenue requirement and our consideration of NRIL's financeability. Therefore, we consider that these balances should be included in the definition of net debt. This is likely to be in accordance with the approach of lenders and credit rating agencies; and

(d) Should other balances that are not included in an accounting definition of net debt such as a pensions deficit be included? It is likely that lenders and credit rating agencies would use the accounting definition of net debt in their analysis, adjusted for issues such as a pensions deficit. In this instance, we believe that including all the other balances that lenders and credit rating agencies include would not be appropriate as it would not reflect how we determined Network Rail's revenue requirement or considered its financeability.

11. The second question we need to consider is whether we should use actual debt or an assumed efficient level of debt. In the PR08 determination we said that it is more appropriate to use assumed efficient debt in the financeability assessment as this provides stronger incentives on Network Rail. However, the main purpose of this licence condition is to replicate a market constraint on Network Rail's borrowing and the market would look at Network Rail's actual financial position rather then a notional position. Therefore, overall it would seem to be more appropriate to use actual debt as the basis of the calculation.

*RAB*

12. It is important that the valuation of the RAB is the most accurate one available. Therefore, we are proposing that it will include the expected balance at 1 April 2009 and the projected expenditure, amortisation and other movements determined or forecast in PR08 amended for any adjustments in line with our RAB roll forward policy.

**Which company should the restriction apply to?**

13. The current level of financial indebtedness licence condition has two separate restrictions on the levels of indebtedness in relation to both NRIL and NRIF. Given that we are primarily interested in the total amount of debt outstanding, irrespective of which entity within the Network Rail group of companies raises the debt, it is arguable that only one limit needs to be applied to the consolidated entity. We would propose to simplify the licence condition and include a limit only on the consolidated entity.

**Should there continue to be different types of limits?**

14. Network Rail has said to us that there is no need for an absolute level of restriction for the debt to RAB ratio in addition to the lower threshold that requires Network Rail to produce and implement a recovery plan for reducing the ratio below that threshold. Network Rail makes the point that there is a single level of the debt to RAB ratio upon which the company should be acting. Given that failure to produce and implement a recovery plan at the lower threshold could trigger enforcement action (including a fine) and

ultimately the threat of licence revocation, Network Rail says that an additional higher threshold adds nothing useful to this. We think that Network Rail's arguments have some merit and that we should retain only the lower threshold in the licence.

**Level of indebtedness**

15. Network Rail's debt to RAB ratio was forecast in our final determination to reach a maximum level of 63.5% during CP4. Since then inflation and expenditure forecasts have changed and we now estimate that Network Rail's debt to RAB ratio will reach a level of around 66.4% during CP4.[6] Our revised forecast for CP4 includes £3bn (in 2006-07 prices) additional capital expenditure not included in our PR08 determination, consisting of government funded investments such as Crossrail, Edinburgh to Glasgow improvements and third party investments.

16. We have considered various scenarios which could cause the debt to RAB ratio to increase beyond the forecast in paragraph 15 and which are outside of Network Rail's control. This could include lower than forecast inflation and further additional capital expenditure eligible to be added to the RAB. We believe that it is appropriate to allow for a reasonable amount of headroom in setting a debt to RAB threshold which would trigger a recovery plan, in order that some changes outside of Network Rail's control in addition to a reasonable level of overspend could be absorbed.

17. Rather than allow significant headroom in the debt to RAB ratio to protect against large variances in inflation forecasts between the PR08 assumption and the actual outturn, and further very significant capital programmes, we believe that a more appropriate approach is to retain the current provision in the financial indebtedness licence condition which allows us to consent to higher debt to RAB limits in such circumstances.

18. It is clearly not possible for us to second guess precisely at what level of financial indebtedness investors would step up their scrutiny of Network Rail and possibly require more information and remedial action to improve the position. We are also mindful that the sentiment of investors will vary according to market conditions. Nevertheless, we need to make a judgement about the level of financial indebtedness at which it would be reasonable to assume that some form of heightened scrutiny would have been applied by investors. Our judgement is that this would occur long before the debt to RAB ratio reached the existing threshold of 85%.

19. We believe that a threshold ratio between 70-75% would be more appropriate. Based on the latest projection of the debt to RAB ratio reaching a high of 66.4% in CP4, this would enable Network Rail to borrow an additional £1.5 billion (in 2006-07 prices) at the lower end of the range and £3.5 billion (in 2006-07 prices) at the upper end of the range to fund inefficient overspends that will not be added to the RAB before the threshold was reached and a recovery plan required. This is approximately 5% of Network Rail's

[6] Network Rail's CP4 delivery plan has a similar but slightly higher forecast debt to RAB ratio.

forecast expenditure over CP4 at the lower end of the range and 12% at the upper end of the range.

20. As set out in paragraph 14, we do not believe that the licence condition needs to continue to contain absolute limits. However, if consultees disagree, we would be grateful if they could state their reasons and at what level an absolute ratio should be set. Network Rail has said to us that if an absolute limit were to be set, this should be a ratio of 100% since any other level would undermine the purpose of the RAB.

## Other issues

*Other financial ratios*

21. In PR08, as well as the debt to RAB ratio, we used other financial ratios such as the adjusted interest cover ratio to consider Network Rail's financeability. To be more consistent with PR08, should we include other financial ratios such as the adjusted interest cover ratio as one of the limits in the financial indebtedness licence condition?

*Time-limited provision*

22. We believe that the revised financial indebtedness licence condition should be time-limited, with the removal of the licence condition to coincide with the future introduction of a restriction of use of the FIM.

