Introduction

1. The Strategic Rail Authority ("the Authority") is a non-departmental public body created by the Transport Act 2000. The overall aim of the Authority is to provide leadership to the rail industry and ensure that the industry works co-operatively towards common goals.

Network Rail

2. On 3 October 2002 Network Rail Limited, which is a company without shareholders, limited by guarantee, acquired the shares of Railtrack Plc from Railtrack Group Plc for £510 million, including acquisition expenses. Network Rail Limited (Network Rail) financed the purchase by a grant of £300 million from the Authority and a commercial loan of £210 million.

3. Note 1 to the accounts of the Authority explains the relationship between Network Rail and the Strategic Rail Authority as set out in agreements entered into by both parties on 3 October 2002. As I announced on 28 June 2002, in my opinion, the Government, via the Strategic Rail Authority is, through the support facilities in place, providing security to the providers of debt finance to Network Rail and is acting as the lender of last resort in the event of financial difficulties. In doing so the Government, via the Strategic Rail Authority is the party bearing the risk that would usually be borne by equity capital.

4. Applying Financial Reporting Standard 5: "Reporting the Substance of Transactions", I therefore concluded that Network Rail should be accounted for as a subsidiary of the Strategic Rail Authority and the Government agreed with this view in the Secretary of State for Transport's responses to Parliamentary questions on 2 and 19 July 2002. Accordingly, the results and transactions of Network Rail, including its assets, liabilities and borrowings, have been consolidated into the Authority's group accounts for 2002-03. The consolidated income and expenditure account is on page 78 and the consolidated balance sheet on page 81.

Accounting for the railway network

Network assets are valued at £12,764 million

5. The consolidated balance sheet of the Authority includes the railway infrastructure assets owned by Network Rail. These network assets of £12,764 million, including track, route structures, stations and depots, constituted more than 97 per cent by value of the total fixed assets recognised in the Authority's group balance sheet at 31 March 2003.

The assets have been valued at the Regulatory Asset Base, reflecting their value in use

6. As part of my audit of the Authority's accounts, I have considered the accounts and accounting policies of Network Rail, including the basis of accounting for the rail network. These assets have been included in the balance sheet of Network Rail and the consolidated balance sheet at their value in use. This is derived from the value assigned to all of its assets by Network Rail under regulatory accounting guidelines issued by the Rail Regulator, which is called the Regulatory Asset Base. The Regulatory Asset Base determines the level of future income streams which Network Rail will receive from train operating companies as charges for gaining access to the rail network, and is consequently an appropriate basis for calculating the current value of the asset base. Additionally the value of £12,764 million includes certain assets which are not part of the Regulatory Asset Base.

7. The Regulatory Asset Base is increased by the value of agreed enhancements to the network and other adjustments specified by the Regulator. A key assumption in Network Rail's accounts is that, over time, the value of the Regulatory Asset Base will be sufficient to generate enough income to ensure that Network Rail can achieve an operating surplus. The validity of this assumption will only be confirmed once the Regulator has published his final conclusions in his interim review of Network Rail's access charges, which is expected by 31 December 2003.

The value in use is less than the replacement cost

8. Network Rail's value of its railways network assets of £12.764 billion is less than the cost of replacing the rail network in its current condition, estimated by Network Rail's engineers to be greater than £70 billion.

The value in use differs from the value used by Network Rail's predecessor, Railtrack Plc

9. Network Rail's basis of accounting for its rail network assets differs from that used by Railtrack Plc. Railtrack Plc valued the network assets at the original or historic cost of constructing the network. Railtrack Plc did not, however, charge depreciation each year to the profit and loss account to reflect the usage of these assets, but instead adopted an accounting practice known as renewals accounting for track, route structures, stations and depots. This practice allows organisations maintaining an infrastructure system or network in a steady state, to charge to their profit and loss account the annual cost of maintaining that asset as a proxy for depreciation. Over time, surveys of the condition of the asset should indicate whether it is being maintained in a steady state. If it is not, the use of renewals accounting may not be permissible.

Network Rail's directors believe the revised basis of valuation is more appropriate for a number of reasons

10. As noted in paragraph 6 above, Network Rail's Directors believe that the historic cost basis adopted previously by Railtrack Plc does not reflect the true economic value of the network, as does its value in use. Further, UK accounting standards are due to be harmonised with international accounting standards by 2005, and the renewals accounting practice adopted by Railtrack Plc will no longer be permitted under international accounting standards. In its 2002-03 accounts therefore, Network Rail Infrastructure Limited, renamed from Railtrack Plc, has charged depreciation of £438 million, compared to £1,889 million which would have arisen had Railtrack Plc's policy been adopted.

