

Periodic review 2008

October 2008



OFFICE OF RAIL REGULATION



Network Rail's outputs and funding for 2009-14

On 30 October 2008 we published our determination of Network Rail's outputs and its funding from access charges and other sources for control period 4 (CP4, April 2009 to March 2014). In CP4 Network Rail will deliver significant improvements in train reliability, network capacity and safety. We have determined that the revenue the company requires to deliver these outputs is £26.7bn.

From draft to final determination

In June 2008 we published for consultation our draft determinations of Network Rail's outputs and access charges/funding for 2009-14.

In making our final determination we have considered carefully the many responses we received on our draft determinations, the implications of current conditions in the financial markets and Network Rail's latest financial forecasts for the remainder of the current control period (CP3) which ends on 31 March 2009. This has led us to make a number of changes compared to our draft determinations.

Balanced package

Our determination is a package of decisions. Besides the decisions on outputs, access charges and funding, the other parts of the package include the obligations in Network Rail's licence; the monitoring and enforcement of the outputs; the financial framework and the protections for Network Rail against cost and revenue uncertainties; and the industry contractual and incentive arrangements. The package should be considered and judged as a whole.

We have established the package carefully, based on strong evidence, to ensure that Network Rail, improving as it should, will be able to finance its activities.

We consider that the new incentive arrangements and regulatory protections strike the right balance between risk and reward. They will encourage Network Rail, working with its industry partners, to achieve and outperform our determination, whilst delivering all the required improvements in train performance, safety and capacity.

Periodic review process

The 2008 periodic review (PR08) is the process whereby we determine the outputs that Network Rail must deliver, and the levels of access charges paid by train operators for use of the infrastructure, during CP4. Our determination is the result of over three years work since we started PR08 in 2005.

The access charges we are determining in PR08 are the track access charges payable by franchised passenger, open access passenger and freight train operating companies. The station long term charge is payable by users of stations. We are also establishing the level of network grant that the governments in England & Wales and Scotland will pay to Network Rail in lieu of access charges. The remainder of Network Rail's funding comes principally from the income it gets from property rental and sales.

Although Network Rail is a GB-wide company, and finances itself on this basis, we have established separate calculations of the company's revenue requirement and access charges for England & Wales and Scotland, in the context of the separate responsibilities that the Secretary of State and Scottish Ministers have for setting the strategy for, and funding, the railway.

Key output requirements in CP4

The outputs we have established for CP4 will lead to continued improvements in train reliability and safety, major enhancements to the rail network and a significant reduction in disruption. The enhancement programme is the largest on the network for decades, including providing additional capacity for more than 20% more passenger journeys. The key output requirements of our determination, which provides for all the high level output requirements specified by the Secretary of State for Transport and Scottish Ministers, are:

Improvements in reliability and reduced levels of disruption

- 20% reduction in late or cancelled trains. Train punctuality increasing to at least 93% for local services in south east England and 92% elsewhere;
- at least a 25% reduction in delays to freight trains caused by Network Rail;
- reductions of over a third in disruption to passenger services caused by engineering work and no worsening of the position for freight. This will include introducing Network Rail's seven-day railway concept on priority routes

Improvements in safety

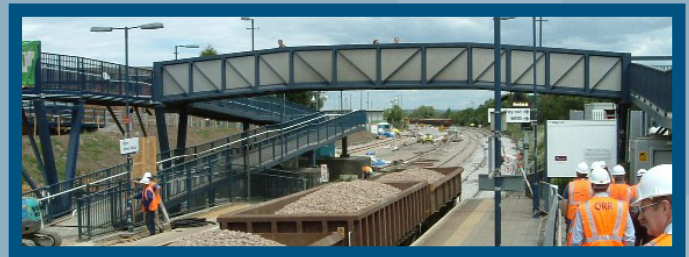
- a 3% reduction in the risk of death or injury to passengers and rail workers from accidents on the railway;

