OFFICE OF RAIL REGULATION

2013 PERIODIC REVIEW

Periodic review 2013
First consultation

May 2011

Contents

Chair's foreword

This is a critical time for the rail industry – and it needs to demonstrate that it is up to meeting the challenges and grasping the opportunities it faces.

Sir Roy McNulty has published his study on the industry's value for money. In England & Wales, the Department for Transport is making changes to the franchising model and is considering the wider structure of the industry. In Scotland, the new government is developing its priorities. Network Rail has begun its programme of devolution to allow for greater partnership working with train operators at route level.

The railway can benefit from the significant growth in future demand that is projected and deliver more for the economy. But in order to grow it needs to reduce its costs. Sir Roy has clearly recognised that the industry needs to, and can, reduce its costs significantly.

Through this periodic review we can drive through the step change required in delivery and efficiency for the benefit of taxpayers and the passengers and freight customers who rely on Britain's rail network. At the heart of the review is our assessment of what Network Rail needs to deliver in the regulatory control period starting in April 2014 and how much funding it will receive. But the decisions taken will have an impact on the whole sector, not just Network Rail, and last longer than the regulatory control period.

Through the periodic review we aim to develop better incentives on the rail industry to do things differently and better. The review requires the active involvement of the whole industry, suppliers, customers, funders and wider stakeholders in making informed choices around what the railway can deliver for the money available.

This document marks the start of what we hope will be a wide-ranging debate. We are committed to open consultation on all the issues, and to giving full consideration to the responses we receive. We look forward to receiving your views on the issues raised in this document and to your engagement throughout the review.

Anna Walker, Chair, Office of Rail Regulation

25 May 2011

Acronyms and abbreviations

ATOC	Association of Train Operating Companies
BIS	Department for Business, Innovation and Skills
Capex	Capital expenditure
CLG	Company limited by guarantee
CP3	Control period 3 (1 April 2004 – 31 March 2009)
CP4	Control period 4 (1 April 2009 – 31 March 2014)
CP5	Control period 5 (1 April 2014 – end date to be decided)
DfT	Department for Transport
FIM	Financial indemnity mechanism
FOC	Freight operating company
HLOS	High level output specification
IIP	Initial industry plan
MIP	Management incentive plan
OM&R	Support and operations costs, maintenance and renewals
Opex	Operating expenditure
ORR	Office of Rail Regulation
PAYG	Pay-as-you-go
POG	Planning oversight group
PPM	Public performance measure
PR08	Periodic review 2008
PR13	Periodic review 2013
PTE	Passenger Transport Executive
RAB	Regulatory asset base
RFF	Ring-fenced investment fund
RFOA	Rail Freight Operators Association
RIA	Railway Industry Association
RPI	Retail price index
RUS	Route utilisation strategy
SBP	Strategic business plan
SoFA	Statement of public financial resources available
TOC	Train operating company

Executive summary

Purpose of this document

1. This document is our first main consultation on the 2013 periodic review (PR13).

2. A periodic review is a programme of work through which decisions are made on what outputs Network Rail should deliver and the levels of access charges payable by train operators and other sources of funding the company receives. PR13 will establish outputs and access charges/funding for control period 5 (CP5) which will begin on 1 April 2014. We determine the outputs and access charges/funding in the context of the priorities for railways set out by the governments in England & Wales and Scotland and the public financial support they make available.

3. PR13 will also establish the wider 'regulatory framework', including the financial framework for Network Rail and the incentives acting on it and train operators to deliver and outperform the determination, including targets for performance. A periodic review is a major programme of work for the whole industry. The decisions taken have significant implications for Network Rail, its suppliers, train operators, taxpayers, passengers and freight customers.

4. The purpose of this document is to:

   (a) explain the context, process and timetable for the review to allow stakeholders to plan their engagement;

   (b) set out our objective for PR13; and

   (c) consult on a range of key issues relating to the approach we will take to determining Network Rail's outputs and access charges for CP5.

Context of the review

5. Looking ahead to CP5 and beyond, rail faces some critical challenges that set the context for our review:

   (a) the need for the industry to improve efficiency and hence reduce costs to taxpayers and customers;

(b) the need to improve the availability and transparency of industry financial data to allow new incentive structures to be introduced and more effective benchmarking to be carried out;

(c) the importance of the industry playing a bigger role in planning and delivering the railway;

(d) the need to optimise the use and development of the network;

(e) the need to ensure the appropriate balance of risk and reward; and

(f) the importance of maintaining the focus on a safe railway.

6. The rail value for money (vfm) study led by Sir Roy McNulty has now been published. This has emphasised the need for clearer industry leadership, stronger and better aligned incentives and the need for the industry to make significant further efficiency improvements – of around 30% by 2018-19 compared to the 2008-09 baseline (noting that some of this improvement is already in-hand). The DfT is also proposing reforms of the rail industry. Some important changes stemming from the vfm study and proposals to reform the rail industry are already beginning to happen:

(a) train operators will start to take over full responsibility from Network Rail for the maintenance, repair and renewal of stations;

(b) DfT has announced it will move to longer franchises and more flexible specifications. This should facilitate the strengthening and alignment of incentives for Network Rail and train operators to work together to improve efficiency, which PR13 will help deliver;

(c) Network Rail has started the process of devolving greater responsibility for the management of the network to routes, which should - in conjunction with our work to disaggregate Network Rail's financial data - facilitate better partnerships with train operators and the implementation of incentives for cost control and revenue growth at this level;

(d) In the light of the vfm study recommendation in this area, Network Rail is considering letting one or more concessions for the management of infrastructure at a route level, with one of these potentially starting from the beginning of CP5. Such a concession would be a separately managed entity from Network Rail, be subject to regulation and provide a basis for comparability with Network Rail; and

(e) allied to this, Network Rail is also considering establishing a distinct network wide ‘system operator’ function to undertake system wide processes.

Our objective for, and conduct of, PR13

7. Our proposed objective for PR13 is: **to protect the interests of customers and taxpayers by ensuring our determination enables Network Rail and its industry partners to deliver or exceed all the specified outcome and output requirements, safely and sustainably, at the most efficient levels possible comparable with the best railways in the world by the end of the control period**.

8. In order to achieve our objective, we believe our approach to establishing the determination for CP5 and our approach to regulating delivery of it should be output and outcome based. Regulating on the basis of outputs and outcomes rather than inputs gives Network Rail flexibility as to how its outputs are achieved so that it can manage its business efficiently and respond to changes in circumstances and the developing needs of its customers and funders.

9. We also intend to use, as far as possible, market mechanisms and promote competition, because these are more likely to be responsive to the changing needs of rail users and more likely to lead to better outcomes than purely regulatory mechanisms.

10. We will design incentives to promote Network Rail’s delivery and outperformance of the outputs and access charge levels we set. A key feature of PR13 will be the development of stronger incentives for Network Rail and train operators to work together to reduce costs at route level.

11. We intend to conduct PR13 in line with best practice regulation principles and reflect the recommendations from the independent review of PR08 that we commissioned. We will engage fully with stakeholders, take full account of changes in government policy and encourage the industry itself to take more of the lead on, and responsibility for, planning and delivery.

Timetable

12. There will be three broad phases of work in PR13:

(a) **development phase**: running from now until our advice to ministers on the possible range of Network Rail's costs and key regulatory issues in February 2012. We will be taking forward development of the regulatory framework with the responses to this consultation being central to this. We will also be providing advice to the two governments on the development of their HLOSs/SoFAs.[1] In February 2012 we expect to issue our 'notice of a charges review' to the Secretary of State for Transport and Scottish Ministers, formally requiring them to provide us with their HLOSs and SoFAs in July 2012. These are a crucial input to the PR13 determination;

(b) **formal review phase**: running from February 2012 until October 2013. During this phase Network Rail produces its strategic business plan (SBP) for CP5 in response to the HLOSs, we review the SBP and decide if the governments' HLOSs are affordable. We make our determination on Network Rail's outputs, access charges and the regulatory framework for CP5, including decisions on improving Network Rail's efficiency; and

(c) **implementation phase**: running from the date of publication of our determination in October 2013 until the start of CP5 on 1 April 2014. During this phase changes to the access contracts are made, which are the key means of implementing many of the decisions we take in the review. Network Rail will also develop its CP5 delivery plan during this period.

Regulatory framework and key issues

13. In this document we consult on a range of key issues relating to the regulatory framework for CP5.

[1] The 'high-level output specifications' (HLOSs) will set out what outputs the governments in England & Wales and Scotland want to see delivered in CP5, and the 'statements on the public financial resources available' (SoFAs) set out the available funding.

14. **Price control framework**: we are consulting on further geographical separation of the price controls for each of Network Rail's operating routes[2] beyond setting out separate assessments of income and expenditure at each route level as part of the wider (England & Wales) price control. We are consulting on route level incentives and access charges. A key issue that will be considered in making decisions on the price control framework is the extent to which Network Rail is free to manage financial risk and outperformance/underperformance across all routes, i.e. will it be able to use surpluses achieved in one route to fund any shortfall in another rather than having each route effectively ring-fenced?

15. **Outputs**: there is still some way to go before outputs are set as the governments' HLOSs will not be published until July 2012. But there are issues of principle for both government and ourselves to consider, and we are consulting on these principles, for example whether the focus should be on outcomes (for example a new outcome target for customer satisfaction) or outputs, how best to present a 'scorecard' of Network Rail's performance, what this should cover and to what extent outputs should and can be set at a route level.

16. **Improving incentives**: incentives are central to the regulatory framework. We want to ensure that Network Rail faces strong incentives to perform well in its wide-ranging ranging roles. We also want it to forge partnerships with passenger and freight operators to enable the delivery of improved whole-industry outcomes. In PR13 we will undertake a comprehensive review of incentives. In particular:

    (a) following initial discussion with key stakeholders we consider that we should introduce a version of the efficiency benefit sharing mechanism which would work at the Network Rail operating route level. The aim would be for Network Rail and train operators to work together to reduce costs. This mechanism would provide train operators with a share of the benefits if Network Rail's costs were lower than expected, but they would pay part of the impact of costs being higher than expected – an 'upside' and 'downside' mechanism;

[2] This applies to England & Wales. Scotland remains one route.

(b) we are also consulting on whether Network Rail should share in train operators' revenues and, potentially, costs. There is also a question of whether train operators should be exposed to changes in Network Rail's costs at a periodic review;

(c) there may be benefits from an enhancement efficiency benefit sharing mechanism, based on bespoke arrangements between Network Rail and train operators;

(d) we are considering whether Network Rail's incentives to make best use of capacity should be improved; and

(e) we are also considering whether we should introduce additional incentives for innovation and carbon reduction.

17. Some of the possible areas of incentive improvement are matters for the franchise authorities (e.g. Network Rail sharing train operator costs and revenues) rather than us, but we are opening up the debate as the topics are important as part of whole industry incentives

18. **Financial framework**: we are not consulting on all issues relating to the financial framework at this stage (we will consult more widely on this in February 2012, which follows the Secretary of State's announcement on industry reform in November). At this stage we are seeking views on the indexation mechanisms that are used to rebase Network Rail's income each year during the control period as well as other mechanisms (e.g. 're-openers') that enable Network Rail to manage risk and uncertainty in its costs and revenues during the control period. We intend to retain the same broad approach to amortisation in CP5 that we introduced in CP4. We are seeking views on the balance between capital and operating expenditure incentives, to ensure that there is no undue bias towards capital expenditure and that there are strong enough incentives on Network Rail and the industry to implement operational solutions to optimise the use and development of the network. The duration of the control period is currently five years and we are consulting on whether it should be lengthened or shortened for CP5.