## Feedback

23. We welcome comments on any issue raised in this letter. We will take them into account in taking forward our final proposals on Network Rail's level of financial indebtedness licence condition. If you would like to discuss any of the issues in this letter, please contact Carl Hetherington (Head of Regulatory Finance) on 0207 282 2110.

24. Please can you send your views on the issues we have raised in electronic format (or if not possible, in hard-copy format) by Friday 31 July 2009 to:

Linda Smith
Office of Rail Regulation
1, Kemble Street
London WC2B 4AN
Tel: 020 7282 2066
Email: Linda.Smith@orr.gsi.gov.uk

25. You should indicate clearly if you wish all or part of your response to remain confidential to the Office of Rail Regulation (ORR). Otherwise, we will make it available in our library, publish it on our website and we may quote from it. Where you make a response in confidence, you should attach a summary, excluding the confidential information, which can be treated as above. We may also publish the names of respondents in future documents or on our website, unless a respondent indicates that they wish their name to be withheld.

26. Copies of this document can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely

J. R. Thomas

**John Thomas**

**ANNEX A**

**List of Consultees**

Association of Train Operating Companies

Credit rating agencies

Department for Transport

Freight Operating Companies

HM Treasury

National Assembly of Wales

Network Rail

Passenger Focus

Passenger Transport Executives

Rail Freight Group

Rail Industry Association

ROSCOs

Train Operating Companies

Transport for London

Transport Scotland

Welsh Assembly Government

**ANNEX B**

## Condition 3 of the network licence – financial indebtedness

### 3 Financial indebtedness

3.1 Except with the written consent of ORR, the licence holder shall ensure that as at the end of the financial year to which the financial statements prepared under condition 11 relate:

(a) the total amount of financial indebtedness of Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance shall not exceed 90 per cent of the Regulatory Asset Base of the licence holder applicable at that time; and

(b) the total amount of financial indebtedness of the licence holder, any subsidiaries of the licence holder, Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance shall not exceed 100 per cent of the Regulatory Asset Base of the licence holder applicable at that time.

**3.2 Without prejudice to condition 3.1:**

(a) the licence holder shall use reasonable endeavours to ensure that the total amount of financial indebtedness of Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance shall not at any time exceed 85 per cent of the Regulatory Asset Base of the licence holder applicable at that time;

(b) if the total amount of financial indebtedness of Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance exceeds 85 per cent of the Regulatory Asset Base of the licence holder applicable at that time, the licence holder shall, within such time periods as ORR may notify as being appropriate in the circumstances:

(i) provide to ORR details of the steps it intends to take to reduce the amount to 85 per cent or below;

(ii) take those steps; and

(iii) provide to ORR evidence that it has taken those steps.

3.3 The licence holder shall provide, from time to time as requested by ORR and in any event every year in the regulatory financial statements it prepares pursuant to condition 11, confirmation that, in respect of the financial year to which the statements relate, it has complied, and, in respect of the following financial year, it is likely to comply, with condition 3.1 and (where applicable) with condition 3.2(b) and, if so requested by ORR, evidence in support of that confirmation.

3.4 The licence holder shall pay to the Secretary of State, at least annually, a fee in respect of the state financial indemnity.

3.5 In this condition:

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| "fee" | means the amount equal to 0.8 per cent (on an annual basis) of the daily outstanding amount of financial indebtedness incurred by Network Rail Infrastructure Finance and which is supported by the state financial indemnity; |
| "financial indebtedness" | means any indebtedness of a financial nature of the relevant entity, for or in respect of:<br>(a) moneys borrowed;<br>(b) any acceptance credit;<br>(c) any bond, note, debenture, loan stock or other similar instrument;<br>(d) any redeemable preference share;<br>(e) any finance or capital lease;<br>(f) any foreign currency derivative transaction protecting against or benefiting from fluctuations in foreign exchange rates;<br>(g) any other transaction (including any forward sale or purchase agreement) which has the commercial effect of a borrowing;<br>(h) any counter-indemnity obligation in respect of any guarantee, indemnity, bond, letter of credit or any other instrument issued by a bank or financial institution; and<br>(i) any guarantee, indemnity or similar assurance against financial loss of any person in respect of any item referred to in paragraphs (a) to (g) above,<br>and for the purposes of this condition 3: |

(a) financial indebtedness:

(i) is calculated by reference to the principal amount outstanding of any such financial indebtedness (and no mark to market value will be used to calculate its amount);

(ii) excludes any financial indebtedness between the licence holder or any of the licence holder's subsidiaries and Network Rail Infrastructure Finance or any of Network Rail Infrastructure Finance's subsidiaries;

(iii) excludes any financial indebtedness between the licence holder and any of its subsidiaries;

(iv) excludes any financial indebtedness between any of the licence holder's subsidiaries;

(v) excludes any financial indebtedness between Network Rail Infrastructure Finance and any of its subsidiaries;

(vi) excludes any financial indebtedness between any of Network Rail Infrastructure Finance's subsidiaries; and

(vii) excludes any derivative transaction other than as set out in paragraph (f) above;

(b) where financial indebtedness denominated in a foreign currency is hedged by a derivative of the type set out in paragraph (f) above, the principal amount outstanding shall be calculated by reference to the sterling amount payable under the relevant derivative; and

(c) total financial indebtedness shall be calculated net of any cash or cash equivalents held by the licence holder and Network Rail Infrastructure Finance or their subsidiaries;

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| "Network Rail Infrastructure Finance" | has the meaning given to it by condition 4.33; |

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|---|---|
| Regulatory Asset Base” | has the meaning given to it by condition 11.16; |
| “state financial indemnity” | means the financial indemnity provided by the Strategic Rail Authority on 29 October 2004 (and transferred to the Secretary of State on 26 June 2005), which is available until 2052. |