

Statutory contingent liabilities in support of Network Rail

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Statutory contingent liabilities in support of Network Rail's debt issuance programme

1. It is the normal practice, when a government department proposes to undertake a contingent liability in excess of £100,000 for which there is specific statutory authority, for the department concerned to present to Parliament a Minute giving particulars of the liability created and explaining the circumstances.
2. It is also normal practice for a government department to inform Parliament of the particulars of any contingent liability created by a body sponsored by the department, which the body in question might not be able to meet from within its own resources.
3. This minute informs Parliament of the particulars of statutory contingent liabilities to be created by the Strategic Rail Authority (the SRA) in support of Network Rail's (NR) Debt Issuance Programme (DIP).

Summary

4. Network Rail's short to medium term borrowing is presently supported by £17bn of standby credit facilities and related support arrangements provided by the Strategic Rail Authority (SRA). These facilities are time limited, and expire at various dates between 2005 and 2009. As at 31 March 2004, they supported close to £13bn of outstanding NR borrowing. In addition to the £17bn standby credit facilities, the SRA has made available to NR a £4bn standby credit facility for use as a long term contingency buffer, available until 2052. Further details of the support are set out in minutes from the Secretary of State for Transport (the Secretary of State) laid before Parliament on 27 June 2002 and 4 February 2004.
5. The £17bn standby credit facilities supporting NR's short and medium term borrowing were always intended to be a transitional measure, until NR established a robust framework for its long term financing needs. The presentation to Parliament of the White Paper 'The Future of Rail' on 15 July 2004, as well as the Final Conclusions to the Access Charge Review 2003 published in December 2003, means that NR is now in a position to launch its long term financing platform, known as the Debt Issuance Programme . Over the next 5 years, the DIP is expected to raise around £22bn to refinance NR's existing borrowing and to fund its activities.
6. The DIP will progressively replace the £17bn of standby credit facilities available to support NR's short and medium term financing and will benefit from Government support through a Financial Indemnity (FI). By March 2009, the £17bn standby credit facilities should have been completely replaced. In that year, Government support for NR's borrowing is expected to comprise around £22bn of debt raised through the DIP and benefiting from the FI, and the £4bn in respect of a standby credit facility available as a long term contingency buffer (but which, however, is not expected to be drawn). NR borrowing supported by the FI may increase in later years, depending on the outcome of future Access Charge Reviews. The FI should ensure NR has access to sufficient finance at very cost-effective terms.
7. To ensure Parliament continues to be informed of the value of contingent liabilities under these arrangements, forecasts of NR's debt will be reported to Parliament annually, or as soon as possible if current year forecasts are likely to be exceed by 5% or more. These arrangements are discussed further at paragraph 29 below.
8. The SRA will be the initial provider of the FI as it has powers to do so under the Transport Act 2000. This role will transfer to the Secretary of State once the necessary legislation has been passed to wind up the SRA, as part of the reforms to the UK rail industry announced in the 'The Future of Rail'.
9. The Government's view is that the FI is highly unlikely to be called. The Final Conclusions to the Access Charge Review 2003 published in December 2003 and the Regulator's Approval of NR's proposed financing arrangements published in March 2004 provide a sound financial framework for NR for the next five years. The independent Office of Rail Regulation (ORR), in accordance with its statutory duties, will do similarly for subsequent periods. The National Audit Office (NAO) has confirmed that the FI should be shown as a contingent liability in the Department for Transport's resource accounts and SRA's unconsolidated accounts.
10. Further details of the arrangements for the DIP and the FI are set out below, as are assessments of the value of the contingent liabilities arising from the FI and a risk assessment of the likelihood of these liabilities crystallising.

