INFORMED SOURCES e-Preview August 2023

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More heavy-reading this month, I'm afraid. But given the state of the industry, we need to understand the background to what's going on.

Debt – privatisation's poison pill
CP7 Draft Determination highlights funding constraints
TfW details Class 230 costs

This month's lead item emerged from my attempt to create a whole industry Profit & Loss Account, published in the June Modern Railways. What stood out from the final table was the £2.85 billion cost of finance. Of this, £2.75bn is interest payment on Network Rail's debt.

This represents roughly a quarter of current fares revenue and, although it is not funded through Network Rail's revenue grant, can only fuel the Government's claim that the cost of the railway is unsustainable.

To find out how Network Rail acquired £55bn of debt, I go back to how British Rail was funded and then follow the money through each stage of privatisation. Figures here are not adjusted for inflation although they are in the column.

In 1996, Railtrack inherited from BR £296 million in loans from the Passenger Transport Executives plus £1,342m from the Government's National Loans Fund (NLF). However, the NLF loan was cancelled and the PTE debt transferred to a separate Government company.

Following some complex financial manoeuvring with bonds and debentures involved in the float, when Railtrack published its Report & Accounts for 1996-97 Net debt was £522m.

By 2002, when Network Rail bought Railtrack out of administration, it inherited borrowings of around £8bn. As a company limited by guarantee Network Rail could still borrow on the money markets.

And, boy, did it borrow! This spending spree was aided and abetted by a fundamental feature of regulated privatised utilities in the UK– the Regulatory Asset Base (RAB).

During a Periodic Review, the RAB was a key element in the Office of Rail & Road's (ORR) process for determining Network Rail's income for the next Control Period. As enhancements and renewals were completed during a Control Period, their value was added to the RAB.

When the next Control Period came around the enlarged RAB was used to calculate the return to cover the interest on the money borrowed to pay for the latest enhancements. Thus was born what became known as the 'Network Rail Credit Card'. In crude terms if a project ran over budget, Network Rail could borrow the extra money, slap the completed scheme on the RAB and be assured that the interest on the extra borrowing would be available.

This free-spending decade ended in December 2013 when the Office for National Statistics (ONS) announced that Network Rail would be reclassified as a central government body in the public sector. Around £30bn of debt was transferred to the government's balance sheet. But, in future, Network Rail borrowing, just as with BR, would be available only from the National Loans Fund. Borrowing has come full circle.

Under the new arrangement, existing commercial debt was unaffected. But as the bonds issued by Network Rail have expired, they have been replaced with NLF borrowings.

However, more significant than the financial settlement were changes in Network Rail's relationship with government. In particular DfT required a right of approval for any new business and the related financial arrangement.

All this helps explains the interminable delay in updating the Rail Network Enhancements Pipeline (RNEP). DfT is going to have to fund what's in the pipeline and, as I write, the Chancellor is reported to be demanding further efficiency savings and spending cuts from all Government Departments.

Draft Determination - constraints and concerns

In its Strategic Business Plan (SBP) for Control Period 7 (1 April 2024-31 March 2029), analysed last month, Network Rail emphasised the need to focus its limited renewals expenditure on the routes generating the most revenue. On other lines increased maintenance, and, perhaps, operating restrictions, would compensate for delayed renewals.

Responding to the SBP, the Office of Rail & Road's Draft Determination for England & Wales for CP7 picks up the same theme of limited funding. The recurring phrase is 'financially constrained.'

ORR notes that 'wider fiscal conditions' mean that funding for CP7 is constrained 'relative to the needs of the asset renewal cycle'. It accepts that choices are having to be made on where expenditure should be prioritised 'to deliver best value for the railway now and in the future.'

Criticism of the SBP includes what ORR considers an underestimate of likely risk. Network Rail has assumed that renewals could be de-scoped to meet any extra costs over a modest £500m risk fund. ORR wants the fund increased to £2bn.

As reported in my analysis of the SBP, Network Rail was forecasting that focusing its limited renewals funding on the routes generating the most income would result in an overall fall in asset reliability during CP7. This, in turn would show up as an increase in Service Affecting Failures and a ‘small’ deterioration in train performance.

ORR is having none of this. ‘We expect no further decline in train performance, and for Network Rail to deliver ambitious but deliverable improvements for passengers and freight customers’, is the Regulator’s response to such defeatism.

Having reviewed the SBP’s forecasts, ORR has determined ‘an ambitious yet realistic level of performance’ for each Region.

Network Rail’s Passenger Cancellations forecasts are also dismissed as ‘unambitious,’ ‘especially when compared to historic performance.’ A more-stretching 2.3% is set across all Regions for each year of CP7.

However, the SBP’s ‘Freight Cancellations’ forecasts are deemed ‘ambitious, yet realistic’. Even so, ORR is mostly setting the CP7 baseline trajectory at, or just below. the most demanding, level in the range.

Constrained funding means that expenditure on renewals of core assets during CP7 will be down 11% compared with the current CP6. ‘Core renewals’ cover track, off-track, signalling, level crossings, earthworks, drainage, buildings, electrification and fixed plant, plus telecoms.