19. **Access charges**: access charges provide the basis for Network Rail to recover the efficient costs it incurs in managing the infrastructure used by train operators, a means to allocate costs to those that cause them and hence

provide incentives to train operators, suppliers and funders for the efficient use and development of vehicles and the infrastructure.

20. We are considering a number of improvements to how the current charges work and some possible more far reaching changes (building on some initial consultation for CP5 that we undertook in 2010). These include the introduction of new charges to make better use of existing capacity. In essence this would provide for a more ‘economic’ basis to access charging and stronger price signals to incentivise train operators to use the network efficiently and Network Rail to accommodate demand and develop the network efficiently. These improvements and changes include:

    (a) reviewing the detailed calculation of the variable charge and assessing whether it should be geographically disaggregated. This aligns with devolution and a greater local focus in the industry and would improve cost reflectivity and transparency but could introduce additional complexity to the industry;

    (b) reviewing the pros and cons of introducing scarcity and reservation charges, both intended to encourage the more efficient use of capacity. A scarcity charge would reflect the costs of providing new capacity and hence would mean higher charges in capacity constrained areas, while a reservation charge would be designed to make more efficient use of freight paths, with charges reimbursed if paths are used; and

    (c) examining changing the structure of charges to encourage greater competition, i.e. to provide for open access operators to compete more directly with franchised operators if they pay higher track access charges (including reviewing the ‘not primarily abstractive’ test in line with this).

21. In reviewing the structure of charges we will need to consider the interaction between the possible changes, for example how a geographically disaggregated variable usage charge would interact with a scarcity charge, and the speed at which any changes could be sensibly implemented.

22. **Package:** our determination for CP5 will be a balanced ‘package’ of decisions and judgements covering all the aspects of the regulatory framework, in the context of the governments’ HLOSs/SoFAs and the reasonable requirements of all of Network Rail’s customers and funders. In making our decisions we

will consider the interaction between all parts of the framework and the implications of the possible changes, to ensure that the package is fit for purpose.

Consultation

23. We are seeking responses to the questions raised in this document by 2 September 2011.

24. Our website provides a full set of documentation on previous periodic reviews and will be updated with material for PR13. We will be holding industry workshops during the consultation period in Edinburgh (on 5 July 2011), Cardiff (on 11 July 2011), London (on 12 July 2011) and Manchester (on 21 July 2011), with further workshops on specific topics. For more details about these events see our website.

1. Introduction

Purpose of this document

1.1 A periodic review is a programme of work through which decisions are made on what outputs Network Rail should deliver and the levels of access charges payable by train operators and other sources of funding the company receives (reflecting a challenging but achievable level of efficiency improvement), in the context of the priorities for railways set out by the governments in England & Wales and Scotland and the public financial support they make available.

1.2 A review also establishes the wider ‘regulatory framework’, including the financial framework for Network Rail and the incentives acting on it and train operators to deliver and outperform the outputs and our assumptions of income and expenditure. A periodic review is one of our core functions and is a major programme of work for the whole industry. The decisions taken in a periodic review have significant implications for Network Rail, its suppliers, train operators, taxpayers, passengers and freight customers.

1.3 This document is our first main consultation on the 2013 periodic review (PR13).[3] PR13 will establish outputs and funding for control period 5 (CP5) which will begin on 1 April 2014.[4] The purpose of this document is to:

(a) explain the context, process and timetable for the review to allow stakeholders to plan their engagement;

(b) set out our objective for PR13; and

(c) consult on a range of key issues relating to the approach we will take to determining Network Rail’s outputs and funding for CP5.

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3 Our PR13 web page is at http://www.rail-reg.gov.uk/server/show/nav.2446.

4 We completed our last periodic review in October 2008: the 2008 periodic review (PR08), which established Network Rail’s outputs and funding for the period from 1 April 2008 to 31 March 2014, known as control period 4 (CP4). Our determination for CP4 is available at http://www.rail-reg.gov.uk/upload/pdf/383.pdf.

Context and key issues for PR13

1.4 PR13 will be carried out against the backdrop of a number of important achievements by Network Rail and the rail industry, but also in the context of a number of major challenges and opportunities.

1.5 Over the last decade the industry has achieved significant improvements in operational performance and safety. Customer satisfaction has improved and the growth in demand that started in the mid-1990s has continued. Figure 1.1 shows the trend in the main measure of industry operational performance, the public performance measure (PPM[5]). Following the collapse of performance after the Hatfield accident in October 2000 the industry has worked together to deliver significant improvements in PPM, which has now recovered to levels above those prior to Hatfield.

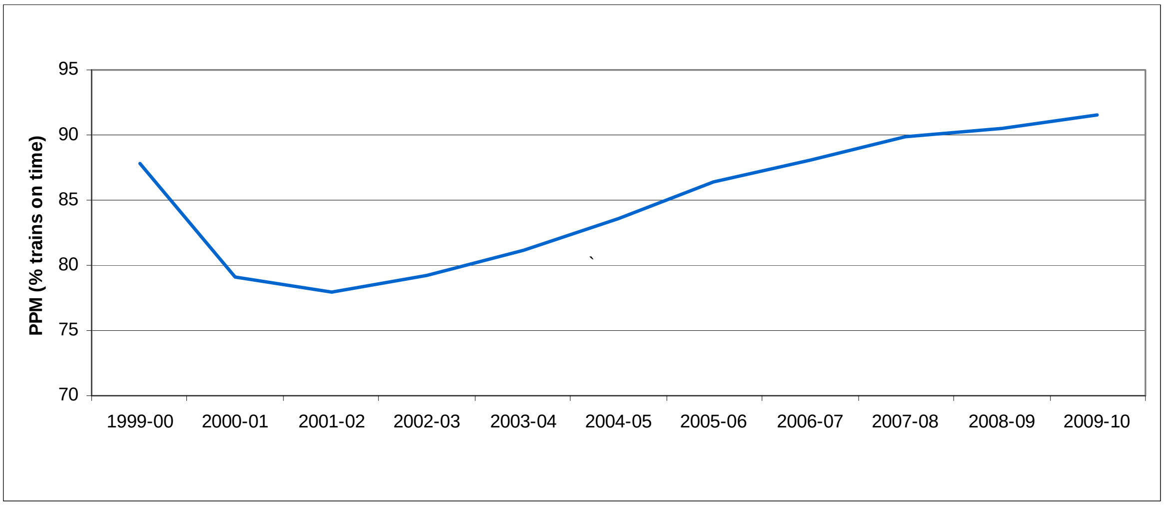

Figure 1.1: PPM since 1999-2000

1.6 The railway has confirmed its position as a key transport mode in a variety of passenger and freight markets across Great Britain, and one which is more environmentally friendly than other forms of transport.

1.7 The improvements in PPM have gone hand-in-hand with passenger and freight growth, as figures 1.2 – 1.4 show. Passenger kilometres have risen from some 28 billion in 1994-95 to around 50 billion in 2009-10 and the

[5] PPM is the percentage of passenger trains arriving at their destination, having made all booked calls, and within a specified lateness margin (typically five minutes, or ten minutes for some long-distance services).

number of passenger journeys each year has increased from about 700 million to over 1.2 billion over the same period. The network has become increasingly intensively used and the number of trains on a weekday has increased to 24,000, 25 per cent more than at privatisation in 1994. Traffic levels have generally held up strongly through the recent recession and traffic is widely forecast to double by 2030. Freight has also shown significant growth since 1994-95, although there has been a downturn over the last three years due to the effects of the recession and a reduction in the movement of coal (due both to the economy and energy policy and relative energy prices).