The Debt Issuance Programme

11. The DIP is a long term financing arrangement expected to last until October 2052, so covering the same period as the £4bn standby credit facility acting as a long term contingency buffer referred to above.
12. Over the next 5 years, the DIP is expected to raise £22bn. By March 2009, this should have been used to refinance all NR's existing short and medium term borrowing and also to finance its investment programme. The £22bn is NR's latest estimate of its total borrowing requirements to March 2009 and is consistent with the Final Conclusions of the Access Charge Review 2003 as well as the Rail Regulator's approval of NR's financing plans in March 2004. Both these documents cover the five year control period from April 2004 to March 2009. Subsequent Access Charge Reviews carried out by ORR will cover later control periods and may lead NR to revise its borrowing forecasts. It is also possible that ORR may undertake interim reviews of access charges that will affect forecasts to March 2009.
13. The DIP is a highly flexible financing platform, which will allow NR to raise finance in a number of forms, including bonds, commercial paper, and bank facilities. It is likely to include debt with a range of maturities, short, medium and long term, at fixed and variable interest rates, and with a range of other terms. Some debt is likely to be issued in foreign currencies, with appropriate hedging arrangements. To minimise exposure to adverse movements in interest rates, NR is expected to enter into interest rate hedging arrangements in line with its treasury policy. This hedging will be supported by the FI.
14. The DIP will operate through Network Rail Infrastructure Finance PLC (NRIF), an orphan vehicle associated with the NR group, set up with the sole purpose of raising debt under the DIP. For accounting and regulatory purposes, NRIF will be treated as part of NR.
15. Inter Company Loan Agreements between NRIF and NR will allow for the proceeds of debt raised by NRIF to be loaned to NR, on a subordinated basis in certain circumstances, and under which NR will provide NRIF with funds to meet its debt service obligations under the DIP.

Financial Indemnity

16. To ensure that NR has access to sufficient borrowing on cost effective terms to both re-finance short and medium term facilities and to fund its investment programme, the Government has agreed to put in place a Financial Indemnity in support of the DIP. The FI will be available until October 2052.
17. Under the terms of the FI, DIP debt holders will be indemnified against any shortfall in debt service payments by NRIF, whatever the cause and to a theoretically unlimited amount (but see the further discussion below at paragraphs 20 to 28). The FI is therefore a straightforward way of supporting NR's borrowing. It should provide NR with the flexibility needed to allow it to manage the DIP as it sees best to obtain appropriate and cost effective finance. The FI should allow NR access to the cheapest possible finance available to a private sector company, delivering value for money for both taxpayers and farepayers.
18. The initial FI provider when the DIP is launched will be the SRA. 'The Future of Rail' set out the Government's intention to wind up the SRA and transfer its financial liabilities to the Secretary of State, subject to the necessary legislation being passed. Once this has occurred, the Secretary of State will become the FI provider, as well as taking on SRA's other obligations in support of NR's borrowing. The SRA will be initial FI provider because Parliament has, by virtue of the Transport Act 2000, given the SRA the legal power to do so.
19. As a result of the changes to the rail industry structures proposed in the 'The Future of Rail' the DIP and associated FI is a better and cheaper way for NR to meet its long-term finance requirements than the previously envisaged securitisation of track access charges and grants.

Value of contingent liabilities arising from the FI

20. The value of the Government's contingent liability under the FI will be determined by the quantum and terms of the debt raised by NR under the DIP, rather than the value of standby credit facilities as is the case for existing support.
21. In principle, Government's liability under the FI is an unlimited amount. However, there are a number of controls on NR which mean its borrowing under the DIP, and hence Government's exposure under the FI, is limited.
22. These controls primarily arise from the economic regulation framework for the railway. As part of its agreement to the DIP, the ORR intends to establish controls on the total amount of DIP debt through a new condition in NR's Network Licence. The licence condition will provide that if DIP debt is above 85% of NR's Regulatory Asset Base (RAB), NR will be required to provide ORR with a plan for how it will reduce debt to below this threshold and then carry out the plan. The maximum amount of DIP debt permitted will be 90% of the RAB. Should NR exceed this, it would be in breach of its Network Licence and could face enforcement action by ORR.
23. It is highly unlikely that NR's DIP borrowing will ever approach the proposed limits in the Network Licence, due to other aspects of the regulatory framework. Should NR's cumulative expenditure exceed by more than 15% that allowed in the Final Conclusions of the Access Charge Review 2003, ORR can call an interim review of the company's income requirements. In the course of such a review, the outputs NR is required to deliver might be adjusted downwards to remain within expenditure limits, or its income might be increased.
24. ORR will also be regularly monitoring NR's expenditure and would expect to question NR about any indication of possible overspends, well before the 15% trigger was approached. NR have already made good progress in controlling costs, as evidenced by underspends for 2003/04 as shown in their 2004 business plan and also early indications for 2004/05. NR is committed to achieving the 31% efficiency saving set in the Access Charge Review 2003.
25. The proposals in 'The Future of Rail' envisage a new approach to future Access Charge Reviews. Subject to the passage of the necessary legislation, the Secretary of State will specify the high level outputs for NR to deliver, in respect of which the ORR will then establish an efficient price. This would involve an iterative process to ensure that the specified outputs were consistent with available public expenditure. Such a process should further ensure that NR's DIP borrowing remains within forecast levels.
26. In addition to the economic regulation framework, NR has given contractual undertakings to the FI provider as to how it will carry out its financing under the DIP, for example that any foreign currency borrowings will be appropriately hedged against exchange rate movements, and that it will provide certain financial information. NR will also carry out interest rate hedging in line with its treasury policy.
27. The regulatory controls and contractual undertakings set out above should ensure that Government's exposure under the FI is effectively managed.
28. As mentioned above, NR's latest estimate is that the DIP will have raised around £22bn by March 2009. The total amount of DIP debt may be higher in later years to finance investment required in the network as determined by the outcome of future Access Charge Reviews. By March 2009, total Government support for NR borrowing will comprise the estimated £22bn of DIP debt supported by the FI and the £4bn standby credit facility (long term contingency buffer) referred to previously, which is not expected to be drawn. The requirement for the £17bn standby credit facilities supporting NR's short to medium term borrowing should have fallen away as this borrowing should have been refinanced through the DIP.

