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OFFICE OF RAIL REGULATION

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Paul Plummer Esq
Director, Planning & Regulation
Network Rail Infrastructure Limited
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Dear Paul

CP4 pre-tax rate of return for the investment framework

1. For our 2008 periodic review determination, we established an allowed rate of return of 4.75%[1] to reflect Network Rail's risk adjusted cost of capital. In order to arrive at this figure we did not make any explicit point estimate assumptions regarding the individual debt and equity components of the allowed return.

2. As you know, we have changed our approach at periodic reviews to remunerating Network Rail for its expected tax liabilities such that these will no longer be provided through a tax wedge included in the cost of capital. Instead, you will be provided with a specific allowance for tax based on forecast efficient tax liabilities during the control period.

3. However, this approach does not adequately deal with third party investments undertaken during a control period but which were not included in the most recent periodic review determination. Using the allowed return of 4.75% to calculate charges for these investments would not provide you with sufficient revenues to pay future tax liabilities associated with these investments (unless remunerated through charges or grants at future periodic reviews) whilst earning your full risk adjusted cost of capital.

4. The simplest way of dealing with this is for you to use an equivalent pre-tax cost of capital to calculate charges associated with third party investments undertaken through the investment framework. We therefore need to make some plausible assumptions about the different components of the cost of capital to convert the 4.75% vanilla cost of capital to a pre-tax cost of capital.

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[1] Vanilla post-tax weighted average cost of capital.

5. We have revisited the ranges for the cost of debt and cost of equity that CEPA set out in the work done for us on the cost of capital during PR08. By taking reasonable spot estimates within these ranges, we have concluded that the pre-tax allowed rate of return for CP4, to be used for the purpose of the investment framework, should be set at 6.0%.

6. We continue to consider that project specific risks that require a different allowance for risk (for example, where a fixed price is offered) should be treated by varying the contingency allowed in the cost estimate for unforeseen risks rather than by varying the rate of return applied to the capital costs.

7. Network Rail will clearly want to satisfy itself that it has the capacity to finance additional investments.

8. I have copied this letter to the Department for Transport and Transport Scotland.

Yours sincerely

J. R. Thomas

John Thomas