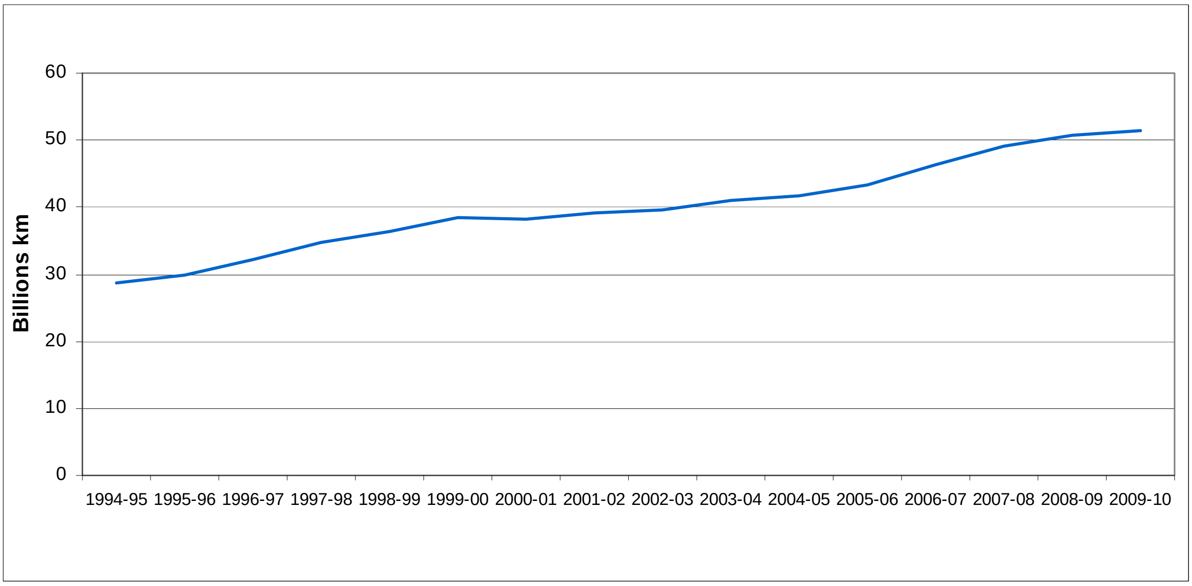

Figure 1.2: Passenger kilometres since 1994-95

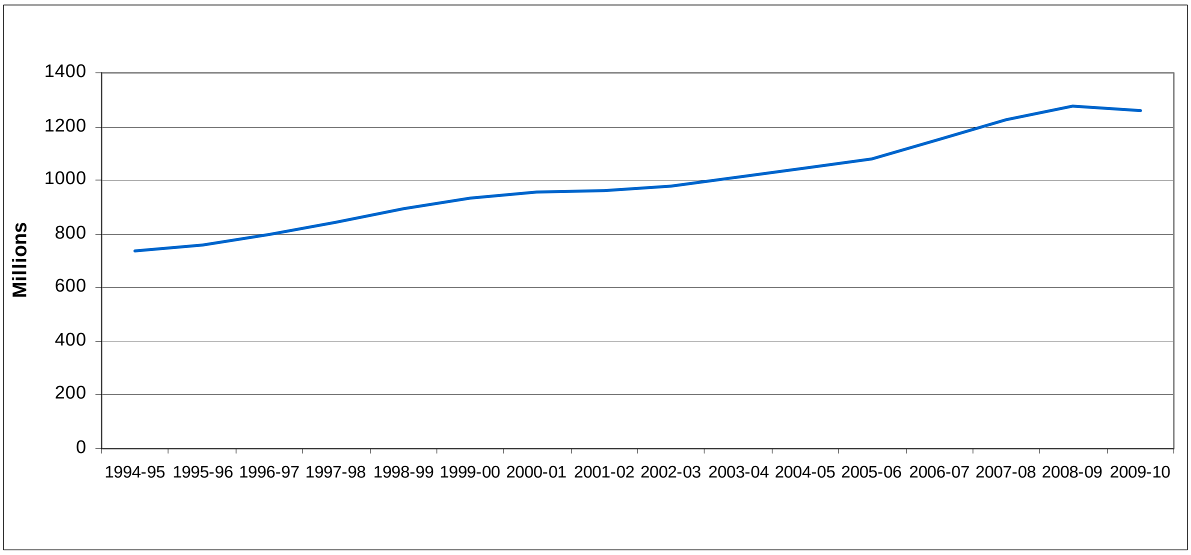

Figure 1.3: Passenger journeys since 1994-95

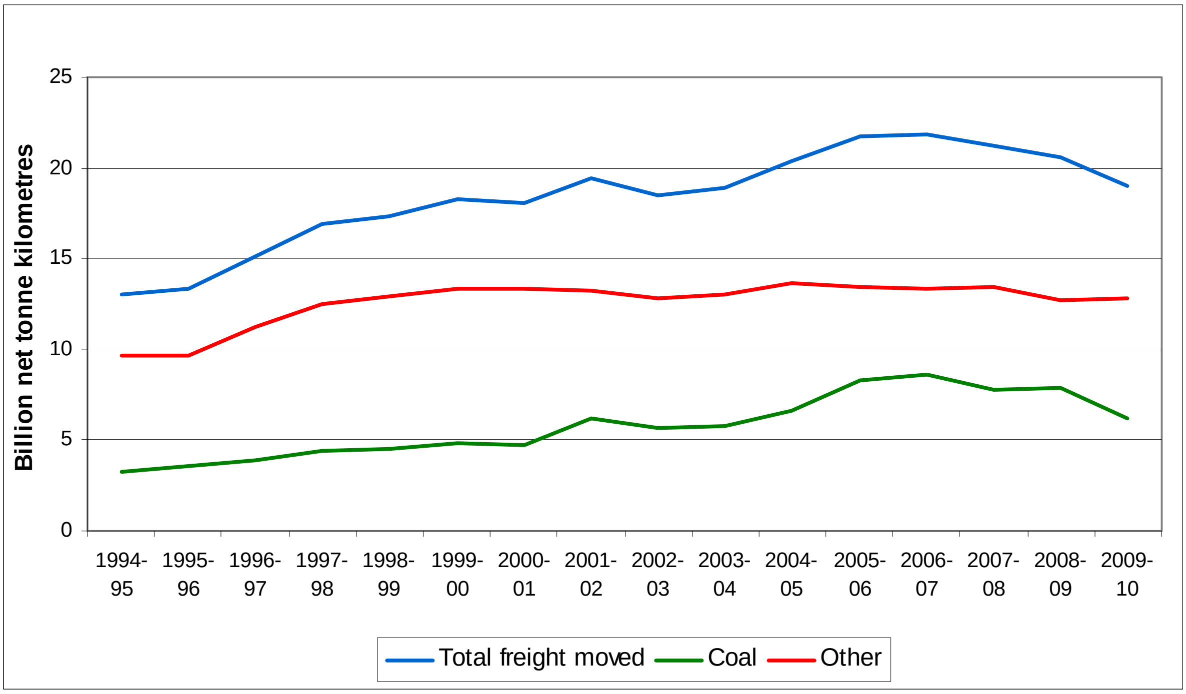

Figure 1.4: Freight tonne kilometres since 1994-95

1.8 Network Rail has a central role in the industry. Since it took over ownership of the rail infrastructure in 2002 from Railtrack (in administration) it has delivered significant investment in the network of some £27 billion,[6] including implementing schemes to enhance the capacity and capability of the network in response to the increases in traffic.

1.9 The company has also made important strides to improve its efficiency. When it took over the infrastructure Network Rail inherited a situation where, in the aftermath of the Hatfield accident, costs had risen dramatically. As figure 1.5 shows, operating, maintenance and renewals expenditure rose to more than £7 billion in 2003-04, around double the level of the years between privatisation and Hatfield. Part of the increase in costs was necessary to address the deficiencies and shortfall in asset maintenance and renewals but a significant amount was due to inefficiency. Since 2003-04 Network Rail has improved its efficiency by more than 30 per cent, which is the equivalent of £11 billion of cost savings over the period. The benchmarking work we have undertaken shows that there is still further efficiency improvement that Network Rail can make in CP5, building on its progress to date.

[6] £21 billion on renewals and £6 billion on enhancements.

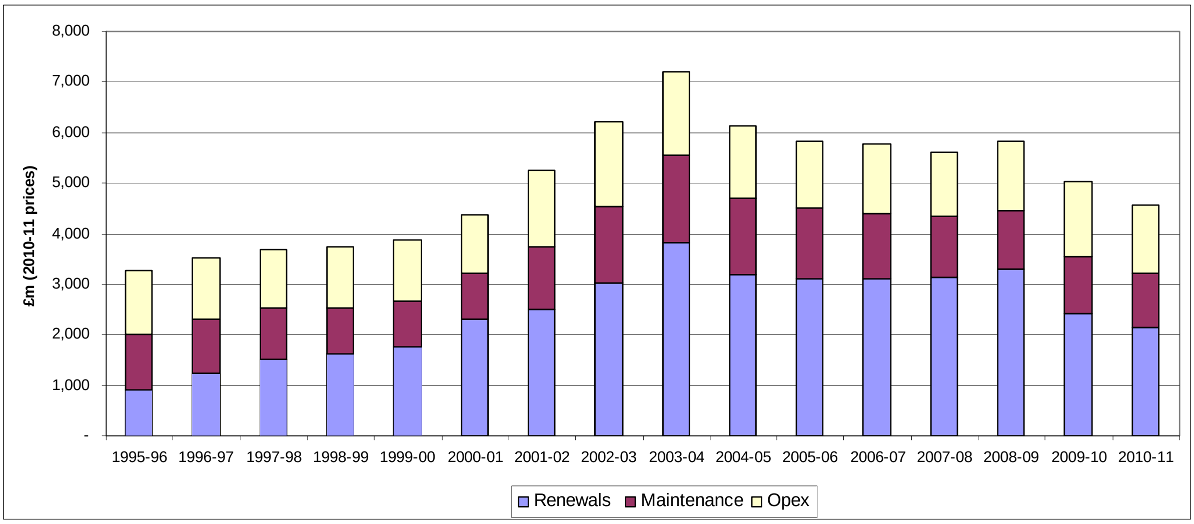

Figure 1.5: Network Rail's operating, maintenance and renewals expenditure since 1995-96

Rail value for money study

1.10 On 19 May 2011, Sir Roy McNulty published the report of the study he led to make recommendations to improve value for money (vfm) in the industry (which we jointly sponsored with DfT). The vfm study has highlighted both the growth opportunities for the industry, through the rising demand for rail, but also, critically, the value for money challenge that the whole rail industry faces and the need to respond to this for passengers and taxpayers.

1.11 The vfm study has highlighted, building on and extending our benchmarking work of Network Rail, that GB rail industry unit costs are significantly higher than they should be for the outputs delivered, and have changed little since privatisation. The study finds that the annual costs of the industry could be reduced by up to £1 billion by 2018-19 compared to the 2008-09 baseline, in addition to the efficiency we assumed Network Rail can achieve in CP4 and the provisional indications for Network Rail's efficiency improvement in CP5.[7]

1.12 The study found a range of barriers to efficiency in the GB rail industry, including: how well the interfaces in the industry have worked; the way in which major players in the industry have operated; the roles of Government and industry; the nature and effectiveness of incentives; the franchising

[7] In PR08 we assumed Network Rail could improve efficiency by around 35% over ten years, assuming 21% of this in CP4, with the remainder provisionally indicated for CP5 (albeit stating that we would review the scope and phasing of efficiency for CP5 in more detail as part of PR13).

model; the fares structure; the legal and contractual frameworks; supply chain management; insufficient emphasis on whole-system approaches; and the relationships and culture within the industry.[8]

Key challenges

1.13 Looking ahead to CP5 and beyond, building on the findings of the vfm study, rail faces some key challenges that set the particular context for PR13:

(a) **improving efficiency and hence reducing costs to taxpayers and customers**. As the vfm study finds, the rail industry can, and must, improve its efficiency further. Network Rail, working with the train operators and the supply chain, must continue to improve its own efficiency, but it is only by working together that the industry can make the further improvements that are necessary. If it meets this challenge it will strengthen its position to meet the longer term needs of its customers, improve its competitive position against other transport modes and reduce the dependence on taxpayer support. The work we will do in PR13 to assess the efficiency improvement achievable by Network Rail in CP5 is critical to this, as will be the work we do to better align the incentives between Network Rail and train operators so that they work in partnership to reduce whole industry costs;

(b) **improving the availability and transparency of industry financial data**. We want to see Network Rail and the industry produce better quality data at a more disaggregated level. This will mean: we can undertake more robust benchmarking; there will be a basis for providing regional efficiency benefit sharing; local decision making is facilitated, for example by passenger transport executives (PTEs); and better information is provided to taxpayers and farepayers;

(c) **giving the industry a bigger role in planning and delivering the railway**. The industry is closer to customers than government and the vfm study has recommended an enhanced role for the industry. We have asked the industry to develop an initial industry plan to inform decisions on PR13 and we will expect Network Rail, working with its industry partners, to produce a clear and robust delivery plan before the

[8] *Realising the potential of GB rail: report of the rail value for money study*, May 2011. This can be accessed at http://www.rail-reg.gov.uk/server/show/ConWebDoc.10401.

new control period begins in April 2014, to set out how it will achieve the outputs required;

(d) **optimising use and development of the network**. Meeting rising demand and rising customer expectations on an increasingly busy network and allowing rail to play its role in supporting economic growth, at a time of tight public financial resources, will require robust assessment to choose between capital enhancement, operational and pricing options. We will expect Network Rail's and the industry's plans for PR13 to demonstrate that a wide range of options have been considered. In addition, a key part of PR13 will involve developing incentives and access charges to better underpin optimal use and development of the network;

(e) **having the right approach to risk and reward**. We need to allocate risks between Network Rail and its customers and funders based on who is best placed to manage them in a way that provides the best value for money overall. Through PR13 we intend to establish a challenging but achievable determination for Network Rail for CP5, reflecting the greatest possible efficiency improvement. In doing this we need to appropriately balance the funding provided to Network Rail with the incentives we place on the company to deliver and outperform our determination and the mechanisms we provide to manage risk. This is to ensure that the overall risk/reward trade-off is appropriately balanced; and

(f) **maintaining the focus on a safe railway**. There will be a need for significant change in the rail industry and it is essential that the way change is planned and implemented does not compromise safety. We will ensure safety is integral to our approach to PR13.

1.14 Although PR13 cannot address all the challenges facing the industry, it provides a vehicle for the industry to discuss, develop and implement measures to achieve many of the significant improvements necessary to deliver a better railway. In particular, as emphasised above, PR13 will provide for robust assessment of Network Rail's costs and funding requirement and the design and implementation of strong and aligned incentives that facilitate Network Rail and train operators working together to drive down costs, grow revenue and to optimise use and development of the network.

1.15 Many of the changes also require changes to the governments' (and other franchising authorities) approach to franchising and it may only be sensible to implement some changes during refranchising. In particular, in order to facilitate joint incentives it will be essential to switch off or relax the 'no net loss, no net gain' provisions in franchises that currently exist. These insulate train operators from financial impacts of changes we make at periodic reviews, which have the effect of nullifying many of the incentives for train operators to work together with Network Rail to drive down costs. We are having further discussions on this. Eight of the current 19 franchises are due for renewal (see annex G for a summary franchise timetable) before the start of CP5 which provides a basis to introduce the changes necessary. However we assume that continuing franchises will be unchanged which means that in CP5 there will be a mix of approaches across the network that will impact on how new incentives have effect. This is an important issue for us to have regard to as we undertake PR13.

