OFFICE OF RAIL REGULATION

Regulatory asset bases

Paul McMahon, Deputy Director, Markets & Economics
paul.mcmahon@orr.gsi.gov.uk

Measuring investment in transport infrastructure, OECD
9-10 February 2012

Outline

- Some RAB basics – what it is, how it is used
- Example: Network Rail's RAB
- Summary and issues

OFFICE OF RAIL REGULATION

Regulatory Asset Base basics

- A RAB represents the value of the assets used for the regulated activities
- RABs typically established at privatisation
  - Initial value = adjusted flotation value (e.g. for flotation risk)
- Provides a:
  - Means for determining charges – and spreading impact on customers over time
  - Basis for remunerating investors – rate of return and depreciation/amortisation
  - Incentives
  - Transparency on investments and assets

OFFICE OF RAIL REGULATION

RAB basics cont.

- Is a key element of the building block model used to determine the regulated company's revenue requirement and prices / access charges
  - Typically done every five years in a "periodic review"
- RAB model is well understood by investors
  - It generates confidence through the protection provided by regulators
  - Applying their duties and applying clear and coherent RAB policies
  - RAB/income indexed
- Rules necessary for additions:
  - Incentives for efficient capital expenditure
  - Ex ante fixed, ex post review, mechanistic
  - Set out at a periodic review and in regulatory accounting guidelines
- Regulatory Accounts – audited and published each year

Network Rail building block model (average annual values for 2009-14, in 2010-11 prices, GB-wide)

Opex £2.4bn

+

Return £1.9bn

+

Amortisation £1.7bn

-

'Other income' £0.6bn

=

Revenue requirement £6.0bn

Capex £4.1bn

4.75%

RAB £40.8bn

Funded by
Variable charges £0.7bn
Fixed charges £0.9bn
Grant £3.8bn

Network Rail's RAB

- RAB established in 2000
  - Based on adjusted flotation value (c£3bn in current prices) rolled forward
- Network Rail took over Railtrack (in administration) in 2002
- Periodic review in 2003 – to put the company's finances and income on a firm footing for the regulatory control period 2004-09
  - Allowed for renewals expenditure to be added to the RAB
- Significant additions to the RAB
  - Post-Hatfield overspend (capex and opex)
  - Deferred income
  - Incentive payments
  - Rolled-up financing costs
- Strong incentive on the company re over/underspend
- Amortisation of 1/30th each year and 7% of pre-2004 RAB
- RAB disaggregated in 2006