Maintaining station condition

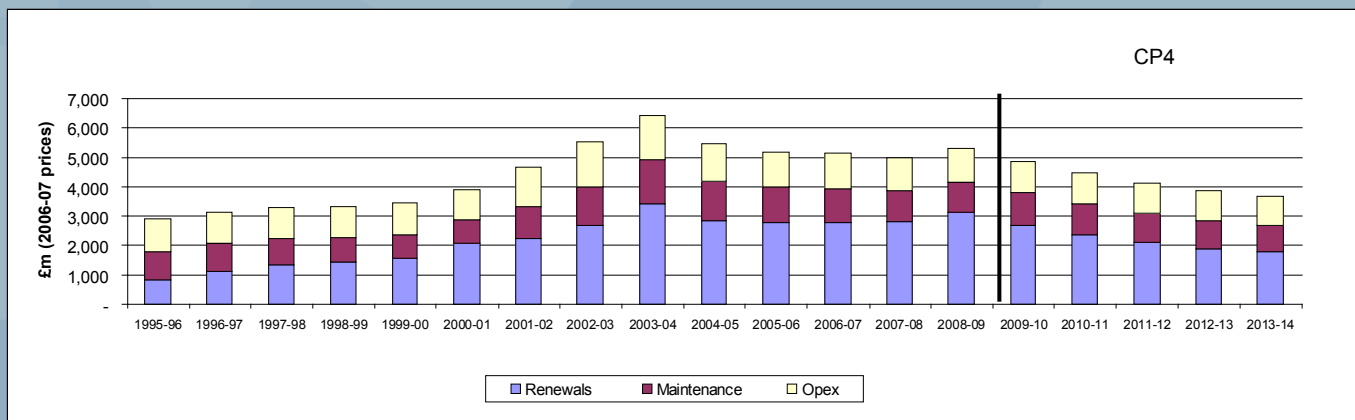
- the average condition of each category of station on the network must be maintained. In addition to this there will be improvements to station condition funded by the national stations improvement programme;
- in Scotland, the average condition across the Scottish network must also be maintained;

Key enhancement schemes

- connecting Kings Cross commuter services into the Thameslink route and increasing its capacity throughout (including relieving the track bottleneck at London Bridge);
- rebuilding Reading station to remove the track bottleneck in that area;
- rebuilding Birmingham New Street station;
- capacity improvements in Cardiff;
- providing capacity relief to the East Coast main line;
- improving line speeds on the Midland main line;
- a new Glasgow Airport rail link;
- completing the new line between Airdrie and Bathgate;
- extensions to more than 500 platforms will be made, to accommodate the longer trains that will be introduced; and
- improvements to the network for freight services funded by the strategic freight network initiative.



Historic expenditure levels (OM&R) and our judgements on expenditure for CP4



Total expenditure to operate, maintain and renew (OM&R) the railway increased from £3bn in 1995-96 to a peak of more than £6bn in 2003-04 in the wake of the Hatfield derailment and the significant increase in activity levels and unit costs. We have undertaken a thorough and detailed assessment of Network Rail's spending needs in CP4. We consider that it will need to spend £20.9bn on OM&R in CP4. OM&R expenditure is expected to reduce to £3.7bn in 2013-14.

In addition to this, Network Rail is expected to spend £7.6bn in CP4 to deliver the enhancements to the network, which is more than twice the amount of expenditure on enhancements in CP3.

Greater efficiency

In making our determination we have carefully considered both the total improvement in efficiency that Network Rail can make and the speed at which it should be able to achieve this. We have undertaken detailed studies to benchmark Network Rail's costs and processes against other international railways and comparable companies. The evidence we have shows clearly that there remains a very large potential for Network Rail to improve its efficiency.

We consider that Network Rail can achieve significantly more efficiency improvement than it included in its plans for CP4.

We recognise the many challenges that the company faces in CP4 and the improvements it will need to make in train performance, safety and capacity, as well as in improving efficiency.