1.16 Some important changes stemming from the vfm study and rail reform discussions are already beginning to happen:

(a) building on industry discussion over the last couple of years, train operators will start to take over full responsibility for the maintenance, repair and renewal of stations from Network Rail;

(b) DfT has reviewed its franchise model and, amongst other changes, will move to letting longer franchises;

(c) Network Rail has started the process of devolving greater responsibility for the management of the network to its routes, under new route managing directors which should facilitate greater partnerships at a route level and underpin regional efficiency benefit sharing;

(d) in the light of the vfm review recommendation, Network Rail is considering letting one or more concessions for the management of infrastructure at a route/regional level, with one of these potentially starting from the beginning of CP5. Such a concession would be a separately managed entity from Network Rail, be subject to regulation and provide a basis for comparability with Network Rail; and

(e) allied to this, Network Rail is also considering establishing a distinct network wide 'system operator' function to undertake system wide processes such as national IT systems and long term network wide planning.

Background to this consultation

1.17 We had originally planned to start PR13, and publish our first consultation, in October 2010. However, the vfm study and the Department for Transport's strategic reviews of franchising and industry reform were ongoing and this introduced significant uncertainty for the context and conduct of PR13. We therefore decided to defer the start of PR13 until there was more clarity on these reviews.

1.18 We recognise that DfT and Transport Scotland still have a number of decisions to take on industry reform and the recommendations of the vfm study. In England & Wales, the Secretary of State will set out his plans on rail reform in November 2011. Following the recent election, the new government in Scotland will set out its priorities.

1.19 These decisions are likely to affect how we carry out this periodic review but we consider that there is now sufficient clarity to start PR13. Indeed, PR13 is a mechanism to implement some of the changes that are or may be sought.

Periodic review legal process and government requirements

1.20 The periodic review process is a legal process (set out in schedule 4A of the Railways Act 1993). An important part of the process is that the Secretary of State for Transport and Scottish Ministers must tell us what they want to be achieved by railway activities during the control period and the public financial resources that are, or are likely to be, available for this. We expect them to do this by producing 'high-level output specifications' (HLOSs), setting out what outputs they want to see delivered, and 'statements on the public financial resources available' (SoFAs) which set out the available funding.

1.21 We will take full account of the HLOSs and SoFAs in making our decisions. We will also take account of the reasonable requirements of all of Network Rail's customers and other funders, including open access passenger and freight train operators, PTEs and local authorities, to the extent that these are not covered by the government specifications.

Structure of this document

1.22 The remainder of this document is structured as follows:

(a) chapter 2 lists the consultation questions in this document;

(b) chapter 3 set outs our proposed objective for PR13;

(c) chapter 4 explains how we plan to conduct PR13;

(d) chapter 5 describes the high level timetable;

(e) chapter 6 summarises our main workstreams in PR13 and the key issues relating to the regulatory framework that we are consulting on now;

(f) annex A lists our statutory duties;

(g) annexes B – F provide more detail on the issues relating to the regulatory framework discussed in chapter 6; and

(h) annex G summarises the franchising timetable.

Issues for consultation and how to respond

1.23 We welcome responses on any aspect of this consultation, and we are also asking a number of specific questions in this document (summarised in chapter 2). Your comments are welcome on all the consultation questions or just those which you think most affect you or your organisation. You may want to give your views on the interactions between the possible changes.

1.24 Please send your responses in electronic (or if not possible, in hard-copy format) by 2 September 2011 to:

Richard Gusanie
Office of Rail Regulation
1 Kemble Street
London WC2B 4AN
Email: richard.gusanie@orr.gsi.gov.uk
Tel: 020 7282 2065

1.25 Please note, when sending documents to us in electronic format that will be published on our website, we would prefer that you email us your correspondence in Microsoft Word format. This is so that we are able to apply web standards to content on our website. If you do email us a PDF document, where possible please:

(a) create it from the electronic Microsoft Word file (preferably using Adobe Acrobat), as opposed to an image scan; and

(b) ensure that the PDF's security method is set to no security in the document properties.

1.26 If you send a written response, you should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise, we would expect to make it available on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, that can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

Further information and next steps

1.27 Our website www.rail-reg.gov.uk will provide information on the progress of the review. If you want to be alerted to developments you can subscribe to our email 'alert' service on the website. Our website also provides a full set of documentation on previous periodic reviews.

1.28 We will be holding industry workshops during the consultation period in Edinburgh (on 5 July 2011), Cardiff (on 11 July 2011), London (on 12 July 2011) and Manchester (on 21 July 2011), with further workshops on specific topics. We will be publishing the presentations and summaries of discussions at these workshops on our website. For more details about these events see our website.

2. Summary of consultation questions

2.1 This chapter provides a summary of our consultation questions which need to be read in the context of the specific chapter. Each question is referenced to the main text and, where relevant, the annexes.

Chapter 3 (our objective for PR13)

Q1 Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

Chapter 5 (high-level timetable)

Q2 Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement with PR13?

Chapter 6 and annex B

Price control separation and Network Rail devolution

Q3 Do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the right level? Do you have views on the information train operators should produce?

Q4 Which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?

Q5 Do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

Chapter 6 and annex C

Outputs

Q6 Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined? Should there be a move to more use of outcome based obligations? Would another approach be appropriate such as specifying inputs or intermediate measures?

Q7 What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

Q8 Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

Q9 How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

Q10 How should the balance between the number of output obligations and their individual significance be struck?

Q11 Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

Chapter 6 and annex D

Incentives

Q12 Do you have views on how the effectiveness of the existing financial incentives can be improved?

Q13 Do you have views on how the effectiveness of Network Rail’s incentives to make best use of capacity could be improved?

Q14 Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level? Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?

Q15 What are your views on exposing franchised passenger train operators to changes in Network Rail’s costs at a periodic review?

Q16 Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?

Q17 We would welcome your views on possible bespoke arrangements for enhancement efficiency benefit sharing and whether there is a need for additional measures to increase the contestability of expenditure?

Q18 Are there further new incentives which you believe should be introduced and what would the benefits be?

Q19 Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

Chapter 6 and annex E

Financial framework

Q20 What are your views on the duration of the control period?

Q21 Do you think that we should retain the single till approach rather than moving to a dual till approach?

Q22 Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

Q23 Network Rail faces a number or risks. At this stage, do you have any views on how general inflation risk and input price risk should be addressed?

Q24 We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

Chapter 6 and annex F

Structure of charges

Q25 Do you consider that our charging objectives remain appropriate?

Q26 What are your views on the geographical disaggregation of variable usage charges?

Q27 What are your views on introducing a charge levied to reflect network scarcity?

Q28 What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

Q29 Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

Q30 What are your views on the proposals to improve incentives to reduce traction electricity consumption?

Q31 Should we put a cap on certain freight charges in advance of our determination and should these be linked to other changes?

Q32 Do you have views on the interactions between these possible changes and when they should be implemented – for example whether some changes should only be introduced after other changes have 'bedded in'?

3. Objective for PR13

Introduction

3.1 This chapter sets out our proposed objective for the review and how we plan to achieve this objective, reflecting the wider economic context for PR13 and our approach to conducting it, as described in chapters 1 and 4.

Key issues

3.2 The key issues that form the wider context for PR13 include:

(a) the need for significantly **greater efficiency and value for money** from the rail industry, and as part of this, the need to address the key recommendations of the vfm study including the alignment of incentives;

(b) **increasing demand** for railway services by passenger and freight customers along with **rising expectations** in terms of safety, performance and service, building on the significant improvements delivered in recent years;

(c) new **DfT policy to encourage private sector investment** through longer franchises in England & Wales and for Network Rail and train operators to be better incentivised to make cost savings and improve customer service. Scottish Ministers will be considering the future shape of passenger rail services in Scotland, and we will take account of the conclusions they reach in our periodic review process;

(d) the demands for the railway to make a significant contribution to **economic growth and carbon savings**; and

(e) the **devolution and reform of Network Rail's structure**, providing opportunities for comparative regulation and requiring a different regulatory approach in CP5.

3.3 We have developed a proposed objective for the review which is consistent with our statutory duties (which are shown in annex A). Ultimately we will need to be satisfied that we have discharged our statutory duties in our conduct of the review.

Overall objective for PR13

3.4 In the context of the key issues set out above we propose that our overall objective for PR13 should be: **to protect the interests of customers and taxpayers by ensuring our determination enables Network Rail and its industry partners to deliver or exceed all the specified outcome and output requirements, safely and sustainably, at the most efficient levels possible comparable with the best railways in the world by the end of the control period.**

Achieving our objective

3.5 Our approach to achieving this objective reflects our view on how best to regulate the railways. We believe our approach should be **outcome and output-based**. Regulating on the basis of outputs rather than inputs gives Network Rail flexibility as to how these outputs are achieved so that it can manage its business efficiently and respond to changes in circumstances and the developing needs of its customers and funders.

3.6 It should also be **market and incentive-based**. We will use, where possible, effective market mechanisms and promote competition, because these are more likely to be responsive to the changing needs of rail users and more likely to lead to better outcomes than purely regulatory mechanisms.

3.7 Hence to achieve the objective, we propose to:

3.8 **Specify outcomes/outputs**:

(a) in a way that reflects what funders and customers want from the railway and which supports full accountability for their delivery through being appropriately targeted, disaggregated and measurable; and

(b) having taken full account of what the taxpayer can afford.

3.9 **Use market-based approaches to drive down costs and support better outcomes for consumers**, by:

(a) strengthening and aligning incentives to encourage greater cooperation between Network Rail and train operators to stimulate investment and improve efficiency and service quality;

(b) facilitating greater contestability for work on Network Rail's infrastructure to reduce costs and support investment; and

(c) encouraging greater competition wherever this can yield benefits for consumers and taxpayers.

3.10 **Set access charges so that they**:

(a) are affordable whilst enabling outputs to be delivered efficiently on a sustainable and value for money basis;

(b) drive cost recovery and whole system cost minimisation; and

(c) send appropriate price signals to encourage the efficient use of capacity.

3.11 **Encourage innovation and the adoption of best practice** that will be necessary for the industry to address the issues that have been preventing it from achieving higher levels of cost-efficiency and performance.

3.12 We consider that if we achieve our overall objective, it should in CP5 and beyond deliver a railway that:

(a) is safer than ever before, and provides consistently good levels of service reliability across the network;

(b) achieves a better match of the available supply to the demand and more efficient use of available capacity, supporting both the reduction of crowding and greater convenience for passengers, and providing increased flexibility and reliability for freight customers;

(c) has levels of efficiency comparable with the best railways internationally, providing value for money for taxpayers and fare-payers; and

(d) supports the development of a more dynamic economy and contributes to the achievement of national commitments to reduce carbon emissions, through both greater energy efficiency and by encouraging greater use of rail for travel and freight haulage by those that would otherwise use less environmentally friendly transport modes.

3.13 Do you agree with our proposed objective for the review? If not, what issues would you add or subtract?

4. How we will conduct PR13

Introduction

4.1 This chapter summarises how we will carry out PR13 in line with best practice regulation and take into account the recommendations from the independent review of PR08.

Principles for economic regulation

4.2 Our approach to regulation is based on the following principles which are consistent with those set out by the Department for Business, Innovation and Skills (BIS)[9]:

(a) **accountability**: we will be transparent in our work and explain our decisions;

(b) **predictability**: we aim to provide a stable environment to allow long term investment decisions to be taken with confidence;

(c) **coherence**: our regulatory framework is set within the government's broader policy context;

(d) **adaptability**: our approach will evolve in response to changing circumstances;

(e) **efficiency**: our interventions will be proportionate and our decision making timely and robust; and

(f) **focus**: we will set priorities focused on outputs and outcomes rather than specified inputs.