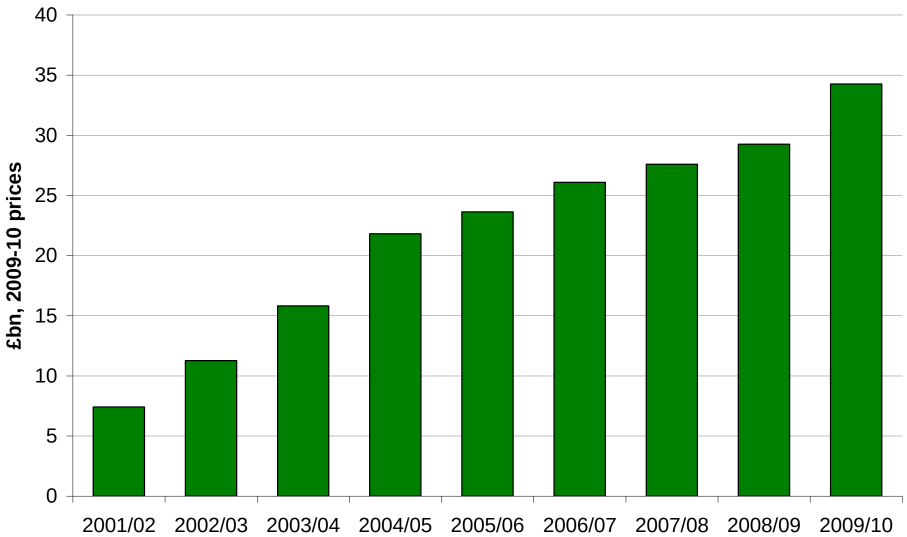
OFFICE OF RAIL REGULATION

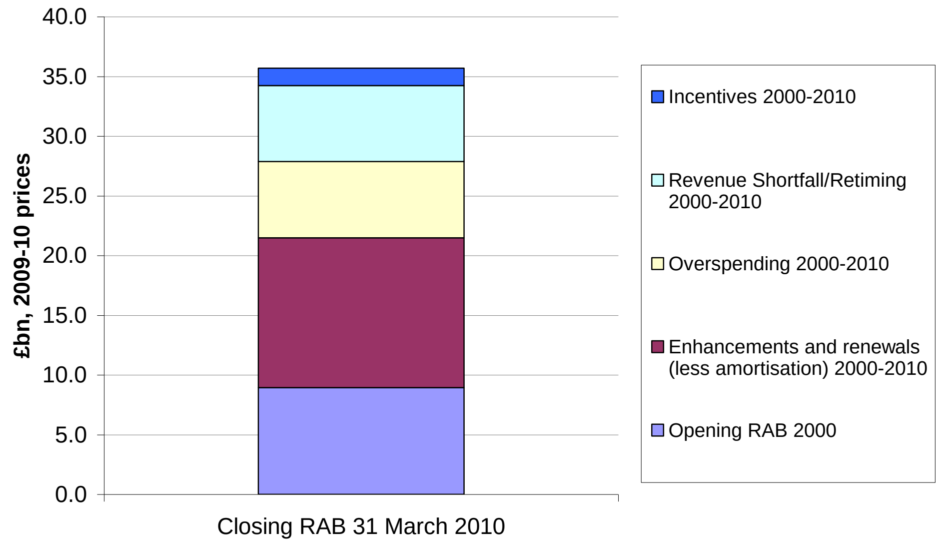
ORR's RAB policy for Network Rail for 2009-14

- RAB policy revised in 2008 periodic review
- Only (efficient) capex added to the RAB
- New incentives for RAB additions
- Amortisation based on long-run renewals and 1/30th of previous non-capex RAB additions

RAB at 31 March 2011 £bn (2010-11 prices unless stated)	
Opening RAB (2009-10 prices)	35.7
Inflation	1.7
Renewals	2.1
Enhancements	1.2
Ring-fenced fund	(0.5)
Amortisation	(1.6)
Closing RAB	38.6

Level of the RAB, structure of the RAB





OFFICE OF RAIL REGULATION

RAB, debt and balance sheet

RAB at 31 March 2011 £bn (2010-11 prices unless stated)	
Opening RAB (2009-10 prices)	35.7
Inflation	1.7
Renewals	2.1
Enhancements	1.2
Ring-fenced fund	(0.5)
Amortisation	(1.6)
Closing RAB	38.6
Net debt	
Opening (cash)	22.8
Closing (cash)	24.5

Balance sheet summary at 31 March 2011 £bn (2010-11 prices unless stated)	
Total assets	41.9
Of which, property, plant & equipment (railway network)	*39.6*
Total liabilities	34.3
Net assets	7.6

OFFICE OF RAIL REGULATION

Issues and summary

- RAB model is tried and tested – is financeable – and has helped generate significant levels of private investment
- Model broadly the same across sectors – but not entirely standard definitions and methods
- Key issues
  - To what extent do cross-sector differences affect investor confidence/commitment?
  - Does the RAB approach distort incentives?
  - Does the RAB approach deter competition?
  - Technical issues – RAB additions, amortisation, etc
  - Cost of capital (including split cost of capital and tradeable RABs)
  - Funding and financing over the long-term – sustainability
  - Extending RABs to other sectors
  - The role of the regulator… duties, commitment/credibility, ...