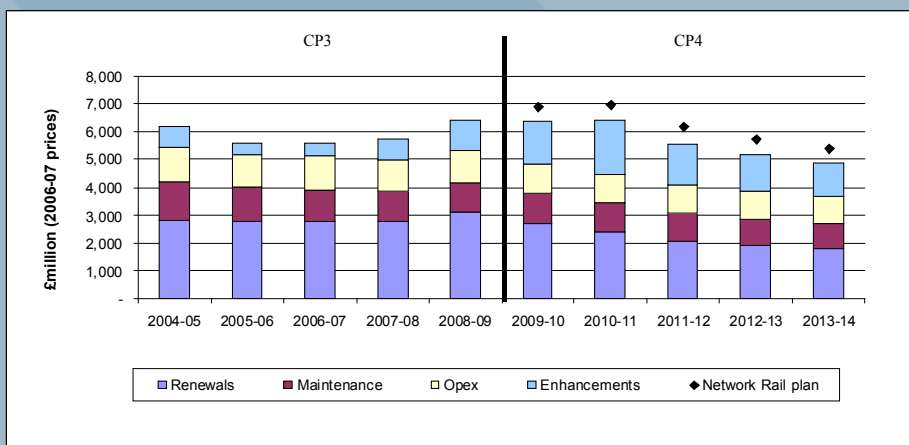
We have assumed that Network Rail requires ten years to close the efficiency gap that exists with its peers. By the end of CP4 we expect overall efficiency improvements in OM&R of 21%. We also expect the company to make significant improvements in the efficiency with which it will deliver its enhancement programme.

The cost savings the company needs to make to address the efficiency gap may require major change to the way it operates. In order that it has time to plan and implement new processes, technologies and working methods, we have assumed lower levels of efficiency improvement in the first two years of CP4. We have recognised the need for some upfront expenditure to facilitate the achievement of the efficiencies (including spending on information technology and corporate accommodation).

Our assumptions for annual efficiency improvement in CP4

	09-10	10-11	11-12	12-13	13-14	Total
Opex	2.8%	2.8%	4.0%	4.0%	4.0%	16.4%
Maintenance	3.2%	3.2%	4.0%	4.5%	4.5%	18.0%
Renewals	5.0%	5.0%	5.5%	5.5%	5.5%	23.8%

Total expenditure in CP3 (forecast for 2008-09) and our determination for CP4

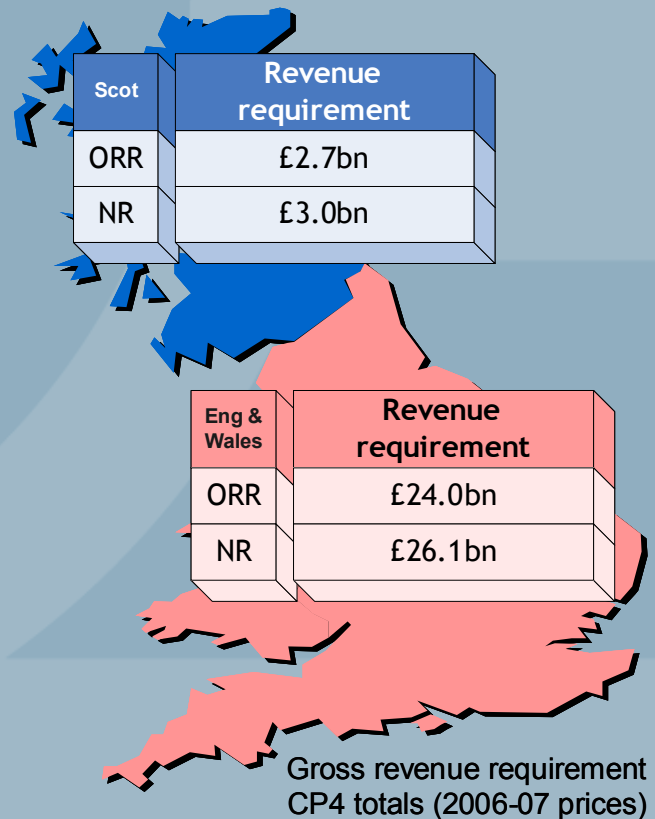


Assessment of the CP4 revenue requirement

We have combined our expenditure and financial assumptions using the standard 'building block' approach used by economic regulators, where renewals and most enhancement expenditure is added to the regulatory asset base (RAB) and remunerated through the amortisation allowance and an allowed return on the RAB.