Independent evaluation of PR08

4.3 Following completion of PR08 our board commissioned an independent evaluation of the way in which we carried out PR08.[10]

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9 *Principles for Economic Regulation*, Department for Business, Innovation and Skills, April 2011. This can be accessed at http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation.

4.4 Overall the independent review judged PR08 to be well managed and delivered. It found our process to be open and inclusive; and that we achieved our principal objectives for the review. But it identified some areas for improvement. We have previously set out our response to these and how we would have regard to them in PR13.[11] The most relevant areas for this consultation are:

(a) the need for an early full consultation on the periodic review objectives;

(b) better and earlier customer and stakeholder representation and engagement;

(c) setting out clearly our information requirements from Network Rail at the start of the review; and

(d) reviewing the approach to the periodic review for Scotland, given the separate responsibility that the Scottish government has for funding and setting the strategy for the railway in Scotland.

4.5 This consultation aims to meet the first recommendation and is the first step in the process for meeting the second. We have defined a number of information requirements from Network Rail which will be set out in our consultation on the assessment of efficient expenditure (see chapter 6). In this first consultation document and elsewhere we will highlight specific issues for Scotland and we have been working with Transport Scotland to understand and take account of their key issues for the railway in Scotland that impact on the periodic review process.

4.6 Taking into account our regulatory principles and the independent review, we see four aspects of the PR13 process as being particularly important:

(a) we will engage fully with stakeholders using a wide range of methods to ensure we consult in the most effective way – including through holding workshops (for which we will publish minutes) and bilateral meetings;

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[10] The report is available at http://www.rail-reg.gov.uk/upload/pdf/PR08evaluation.pdf. Our covering letter for the report may be accessed at www.rail-reg.gov.uk/upload/pdf/PR08evaluation_be050809let.pdf.

[11] Our response to the independent evaluation is available at http://www.rail-reg.gov.uk/upload/pdf/pr13-orr-letter-291009.pdf.

(b) we will work to ensure that the regulatory framework that results from PR13 is as simple as is reasonably practicable, in the context of a complex industry;

(c) we will have regard to the likely changes to industry structure and government approach, for example, by recognising the ‘localism’ agenda and its implications for the review; and

(d) we will also promote the use of the industry’s own long-term planning processes during the review to inform our thinking on the key issues and support greater industry leadership, most specifically through the role of the initial industry plan (see chapter 6).

4.7 Ultimately, passengers and freight customers will be affected by the decisions we take and the input from their representative groups, e.g. Passenger Focus, our forum of consumer experts[12] and the Rail Freight Group, is important. The principal funders (the Secretary of State and Scottish Ministers), Network Rail (as an organisation but also including its members) and the passenger and freight train operators are key parties involved in a periodic review, but there are many other parties who will have a significant interest in the process and the outcomes. These include bodies such as the Welsh Government, Transport for London, passenger transport executives, rolling stock companies, suppliers and local authorities.

4.8 We will conduct our periodic review in a transparent way that supports thorough engagement with stakeholders and uses high quality analysis and information to ensure confidence in our determinations and which promotes accountability. It is therefore important that all parties understand how the process will work, what the timescales are, how they will be involved and what information will be available when.

[12] The forum is a body which advises us on issues from a passenger perspective with the aim of ensuring we focus on delivering for passengers. For more details see http://www.rail-reg.gov.uk/server/show/nav.2505.

5. High level timetable

Introduction

5.1 This chapter explains the PR13 process and the main milestones. The chapter should help stakeholders decide when and where they need to get involved.

Timetable

5.2 There will be three broad phases of work:

(a) **development phase**: from now until February 2012. During this phase we will progress our work on the regulatory framework described in chapter 6 and the industry will develop and publish its initial plan. This phase culminates in our advice to ministers prior to their decisions on the HLOSs/SoFAs. In our advice to ministers we will set out our decisions on the framework for setting outputs and access charges. We will also be assisting with the development of the HLOSs/SoFAs so that we are in a position to carry out our role effectively later in the process;

(b) **formal review phase**: running from February 2012 until October 2013. During this period we will decide if the governments' HLOSs are affordable and make our decisions on Network Rail's outputs, funding and the wider regulatory framework; and

(c) **implementation phase**: running from October 2013 (the date of publication of our determination) until the start of CP5 on 1 April 2014. Unless we receive objections from Network Rail or others which affect this timetable, during this period we will make changes to the access contracts between train operators and Network Rail. It is through changing these contracts that we are able to implement many of the decisions we take in the review. We may also need to make changes to licence conditions. Network Rail will also develop its delivery plan during this period.

5.3 Following the implementation of PR13 we will undertake an evaluation to learn lessons for the next periodic review.

5.4 Table 5.1 summarises the main milestones. Stakeholders need to be clear who they should be contacting at specific points in the process and what decisions are being made, and we have highlighted this below.

Table 5.1: Provisional high-level PR13 timetable

Development phase	
25 May 2011	We publish our first PR13 consultation document
30 June 2011	We publish our document on how we will assess Network Rail's efficient expenditure
By 31 July 2011	We publish a review of the role of open access operators in on rail competition
2 September 2011	Consultation on our first consultation document closes
By 30 September 2011	The initial industry plan (IIP) is published, setting out the industry's view on what should be delivered in the next control period and at what cost
1 October 2011	We seek views on the IIP. This will not be a formal consultation, but an opportunity to get any further views before we produce our advice to ministers
18 November 2011	We receive views on the IIP by this date
By 30 November 2011	Further consultation on detailed incentives issues and proposals
Formal review phase	
23 February 2012	We publish our advice to ministers and decisions on the framework for setting outputs and access charges. We will also consult on detailed financial issues
By 31 July 2012	Secretary of State for Transport and Scottish Ministers publish their HLOSs/SoFAs
1 August 2012	We consult on the outputs Network Rail should be required to deliver
28 September 2012	Our consultation on Network Rail's outputs closes
7 January 2013	Network Rail publishes its strategic business plan
14 January 2013	We consult on Network Rail's strategic business plan

8 April 2013	Our consultation on Network Rail's strategic business plan closes
6 June 2013	We publish our draft determination
5 September 2013	Consultation on our draft determination closes
31 October 2013	We publish our final determination
Implementation phase (assuming no objections)	
November/December 2014	Final access charges (price lists/charge schedules) are audited and approved by us. Review notices are served which start the formal implementation of PR13. (subsequent dates depend on exactly when the review notices are issued)
January/February 2014	Final point (specific date to be defined) at which objections could be made to our review notices (not less than six weeks from the date of publication of the review notice)
January/February 2014	We issue notice of agreement (specific date to be defined)
February/March 2014	We issue our review implementation notice (specific date to be defined)
By 31 March 2014	Network Rail publishes its delivery plan
1 April 2014	Implementation of PR13 determination and start of CP5

Explaining the main milestones

ORR's efficient expenditure assessment: June 2011

5.5 We will shortly be publishing a consultation document on how we intend to assess how much money Network Rail should need to spend in CP5. This will cover the full range of Network Rail's expenditure – support and operations costs, maintenance and renewals costs and the costs of enhancements. A key part of this work will be the method for deciding how much more efficient the company can become in CP5.

ORR's consultation on the role of open access operators in on rail competition: July 2011

5.6 We will be publishing a review of the role of open access operators in on-rail competition. This is described in more detail in annex F.

The industry's initial industry plan: September 2011

5.7 The IIP is being developed by the Planning Oversight Group (POG), which is the industry body overseeing the industry planning work with representatives from Network Rail, passenger and freight operators and suppliers. The purpose of the initial industry plan is to provide information and options to government and ourselves, to inform the HLOSs and SoFAs and PR13 overall. It provides an opportunity for the industry to set out a convincing and affordable strategy which meets the needs of customers.

5.8 It is important that the plan provides a robust platform for the review and POG is seeking views from a wide range of stakeholders. When the IIP is published we will ask for any further views and comments. This will not be a formal consultation – it is not our document – but it will help ensure that the plan fully informs the PR13 process.

5.9 The IIP will specifically address some of the issues raised in the vfm study, for example on whole industry asset management, and hence provide a vehicle for the industry to respond to the review.

5.10 It will set out a 'preferred' scenario which describes what the industry believes needs to be delivered in terms of safety, capacity, performance, journey times and the environment, including trajectories for carbon. The forecast costs and revenues will be set out, including the scope to reduce the cost base through greater efficiency and to increase revenues.

5.11 The plan will also describe the industry's stance on wider policy issues, for example on how much resilience – such as weather resilience – should be built into the network.

ORR's further consultation on detailed incentives issues and proposals: November 2011

5.12 Following the responses to this consultation we intend to publish a more specific consultation on detailed incentives issues and proposals.

ORR's advice to ministers and framework for setting outputs and access charges: February 2012

5.13 Our advice to ministers will draw on: the work we will have completed on the regulatory framework (which is described in chapter 6); consultation responses on this first consultation document; our expenditure assessment consultation; the IIP; and the views we receive on the IIP.

5.14 Our February 2012 document will have a number of purposes. It will:

(a) formally mark the start of the 'access charges review' under the Railways Act 1993. This happens through the issuing of a charges review initiation notice;

(b) provide advice to ministers in England & Wales and Scotland on the possible range of Network Rail costs and outputs for CP5, to help inform the HLOSs and SoFAs;

(c) set out decisions (following consultation responses) on some of the key issues relating to how we will establish Network Rail's outputs and funding for CP5 and the wider regulatory framework, including decisions on the main incentives that should act on Network Rail and, as appropriate, train operators, and any significant changes in the structure of charges. We will also consult at this stage on financial framework issues that are not covered in this consultation, following the Secretary of State's planned statement on rail reform in November 2011;

(d) update the timeline and workplan for PR13; and

(e) set out formal guidance to Network Rail on the requirements for its strategic business plan. This will give Network Rail time to refine its workplans.

The Governments' HLOSs/SoFAs: July 2012

5.15 We expect that by July 2012 the two governments will produce their HLOSs and SoFAs. These documents will set out the required outputs and funding, hence stakeholders who have views on these should contact the relevant government well before July 2012. The two governments will have their own processes for consulting stakeholders. Because we need to consider how to convert the HLOSs into Network Rail's output requirements and we can – subject to funding constraints – require Network Rail to deliver other outputs beyond those in the HLOS, we plan to publish a consultation document shortly after the HLOSs/SoFAs are published to seek views on the outputs Network Rail should deliver.

Network Rail's strategic business plan: January 2013

5.16 Network Rail's SBP is its response to the HLOSs and SoFAs, setting out how it intends to deliver what it will be required to do. The SBP will need to contain all the information we need to make our determination. Hence it will cover all the areas described in chapter 6. Network Rail will work with the industry and other stakeholders to produce this plan. It will set out on its website how it intends to involve stakeholders.

ORR's consultation on SBP: January 2013

5.17 We will consult on the SBP to seek views on the clarity and robustness of Network Rail's plan in order to inform our assessment of it.

ORR's draft determination: June 2013

5.18 We intend to publish our draft determination of Network Rail's outputs, funding and all aspects of the regulatory framework – including incentives and the financial and risk framework – for consultation in June 2013. There will then be an opportunity for all stakeholders to send their views to us before we make final decisions. We would only normally make changes between the draft and final determination if significant new evidence came to light, hence it is important for stakeholders to respond to the draft determination.

ORR's final determination: October 2013

5.19 Following consultation on our draft determination, we will publish our final determination in October 2013.

Other publications

5.20 Throughout the course of PR13 we expect to publish other consultations and documents on specific issues and also meet stakeholders and convene workshops to discuss these. Details will be provided on our website as they become available and the email alert service will provide advance notice.