Reporting arrangements

29. Parliament will be kept informed of changes in the likely value of the contingent liabilities arising from the DIP and FI. NR's latest annual forecasts of its total net debt for the remainder of the then current control period will be reported to Parliament in April each year. If during the first year of the forecasts, it becomes apparent that year-end net debt for that year exceeds the forecast level by more than 5%, Parliament will be informed as soon as is possible. NR's forecasts of year-end net debt for the current control period are:

2004/05	2005/06	2006/07	2007/08	2008/09
£17.2bn	£20.5bn	£21.3bn	£21.8bn	£21.9bn

For 2004/05 therefore, the 5% trigger for a further report to Parliament is equivalent to £860m, and a report would be made if year-end net debt was expected to exceed £18.1bn.

Risk Assessment

30. The NAO have confirmed that Government support for the DIP should be disclosed as a contingent liability in the Department of Transport resource accounts and in SRA's unconsolidated accounts. (Actual NR borrowing will be shown, as now, in the SRA's consolidated accounts).
31. Government's view is that a call on the FI is a highly unlikely event for the following reasons:
- The ORR establishes NR's income. In doing so, ORR allow NR sufficient income to meet its efficient expenditure, debt service costs and to earn a return. ORR has a statutory duty, amongst others, to act in a manner that will not make it unduly difficult for NR to finance its activities. This should ensure NR has sufficient income to meet debt service and other costs, provided it operates efficiently.
 - The Final Conclusions to the Access Charge Review 2003 published in December 2003 and the Rail Regulator's Approval of NR's proposed financing arrangements published in March 2004 provide a sound financial framework for NR for the next five years and beyond. The income determined by the Rail Regulator takes account of NR's financing plans and also includes a return above financing costs to provide NR with a contingency to meet cost shocks.
 - The Final Conclusions provide for the ORR to re-open NR's income determination should NR's actual cumulative expenditure be 15% above or below its allowed expenditure after 31 March 2006. This would give ORR the opportunity to change the outputs NR is required to deliver or to change its income requirement.
 - The SRA has contracted to pay the Network Grants agreed in the Rail Regulator's Approval of NR's proposed financing arrangements published in March 2004. The SRA also has contractual obligations to Train Operating Companies to fund any increase in Track Access Charges arising from Access Charge Reviews. (All these obligations will pass to the Secretary of State as part of the necessary legislation for winding up the SRA).
 - Inter Company Loan Agreements between NRIF and NR are designed to ensure that NRIF always has claims against NR for sufficient funds to meet its debt service obligations.
 - A payment under the FI would be treated as a significant financial failure by NR, potentially leading to the dismissal of the Chairman and Chief Executive of NR.

Transition to the DIP

32. As part of the transition strategy for moving to the DIP, NR intends to extend its existing Commercial Paper (CP) programme by 1 year, so that the final maturity date is in June 2006, rather than June 2005. This should help NR manage its short term liquidity in the most cost effective way. As a consequence, NR has requested that the £4bn SRA support for its existing CP programme, known as the Legacy Working Capital Support Facility (part of the £17bn support for NR's short and medium term borrowing), related direct agreement be extended by the same period.

Non statutory contingent liabilities

33. Details of the contingent liabilities that the Secretary of State would incur in relation to these arrangements, for which there is no specific statutory authority have been laid before the House of Commons.

Approvals

34. The Treasury has approved the proposals described in this Minute in principle. If any liability described in this Minute is called, provision for any payment would be sought through the normal Supply procedures.

Secretary of State for Transport

15 September 2004