ORR’s own assurance reports, plus its routine reporting and monitoring during CP6, have shown that the SBP proposals for CP7 do not sufficiently prioritise the needs of some core assets in each of Network Rail’s Regions. It concludes that the resulting impact on asset sustainability would, in turn, affect long-term train performance and present risks to the safe operation of the network.

ORR’s greatest concerns are with earthworks, structures, operational property and track. The Draft Determination concludes that an additional £550m spending on core renewals will be needed to mitigate the potential risks during CP7. To fund this ORR has identified spending on some projects and programmes during CP7 which it considers are higher than necessary and which could release around £800m for renewals. In the column I detail the sources of these savings.

ORR also cites a number of factors which will increase the demand for maintenance. These include catching up with maintenance deferred from CP6, plus the backlog of activity caused by recent industrial action.

Implementing the recommendations in the reports by Lord Mair and Dame Slingo on managing rail infrastructure in more frequent extreme weather will further add to the maintenance workload. Other factors include rising freight traffic and the impact of ash dieback.

ORR notes that Network Rail’s ‘modernising maintenance’ reforms will be vital to meeting this increased demand, but ‘without losing knowledge, capability and expertise in many asset safety areas and safety specific advice roles.’ While supporting the reforms, ORR needs proof that they will deliver the necessary efficiencies within the resources available while sustaining the required capability to maintain the assets.

Finally, a chilling phrase lurks in the depths of the Draft Determination. It refers to an ‘unexpected shortfall in grant funding compared to the provisional amounts set out in ORR’s draft determination ‘should this ever occur.’

In the Draft Determination, ORR says that it will continue to seek provisional confirmation of the profile and level of Network Rail’s grant payments from Government before publishing the final Determination.

To strengthen Network Rail’s protection against an ‘unexpected shortfall’ in grant funding, ORR will also consult on amending the existing network grant dilution provisions in Schedule 7 of train operators’ track access contracts. This, it says, would shorten the delay between any shortfall in grant funding occurring and a compensating increase in FTAC payments’ which DfT has to cover.

Provision for ‘dilution’ has been an established feature of track access contracts. Dilution occurs if the Secretary of State ‘fails, for any reason, to pay (Network Rail) the whole or any part of the Grant Amount on or before that Payment Date.’

Protection against such dilution has been academic for the last two decade. That ORR is seeking to strengthen Network Rail’s protection suggests that it may be emerging as a real and present danger. Perhaps Government’s talk of an ‘unsustainable’ railway might not be political sabre rattling.

Class 230 costs and history

Transport for Wales has provided details of the costs of its fleet of five 3-car Vivarail hybrid Multiple Units, plus an update on progress with the contract. The capital costs totalled £25m. No leasing company was willing to fund the contract and a sale and leaseback deal arranged by the operator at the time would have been more expensive in the long run than outright purchase by the Welsh Government.

In the column I publish TfW’s detailed breakdowns of the capital and operating costs to date. These provide interesting insights into the rolling stock business.

For example, contractual service entry was during 2019, but the first units did not carry passengers until April this year. TfW lists multiple factors behind the delay, in addition to Vivarail's 'unrealistic' schedule. These resulted in liquidated damages of £1.5m.

But even more money flowed the other way. Brian Ronan, Metro-Cammell's legendary Managing Director, used to say that variation orders on a contract turn a net loss into a gross profit. At £2 million in this case, it looks as though Brian was right.

Also in the column I provide the background to the latest outbreak of cracking at locations where bogie yaw dampers and anti-roll bars are attached to aluminium bodyshells. This time it is the TransPennine Express CAF Mk VA loco-hauled coaches, with similar failures to those found on the manufacturer's Class 195 DMUs.

A spreader plate was developed for the Class 195 yaw damper cracking and a similar solution may be tried on the Mk VA vehicles. Meanwhile CAF and TPE's consultants are trying to determine the root cause.

Roger's blog

Disappointment of the month was the last-minute cancellation of the round-table meeting for the railway press with the Great British Railways Transition Team. This was attributed to an unexpected diary clash.

It was a double pity because at the last GBRTT round-table Lead Director Anit Chandarana was ill and could not take part. Now he is off to DfT as interim cover for a senior post. Everything seems to be interim these days.

The round-table is due to be rescheduled, but I had been looking forward to raising a number of detailed points with Anit. While I am sure his interim replacement as Lead Director will be up to speed, Anit has been there from the start of the Transition Team's work.

As I said at the beginning of this e-Preview, this and last month's columns have been pretty heavy going, with the analysis of the delayed SBP followed by the resulting Draft Determination. Readers may have noticed the absence of Scotland. This is because Network Rail Scotland's forecast spending in CP7 was actually lower than the funding Scottish Ministers made available.

As I am writing this, the definitive SBP, incorporating this largesse, is awaiting endorsement by the Scottish Ministers before being submitted to ORR. Who will then respond with another Draft Determination.

Actually, it's worse than that. Network Rail also published individual SBPs for its English and Welsh Regions: ORR has responded with matching Draft Determinations. When I regain the will to live I will have to get into the detail of these Regional plans.

But in the meantime, I promise that the next Informed Sources swill be a Periodic Review-free zone. I am already researching a range of items on topics I really enjoy covering and, I hope, you enjoy reading.

Roger