Implementation

5.21 The implementation process in the Railways Act 1993 requires us to issue a series of notices:

(a) **review notices**: we have to specify the changes we propose to make to any access agreements (track and station agreements). We must also specify a period of not less than six weeks from the date of publication of a review notice in which Network Rail (or potentially other parties) can object to the proposed changes. If we receive an objection we may issue new review notices or make a reference to the Competition Commission;

(b) **notice of agreement**: if no objection is received we issue a notice of agreement. Any party to an access agreement has the right to give notice of termination to their access agreement, within 28 days; and

(c) **review implementation notice**: if no termination notice is given a implementation notice is published which, in effect, confirms the review notice.

5.22 Do you have any views on our proposed timetable for the review? Do you need further information to plan your involvement with PR13?

6. Regulatory framework and key issues

Introduction

6.1 This chapter explains the broad approach we will use to establish the regulatory framework for Network Rail and consults on a range of key issues relating to our review of the framework and its development for CP5.

The regulatory framework

6.2 Network Rail works within a regulatory framework whereby it must deliver certain outputs in the control period for a broadly fixed level of funding. As part of a periodic review we establish the regulatory framework for the next control period – some aspects of which impact directly on train operators. The framework is a balanced package of decisions and judgements, in the context of the governments' HLOSs and SoFAs and the reasonable requirements of all of Network Rail's customers and funders, which covers:

(a) deciding Network Rail's **outputs** – the outputs and obligations that Network Rail needs to deliver. This includes ensuring that our determination is **'safe'** in the sense that Network Rail is able to continue to meet its legal safety requirements;

(b) the level of **efficient expenditure** Network Rail should incur in achieving its outputs;

(c) the **financial framework** including the treatment of risk and uncertainty, i.e. the regulatory mechanisms that provide protection to Network Rail against unanticipated cost or revenue shocks;

(d) the **structure of access charges** (and the balance between access charges and network grants);

(e) the **financial incentives** to promote achievement or outperformance of our assumptions, including **schedule 8** (the performance regime) and **schedule 4** (the possessions regime); and

(f) **monitoring and enforcement** of PR13, including any changes to Network Rail's **licence** to enable implementation and delivery of its obligations in the context of the regulatory framework.[13]

Building block methodology

6.3 Network Rail's revenue requirement or income is calculated using the standard 'building block' approach widely used by economic regulators. It provides the basis to determine how much funding the company requires during the control period to deliver its obligations and also the sources of this funding.

6.4 The periodic reviews/access charges reviews undertaken for Network Rail (and Railtrack) in 2000, 2003 and 2008 have used this broad approach. The key features of the building block methodology applied in PR08 to establish the revenue requirement for CP4 are:

(a) we assess what Network Rail needs to spend on operating and maintaining the railway for each year of the control period. Network Rail receives income for this on a 'pay-as-you-go' (PAYG) basis. This means that for each pound it needs to spend each year it receives a pound in income;

(b) we assess what capital expenditure on renewals and enhancements Network Rail needs to undertake in the control period. This expenditure is added to the regulatory asset base (RAB) in the year in which it is incurred.[14] But the income Network Rail receives is not on a PAYG basis. Instead Network Rail receives a return on the RAB and an amortisation allowance (which covers the depreciation on the assets);

(c) the return on the RAB covers the interest payments that the company needs to make for its debt, a payment to government for the financial guarantee it receives of its debts, a 'risk buffer' to deal with cost and revenue shocks during the control period, and a 'ring-fenced investment fund' which in normal circumstances is reinvested in

[13] These issues are not covered in this document, but will be consulted on later in PR13.

[14] The exception to this is capex funded through the ring-fenced investment fund, which is not added to the RAB but paid for on a PAYG basis.

enhancement schemes (the approach to the return on the RAB, including the ring-fenced fund, will be reviewed in PR13); and

(d) adding up all the income needed by Network Rail produces what is called a 'gross revenue requirement'. This is funded by track access charges, station long term charge, other single till income and network grant.

6.5 Track and station access charges are payable by train operating companies to Network Rail for the use of its infrastructure. Some of Network Rail's costs vary depending on the amount of traffic on the network and the access charges to pay for these costs are called variable access charges. Network Rail receives 'other single till income' which is mainly income from property. Some of Network Rail's costs are 'fixed' – they do not vary with use and in principle these should be paid for by the operators in the form of fixed access charges, although government currently pays network grant directly to Network Rail in lieu of a significant proportion of access charges.

6.6 Figure 6.1 illustrates the overall regulatory framework and the building block model.

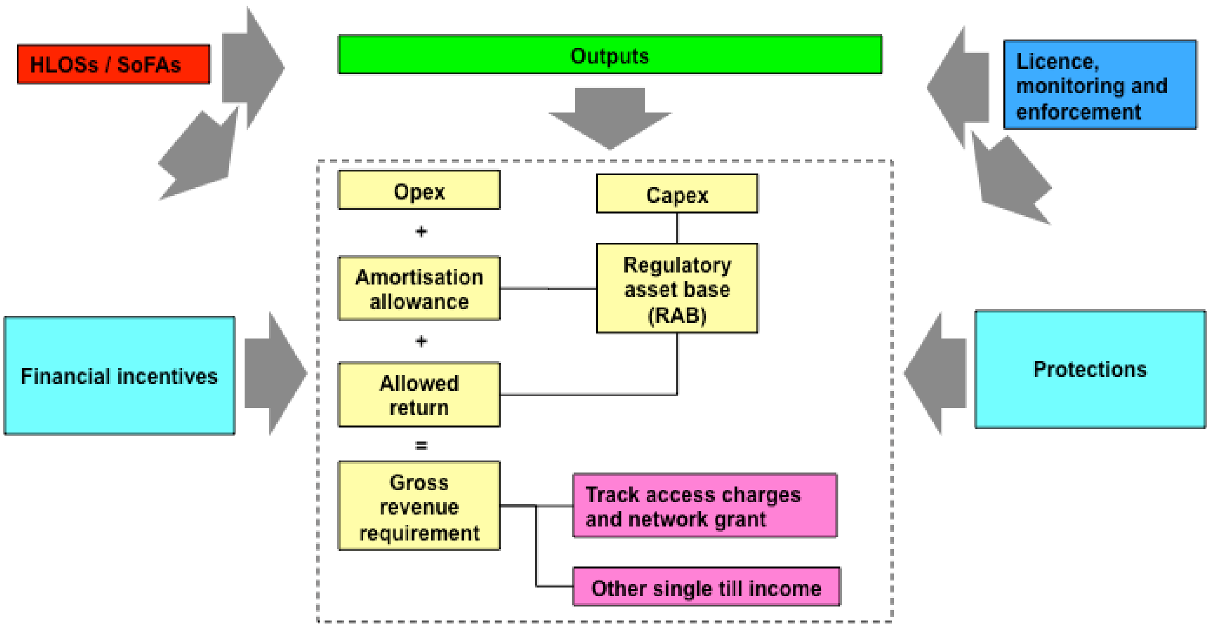

Figure 6.1: Overview of the regulatory framework

6.7 The link between the building blocks and the sources of income is illustrated in figure 6.2

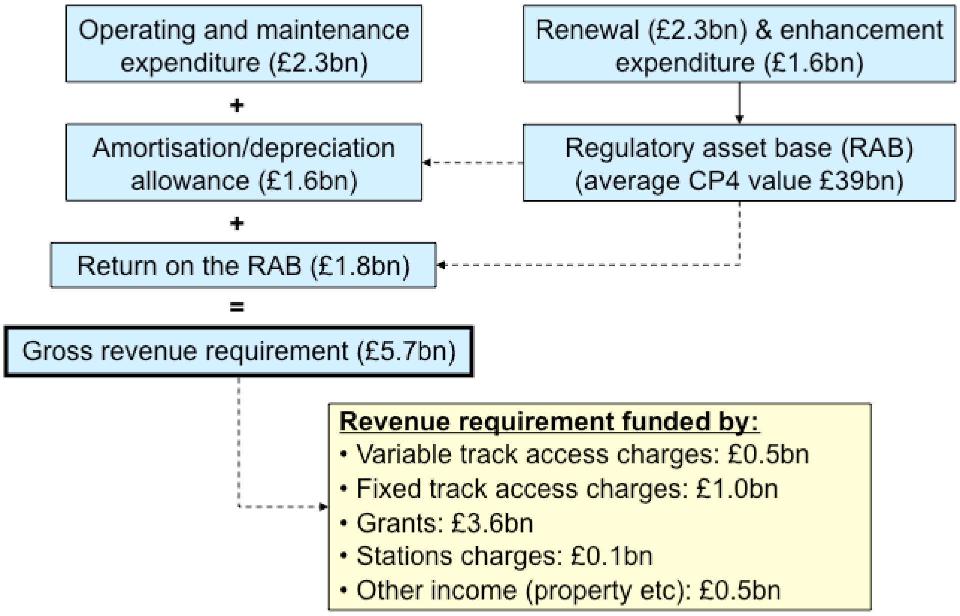

Figure 6.2: Building block approach – average annual values in CP4 income and expenditure (2009-10 prices)

Network Rail devolution, transparency and price control separation

Network Rail devolution and financial transparency

6.8 In line with industry reform work and the recommendations of the vfm study Network Rail has recently announced that it is devolving greater responsibility to its operating route level.[15] This should provide for a greater local/route level focus on the needs of the railway and facilitate better partnerships between Network Rail and train operators at the local/route level across the network. We intend, subject to this consultation and further detailed development, to implement incentives on Network Rail and train operators to work together to improve Network Rail's efficiency at the route level in CP5.

6.9 In order to underpin route level incentives and also to improve transparency and accountability we are working with Network Rail to disaggregate the company's financial data to the operating route level. We are also in discussions with train operators on the data they will produce at a route or operator level.

[15] Network Rail currently has nine operating routes, with a tenth, Wales, to be established.

Price control separation

6.10 In PR08 we developed and implemented 'separate price controls' for England & Wales and Scotland. By this we mean:

(a) separate determination of the outputs and revenue requirement for each area (in the context of the separate HLOSs and SoFAs). This included determining the level of efficient operating, maintenance, renewal (OM&R) and enhancement expenditure in Scotland (although we used the same efficiency assumptions for OMR for the whole of GB. It also included separate RABs and notionally separate debt calculations for the purposes of determining the revenue requirements;

(b) separate determination of access charges (though retaining a GB-wide variable usage charge price list);

(c) separate provisions for dealing with risk and uncertainty in the price control, e.g. re-openers (although the framework is largely the same);

(d) separate monitoring and enforcement of Network Rail's overall performance; and

(e) ensuring that outperformance or underperformance is ultimately retained or borne entirely separately by customers and funders in each area (although not necessarily within the control period).

6.11 We will be reviewing this approach to see if we should go further – by having separate efficiency assumptions for Scotland for example.

6.12 We have also already decided that in PR13 we will determine efficient expenditure for each of Network Rail's operating routes to support financial transparency and efficiency benefit sharing. The issue is how much further should we take price control separation at the operating route level.

6.13 There could for example be more outputs defined at the route level. But the key issue revolves around whether Network Rail will be free to manage financial risk and outperformance/underperformance across all routes, i.e. whether it will be able to use surpluses achieved in one route to fund any shortfall in another, rather than having each route effectively ring-fenced.

6.14 Whilst we established separate price controls for Network Rail's activities in England & Wales and Scotland, we recognised that Network Rail is a GB wide company and finances itself on this basis. For instance, our approach and determination for CP4 did not require Network Rail to establish separate finance companies for England & Wales and Scotland. We are not currently planning to change this approach.

6.15 Annex B discusses price control separation and Network Rail devolution and the information we are requiring of Network Rail in more detail. It also considers train operating company data.