Under the new accounting policy, Network Rail Infrastructure Limited's results for 2002-03 show a pre-tax loss of £290 million. The change in basis of accounting has led to the 2001-02 results of Railtrack Plc being restated, changing the previously reported loss of £1,638 million into a surplus of £295 million

11. As a result of the new accounting policy, the accounts of Network Rail Infrastructure Limited restate the results of Railtrack Plc for last year to show a pre-tax profit for 2001-02 of £295 million, as opposed to the loss reported by Railtrack Plc of £1,343 million, a difference of £1,638 million. The change in accounting policy had no impact on Railtrack Plc's cash and bank balances and other liabilities at 31 March 2002. Net liabilities falling due within one year at that date were £3,964 million, with a further £3,597 million falling due after more than one year, as reported in the audited accounts.

12. The change in accounting policy has no impact on the reported results of the Strategic Rail Authority for 2001-02 as Railtrack Plc was not part of the Strategic Rail Authority Group and not therefore covered by my audit.

Network Rail has also revalued the infrastructure assets because the Regulator has indicated that the value of the Regulatory Asset Base will be increased

13. The Directors of Network Rail have also revalued the network during 2002-03 by £935 million because the Regulator has indicated in his statement of 27 June 2002 that he will increase the Regulatory Asset Base by an amount greater than the level of actual additions to the network, reflecting the additional expenditure on operating, renewing and maintaining the network in the two years to 31 March 2003. Without this increase in the value of the Regulatory Asset Base, Network Rail would have needed to write down the carrying value of the network in its accounts, resulting in an additional impairment charge to its profit and loss account.

The auditors of Network Rail, Deloitte & Touche, are content with the accounting policies adopted by Network Rail

14. Deloitte & Touche, auditors of Railtrack Plc (now Network Rail Infrastructure Limited) and of Network Rail Limited, issued an unqualified audit opinion on the consolidated accounts of Network Rail Limited on 4 June 2003. This implies that they are content with the Directors of Network Rail's decision to change the fixed asset accounting policy previously adopted by Railtrack Plc.

I am satisfied with the accounting policies adopted by Network Rail in so far as they impact on the accounts of the Strategic Rail Authority for 2002-03

15. In auditing the Strategic Rail Authority's consolidated accounts, I have reviewed the accounting policies adopted by Network Rail. I am satisfied that the approach adopted by the Directors of Network Rail to value the railway infrastructure assets is acceptable under financial reporting standards, it is also consistent with the accounting policies of the Strategic Rail Authority including in particular the Authority's requirement to prepare accounts in line with the Accounts Direction issued by the Secretary of State for Transport, including the requirement for the accounts to comply with "Executive Non-Departmental Public Bodies: Annual Reports and Accounts Guidance" issued by HM Treasury. The policy will also be consistent with International Accounting Standards when these are planned to be adopted by UK companies in 2005, whereas the renewals accounting method employed by Railtrack Plc will no longer be permitted.

Going concern basis for preparation of the financial statements

16. The balance sheet at 31 March 2003 discloses an excess of liabilities over assets of £659 million for the group and £1,580 million for the Authority. The Authority's balance sheet includes liabilities for grant and other payments which will be met from future grants or grant-in-aid recoverable from the Authority's sponsor department, the Department for Transport.

17. In line with its Accounts Direction, the Authority recognises liabilities on an accruals basis. However, under the normal conventions applying to Parliamentary control over income and expenditure, the Authority's grant-in-aid cannot be issued or accounted for in advance of need and will be made available once liabilities fall due for payment.

18. In preparing its Supply Estimates for 2003-04, the Department for Transport has taken into account the amounts needed to meet liabilities of the Authority payable in the year. These Estimates have been approved by Parliament and the Authority received funding of £1,575 million during April 2003 to allow it to meet liabilities existing at 31 March 2003.

19. As disclosed in the Foreword to these accounts, the Authority's Directors have assessed that there is no reason to believe that the Department for Transport's future sponsorship of the Authority and future Parliamentary approval of funding to allow the Authority to meet its liabilities will not be forthcoming. Accordingly, the financial statements have been prepared on a going concern basis. I have reviewed the basis for this judgement and have concluded that it is appropriate.

John Bourn
Comptroller & Auditor General

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