Network Rail's gross revenue requirement for CP4 is £26.7bn (compared with £26.5bn in our draft determinations). This is recovered through track access charges, network grant and income from other sources.

Our assessment is £2.4bn less than Network Rail proposed in its plans for CP4.



Improvements in safety

Network Rail must comply with its legal safety obligations and we expect to see continuous improvements in the company's safety performance. Network Rail's ambition to become a world-class company should be a catalyst for it to achieve further significant improvements in its safety performance.

Our inspection plans for CP4 will cover those areas of change where we consider the risks of safe delivery by Network Rail are highest. If weaknesses are found, we will take action.

Securing delivery

We will assess Network Rail's success in the next control period by whether it achieves the outputs on time, as set out in our determination, and does so whilst meeting all its licence and statutory obligations (particularly its asset stewardship obligations). We would see this as the minimum and would expect Network Rail to work to outperform our determination in delivering its outputs and efficiency improvement.

We will monitor Network Rail's progress in delivering the outputs and we will report publicly on this. If this indicates that Network Rail appears likely to fall short of the timely delivery of an output, we will not hesitate to take action to require the company to address promptly its shortcomings. We will consider a culpable failure by Network Rail to deliver a specified output as a serious breach of its obligations.

Incentives

We have improved the incentives that Network Rail and the industry face to work together and improve whole industry outcomes. We are:

- implementing a new efficiency benefit sharing mechanism between Network Rail and train operators. If Network Rail can deliver its outputs for less than we have determined then it will share 25% of this 'outperformance' with train operators. By not including all potential efficiency savings in our draft determinations, we are providing an incentive for Network Rail to outperform our assumptions, working with its industry partners. To allow franchised operators to benefit will require government to waive the 'no net loss, no net gain' terms of franchise agreements;
- updating the volume incentive, to incentivise Network Rail to respond to demand levels greater than those assumed in its strategic business plan; and
- implementing a new mechanism to equalise the incentive that Network Rail has to make efficiency savings on capital expenditure in any year of the control period.

Affordability of the governments' high level output specifications (HLOSs)

Key inputs to PR08 have been the high level output specifications (HLOSs) produced by the governments in England & Wales and Scotland, which set out what they want to achieve from the railways in CP4. Our determination confirms that both HLOSs are affordable over CP4 as a whole for the public funding that the governments are making available to the railways.

Next steps

On 18 December 2008 we will publish the final price lists and the review notices which start the legal implementation of our determination. Network Rail will then have until 5 February 2009 to accept or reject our determination.

If it rejects then we would expect to refer our determination to the Competition Commission. The Competition Commission would review all the evidence available and reach its own view on Network Rail's outputs, regulatory framework and access charges. Whilst any reference to the Competition Commission is in progress our determination will apply.

Network Rail will publish its CP4 delivery plan by the end of March 2009. This will describe how the company will deliver the outputs required by our determination.

The Office of Rail Regulation (ORR), established in July 2004 under the Railways and Transport Safety Act 2003, is an independent statutory body led by a board, with responsibility for the safety and economic regulation of the national rail network and other aspects of rail services. It is also the safety regulator for other railways, including underground railways, heritage railways and trams.

Published by Office of Rail Regulation www.rail-reg.gov.uk

Our PR08 web page (www.rail-reg.gov.uk/server/show/nav.180) contains all the documents for the review