Infrastructure management concession and system operator

6.16 Network Rail is currently considering creating an independently owned (and regulated) route infrastructure management concession. This would complement Network Rail's devolution process and provide for better benchmarking opportunities and 'comparative competition' between Network Rail and the concession. In such an environment, and potentially with greater power in Network Rail's devolved routes, certain network-wide activities would need to be centrally managed. As such, Network Rail is also considering establishing a distinct network wide 'system operator' to manage these activities, which could include management of national IT systems and long term network wide planning.

6.17 Depending on the scope and timing of any concession, or creation of a distinct system operator, there could be implications for PR13 although we see no reason why any likely development would alter the overall timing of the PR13 process.[16] We will consider the implications of a concession on PR13 when there is further clarity.

Consultation questions

6.18 These issues are discussed in more detail in annex B. Our specific consultation questions are:

(a) **do you think that our approach to the disaggregation of Network Rail financial (and other) data to operating route is appropriate? Is the information we are requiring Network Rail to produce set at the**

[16] We would also need to establish an appropriate regulatory framework for the concession.

right level? Do you have views on the information train operators should produce?;

(b) which aspects of the price control should be separated for England & Wales and Scotland, e.g. should the efficiency assumption be separate?; and

(c) do you think there should be further separation of the price control for Network Rail's operating routes and, if so, which aspects of the price control should be separated?

Setting outputs

6.19 As part of the periodic review, we will be defining what Network Rail will be funded to achieve in CP5, in particular how the governments' HLOSs should be delivered. These outputs define Network Rail's obligations and hence let Network Rail's stakeholders know what they can expect from the company.

6.20 There is still some way to go before outputs are set, as the governments' HLOSs will not be published until July 2012. Shortly after the HLOSs are published we intend to consult on the structure of the outputs Network Rail should deliver, including the role of the company in delivering the HLOSs and whether we should set any further output obligations beyond HLOS requirements. The consultation will not deal with the actual level of the targets (e.g. what is the maximum delay minutes Network Rail can cause) - these will be considered after we have received Network Rail's strategic business plan.

6.21 But there are issues of principle for both government and ourselves to consider at this stage, for example around what we mean by 'outputs' and the level of disaggregation of outputs:

(a) we currently define required outputs e.g. percentage of trains on time but we could focus more on outcomes (such as passenger or freight customer satisfaction). The advantage of this would be that ultimately we are seeking better customer satisfaction and percentage of trains on time is just a means to that end. However, it could be argued that it is difficult to set a stretching but realistic customer satisfaction target and that it does not provide Network Rail with a strong focus in terms of areas it must improve. Another different approach would be to specify inputs but this could take responsibility away from Network Rail and reduce efficiency improvements;

(b) in our monitoring of Network Rail we assess whether Network Rail is likely to deliver its outputs. We also review progress on enablers such as the company's approach to asset management (good progress on enablers can deliver higher efficiency and outputs in the medium term) and delivery of inputs such as renewals volumes against plan. We are reviewing the best approach to compiling and presenting alternative 'scorecards' of Network Rail's performance in CP5, including whether there are good composite measures of overall system performance. Our existing approach in terms of required outputs and enablers described in the appendix to Annex c;

(c) we have often defined required outputs through measures over which Network Rail has sole control (within the industry), such as Network Rail delay minutes. For CP4 we defined some requirements using whole-industry metrics (such as PPM), where delivery depends on both Network Rail and train operators. There are three advantages to this:

- these are good measures of service delivery to the end user (passenger or freight customer);
- it reflects Network Rail’s responsibility for whole industry performance; and
- it can help to align Network Rail and train operator incentives more closely, as recommended by the vfm study – particularly if TOC commitments were to be expressed in similar terms and made enforceable by a single body.

(d) However there may be a risk that by doing this we weaken the incentive for Network Rail to perform, as responsibility for delivery is shared more widely across the industry. There is therefore a choice to be made about the right balance between setting whole system outputs and company specific outputs;

(e) there is a further consideration if output requirements are to be set at a route level, as part of separate price controls. Some whole-industry outputs (e.g. PPM) cannot be easily or perhaps even meaningfully set at a route level, as they relate to train operating geography rather than network boundaries;

(f) there is also a choice over the level of detail outputs should be set at and how this then affects what action we take if Network Rail does not deliver them. Should we specify a small number of outputs with failure to deliver any one of these potentially being a serious licence breach, or a larger number of outputs (e.g. with a high degree of local disaggregation) which would tend to reduce the significance of failure to deliver any one output; and

(g) looking specifically at safety, the DfT HLOS for PR08 specified a safety metric, in terms of reducing risk to passengers and workers. A decision will be needed on whether to set a specific safety target in CP5, which could be designed to achieve something which Network Rail (and the wider industry) is not already legally required to do.

Consultation questions

6.22 We are seeking views on the following issues which annex C considers in more detail:

(a) Is the current approach to defining obligations in terms of outputs the best approach? What outputs should be defined? Should there be a move to more use of outcome based obligations? Would another approach be appropriate such as specifying inputs or intermediate measures?

(b) What are your views on how we should compile and present 'scorecards' of Network Rail's performance in CP5?

(c) Should we make more use of 'whole system' outputs over which Network Rail does not have full control, or focus on more narrowly defined outputs which the company is fully responsible for?

(d) How should output obligations be defined in the context of devolved Network Rail routes with separate price controls?

(e) How should the balance between the number of output obligations and their individual significance be struck?

(f) Should Network Rail's output obligations include a specific safety requirement, different from its legal obligations?

Improving incentives

6.23 Incentives are a key component of the regulatory framework for Network Rail. Incentives can be established to encourage (or discourage) a range of behaviours, outputs and outcomes. Some of the incentives we establish at a periodic review also impact on train operators. We want to ensure that Network Rail faces strong incentives to perform well in its wide-ranging roles. We also want it to forge partnerships with passenger and freight operators to enable the delivery of improved whole-industry outcomes. Incentives can help this.

6.24 Incentives are wide ranging. They can cover anything that encourages a company or individual to pursue a certain course of action. Incentives can be categorised as covering:

- **financial incentives** which can act:
  - o at the **corporate level**, for example the financial interests of the company to meet and outperform regulatory targets, such as the profit incentive to outperform regulatory efficiency targets;
  - o at the level of **specific outputs or deliverables**, e.g. to deliver volume growth;
  - o at the **managerial level** – through management incentive plans; and/or
  - o at the **contractual level** – for example the schedule 4 and 8 financial compensation regimes for infrastructure possessions and operational performance in track access agreements, or the level and structure of track access charges paid by train operators to Network Rail;
- **non-financial incentives** which can be related to reputation for example through monitoring and publication of company performance (such as through our quarterly Network Rail monitor) and/or benchmarking (for example through our annual efficiency benchmarking reports); and
- **licence and other legal obligations** which create incentives through the need to meet defined outputs in enforceable arrangements through the periodic review obligations. An example of this is Network Rail's

requirement to achieve a certain percentage of passenger trains arriving on time.

6.25 In developing incentives we face a number of constraints. Importantly, we do not control all the levers that relate to all players in the industry, in particular the franchise arrangements determine how train operators behave. And we take account of the financial structure and corporate status of Network Rail and the franchising model adopted by government. Non financial incentives are not dealt with directly in PR13, and obligations around delivering outputs have been considered earlier. Here we focus on financial incentives.

Current financial incentives

6.26 The key financial incentives currently acting on Network Rail are:

(a) Network Rail retains part of the financial benefits of outperforming against our determination. For example, if it underspends (while still delivering the required outputs) on operating and maintenance costs it retains all the savings for the duration of the control period and it retains the savings on renewals and enhancements for a period of five years irrespective of the point in the control period that the savings are made. If it overspends then it bears all the additional operating and maintenance costs for the control period but bears the impact on renewals and enhancements for five years;

(b) the schedule 8 performance regime: Network Rail is incentivised to improve performance where it is economic to do so as it pays compensation/receives payments from train operators for performance that is worse/better than benchmark;

(c) the schedule 4 possessions regime: Network Rail is incentivised to reduce the disruption from planned engineering works (‘possessions’). The regimes are different for passenger and freight operators but the principle is that operators receive compensation for disruptive possessions; and

(d) a volume incentive: this provides Network Rail with an incentive to accommodate extra traffic on the network above the trajectory assumed in PR08.[17]

Key issues for PR13

6.27 As part of PR13 we want to undertake a comprehensive review of the financial incentives, in the context of the reforms that the industry is facing, to consider whether the existing incentives need to be changed in any way to make them more effective and whether any new incentives should be introduced. In doing this we recognise that the company's financial structure means that the profit incentive which operates in other regulated companies cannot work in the same way. For example, Network Rail has members instead of shareholders and all Network Rail's debts are guaranteed by government. This means that government bears much of the risk, significantly weakening Network Rail's financial incentives.

6.28 We will also consider how the incentives act as part of an overall package with all other aspects of the PR13 determination.

Efficiency benefit sharing

6.29 In PR08 we implemented a new incentive: the 'efficiency benefit sharing mechanism'. This provides for passenger and freight train operators to share a proportion of the financial benefits if Network Rail delivers its outputs for less money than we had assumed, as a result of their involvement with Network Rail to identify and reduce costs. The mechanism, which applies separately for England & Wales and Scotland, does not have effect in franchises that were already in existence when PR08 was implemented. This is because of provisions in franchise agreements which largely protect train operators from the financial implications of changes that result from a periodic review. So, any efficiency savings flow from Network Rail through to government. However, the mechanism does apply to open access passenger, freight and new franchise operators.

6.30 In the light of the discussions on industry reform we believe that giving Network Rail and TOCs joint incentives to reduce costs is important to deliver

[17] For example, if growth on the network is double what we assumed in PR08 Network Rail will receive an incentive payment of around £200m.

our objective. Following initial discussion with key stakeholders we consider that we should introduce a version of the efficiency benefit sharing mechanism which would work at the Network Rail operating route level. This mechanism would provide train operators with a share of the benefits if Network Rail's costs were lower than expected, and they would pay part of the impact of costs being higher than expected – an 'upside' and 'downside' mechanism.

6.31 Apart from being set at a route level and being upside and downside, the mechanism would work in the same way as the existing efficiency benefit sharing mechanism, for example that payments would be in cash and shares are based on the proportion of variable usage charges paid by each operator.

6.32 There may be benefits from an enhancement efficiency benefit sharing mechanism, although due to the scale of some enhancements and the potential distribution of liabilities we do not consider that a formulaic approach should be used for enhancement benefit sharing. However we do support the development of bespoke arrangements where Network Rail can share efficiency gains with train operators.

6.33 We are also considering whether Network Rail should share in train operators' revenues and, as part of the wider set of reforms, it needs to be considered whether there would be benefits from Network Rail sharing train operators' costs.

6.34 Furthermore, there is a question whether franchised train operators should be exposed to changes in Network Rail's costs at a periodic review, although this is an issue for franchise authorities rather than us.

Other new incentives in CP5

6.35 There may be a case for introducing new specific incentives, for example other regulators have introduced specific incentives to encourage innovation. We are also considering whether there should be a new measure of capacity utilisation to increase Network Rail's incentives to make best use of capacity or incentives to reduce carbon.

Taking forward the work in PR13

6.36 As part of PR13 we will be taking forward work in six main areas:

(a) review of the existing financial incentives to consider if their effectiveness can be improved;

(b) detailed design of a regional efficiency sharing mechanism, working at the Network Rail operating route level;

(c) analysis of a possible revenue and cost sharing mechanism between Network Rail and train operators;

(d) consideration of whether there should be bespoke arrangements for efficiency benefit sharing for enhancements;

(e) working with franchise authorities to identify whether there are beneficial changes to new franchise agreements that could better align train operators' and Network Rail's incentives; and

(f) assessing the benefits of providing new incentives to encourage more efficient use of capacity, innovation and reducing the levels of carbon.

6.37 Following this consultation we intend to publish in November 2011 a further consultation on detailed incentives issues and proposals.

Consultation questions

6.38 These issues are discussed in more detail in annex D. Our specific consultation questions are:

(a) Do you have views on how the effectiveness of the existing financial incentives can be improved?

(b) Do you have views on how the effectiveness of Network Rail's incentives to make best use of capacity could be improved?

(c) Do you agree that we should include a regional efficiency benefit sharing mechanism calculated at the Network Rail route level? Are there further issues about how a regional efficiency benefit sharing mechanism should be introduced which you want to highlight?

(d) What are your views on exposing franchised train operators to changes in Network Rail's costs at a periodic review?

(e) Do you believe that Network Rail should share in train operator revenue and/or costs? Are there further issues about introducing a revenue/cost sharing mechanism which you would highlight?

(f) We would welcome your views on possible bespoke arrangements for enhancement efficiency benefit sharing and whether there is a need for additional measures to increase the contestability of expenditure?

(g) Are there further new incentives which you believe should be introduced and what would the benefits be?

(h) Are there other interactions between incentives (and the wider regulatory framework) which we need to take into account?

Financial framework

6.39 The financial framework covers a range of decisions we need to make as part of PR13. In particular:

(a) the duration of the control period;

(b) dual versus single till;

(c) what overall protections and compensation we provide to Network Rail for the risks it faces, including ‘re-openers’ and how we treat specific risks such as inflation;

(d) our approach to amortisation;

(e) how much of Network Rail’s net revenue requirement is paid for by network grant;

(f) the RAB model;

(g) what return Network Rail should be allowed to earn on its RAB and our approach to financeability (i.e. considering whether Network Rail can finance itself during the control period);

(h) how renewals and enhancement under/overspends are treated (as this is usually dealt with through adjustments to the RAB, it is known as the RAB roll forward policy);

(i) the treatment of corporation tax; and

(j) unsupported debt.

6.40 We are not consulting on all issues relating to the financial framework at this stage. We intend to consult on these other financial framework issues in February 2012. The issues we are consulting on now are described below. We have also included a short section on network grant for information and unsupported debt to provide information on recent work:

Duration of the control period

6.41 The duration of the control period in rail has always been established as five years, generally in line with the duration that has been adopted in other regulated sectors.[18] Moving to a longer period could introduce greater risk and uncertainty for Network Rail and would require HLOSs from the two governments to cover this longer period. But it might be seen as providing more stability and predictability – for example, for suppliers. A shorter period would provide greater opportunity for us and government to review Network Rail's circumstances and costs and outputs more frequently, but might reduce Network Rail's ability to plan effectively. There is no objectively 'right' answer to the duration of the control period.

Dual or single till

6.42 Regulated utilities tend to be complex organisations, and may operate in separate markets with different regulatory requirements. Where this is the case, a 'dual till' approach may be adopted so that the price control for each market the business operates in is set as if for a separate company.

6.43 Under the single till approach that we currently use, income that Network Rail is likely to earn on activities such as commercial property income is netted off against network costs in our price control settlement. This allows us to arrive at an estimate of the income that Network Rail requires from access charges if it is to earn a normal level of return.

[18] Whilst planned to be five years, the second control period was in practice reduced to three years (2001-02 to 2003-04) due to the 'interim' access charges review that took place after Network Rail took over Railtrack (in administration).

6.44 In PR08 we decided that there was no strong case for establishing separate 'railway' and 'commercial' tills given our statutory duties. This is still our view – although consultees may have a different view. There is a risk that a dual till approach would increase Network Rail's short-term revenue requirement and hence increase the cost to funders, without material benefit to the industry.

Treatment of risk and uncertainty

6.45 In determining Network Rail's outputs and access charges for CP5, there are risks that the company's actual costs of delivering the required outputs (or revenues it will earn) will be different to those we assume in making our determination. We need to take account of these risks and uncertainties in establishing the overall package for CP5 and consider the balance of risk exposure between Network Rail and its customers and funders. The specific level of risk protection and the balance between risk and reward will be decided when we make our determination. At this stage we are consulting on our overall approach to risk and uncertainty, such as the treatment of 're-openers'.

6.46 We are also consulting specifically on the treatment of general inflation and input price inflation risks, where the options are described in Annex E.

Amortisation

6.47 Our PR08 policy was that amortisation should be set equal to the long-run annual average capital expenditure required to maintain the network in steady state subject to financial sustainability issues. This means that the total allowance for amortisation in any year should be broadly equivalent to the level of investment expenditure that is required in order to maintain the overall capability, age, condition, and serviceability of the network in steady state (i.e. the network would be neither getting better or worse if that level of capital expenditure is sustained over the long-run).

6.48 This would ensure that access charges and Government grants over time reflected appropriately the level of assets consumed by current and future users and funders of the railway.

6.49 We consider that the approach to amortisation that we used in PR08 is appropriate and can also be used for PR13.

Network grant

6.50 Government currently pays network grant in lieu of fixed track access charges, which is done to support government's accounting position. This potentially weakens the accountability of Network Rail to operators, and also affects which operators are seen as subsidy/premium payers, blurring transparency. We consider that Network Rail should receive all of its track access charge income as charges rather than receiving some as network grant. We are discussing these issues with government.

Unsupported debt

6.51 Network Rail's current financial structure materially weakens the role of financial incentives facing Network Rail at the corporate level. As part of PR08, we therefore introduced changes to Network Rail's financial framework that would improve those financial incentives, with the intention that the company would raise unsupported debt. However, due to conditions in the financial markets and rating agency concerns about deliverability of the PR08 determination, Network Rail has not yet raised unsupported debt.

6.52 We are still supportive of Network Rail's plans to issue unsupported debt when the conditions are appropriate, but it is important that the introduction of this is considered in conjunction with the other industry reform initiatives to improve incentives. Some further discussion on the introduction of risk capital by Network Rail (including both debt and equity) has taken place. This could be achieved by either:

(a) issuing just unsupported debt;

(b) issuing unsupported debt as a first step on the way to the introduction of equity; and

(c) move directly to an unsupported debt and equity financed model (i.e. a conventional regulatory model).

6.53 We commissioned the Royal Bank of Canada (RBC) to consider some of the issues involved with risk capital in the context of the industry reform work and their main conclusions in relation to the introduction of unsupported debt were that they:

(a) did not see any major reason why Network Rail should not be able to successfully implement an unsupported debt programme; and

(b) thought that it should be feasible to design an unsupported debt programme, so that it is compatible with the longer term proposals that could be developed as part of industry reform.

6.54 We will consider in detail the issues involved with unsupported debt and risk capital in more detail in our advice to ministers in February 2012.

Consultation questions

6.55 These issues are discussed in more detail in annex E. Our specific consultation questions are:

(a) What are your views on the duration of the control period?

(b) Do you think that we should retain the single till approach rather than moving to a dual till approach?

(c) Do you think that our overall approach to risk and uncertainty in PR08 was appropriate and are there any improvements that could be made for PR13?

(d) Network Rail faces a number or risks. At this stage, do you have any views on how general inflation risk and input price risk should be addressed?

(e) We plan to retain the same high-level approach to amortisation in CP5 that we introduced in CP4. What are your views?

Structure of charges

6.56 Access charges serve a number of purposes, including providing:

(a) a mechanism for Network Rail to recover the efficient costs it incurs in providing track and station infrastructure used by train operators;

(b) a means to allocate costs to, and be recovered from, those that cause those costs to be incurred; and

(c) signals to train operators, their suppliers and funders for the efficient use and development of vehicles and the infrastructure (subject to other policy objectives and constraints).

6.57 Train operators currently pay the following charges to Network Rail:

(a) variable usage charges: to recover the costs which vary with traffic levels;

(b) traction electricity charges: to recover the cost of providing electricity to operate trains;

(c) capacity charge: to recover the extra schedule 8 costs which would arise as the network becomes more crowded;

(d) station long term charge: to recover maintenance and renewal costs (operating costs are covered by a separate 'Qx' charge which is not currently regulated);

(e) other charges: these include charges for freight only lines, an electrification asset usage charge and a coal spillage charge;

(f) fixed track access charge: this charge covers the remainder of Network Rail's revenue requirement. Government currently pays, for accounting reasons, part of the fixed track access charges in the form of a network grant. This is paid directly to Network Rail.

6.58 There have been important policy developments in the industry subsequent to our determination of the current structure of charges and our earlier consultation on the high level structure of charges (discussed in annex F), not least with respect to the DfT’s franchise policy, and the publication of the vfm study. These policies and recommendations require us to challenge our assumptions as to whether the role of charges should change to support the evolving industry more effectively.

6.59 The vfm study highlighted a shortcoming in the current industry structure, namely the disconnect between Network Rail’s costs and the charges borne by its customers. This is due to a combination of the charging structure and the financial adjustment mechanism used in rail franchises. As operators are largely insulated from the effects of any change in Network Rail’s costs, they are not incentivised to seek to reduce these costs, whether through their own actions or through challenge to Network Rail. We are exploring ways of counteracting this effect, for example through an efficiency sharing mechanism, as discussed above and in annex D. Reviewing the way in which the franchise adjusts for the effects of changes to track access charges is an important part of this work.

6.60 Franchises are currently highly specified, so that the influence of charges on service patterns has inevitably been constrained. But as the DfT has now stated its intention to simplify train service specification for future franchises, there will be an increased need to consider mechanisms to allocate scarce capacity. Charges that promote better use of existing capacity would provide for a more 'economic' basis to access charging, and an alternative to administrative procedures for allocating capacity. They would send stronger price signals to incentivise train operators to use the network efficiently and for Network Rail to accommodate demand and develop the network efficiently.

6.61 We are also examining changing the structure of charges to encourage competition, i.e. to enable open access operators to compete more directly with franchised operators if they pay higher track access charges. Our open access policy, including the 'not primarily abstractive' test would be reviewed in line with any implementation of such a new approach to charging.

6.62 We plan to:

(a) review the detailed calculation of the variable charge and assess whether it should be geographically disaggregated. At present the charge is a national one, with each type of vehicle paying the same rate wherever it is on the network. Geographical disaggregation would improve cost reflectivity and transparency but could introduce additional complexity to the industry, depending on how further disaggregation was implemented;

(b) review the pros and cons of introducing scarcity and reservation charges, both intended to encourage the more efficient use of capacity. A scarcity charge would reflect the costs of providing new capacity and hence would mean higher charges in capacity constrained areas, while a reservation charge would be designed to make more efficient use of freight paths, with charges reimbursed if paths are used;

(c) review changes to the charges paid by passenger open access operators. Open access operators do not currently pay fixed track access charges, although they do pay variable charges. In principle we believe there are benefits of encouraging more competition but our ability to do this is restricted by the need to take account of the impact on the value of franchises. This can be addressed by changing the basis on which open access operators charges are calculated;

(d) as a result of changes introduced in PR08, some operators already pay for their traction electricity payments based on metered consumption. We intend to build on this in PR13 and substantially improve the incentives to reduce electricity consumption;

(e) the fixed charge is a residual, after other charges and sources of income have been taken into account, but the current approach to allocating the charge between TOCs can be improved. It would improve transparency in terms of industry finances if we could refine this;

(f) in PR08 we took account of the particular circumstances of freight operators by placing a cap on the level of certain freight charges well in advance of our determination. We are considering repeating this, perhaps linking it into a commitment to contribute to industry cost reductions.

6.63 In reviewing the options we will need to consider the interaction between the possible changes, for example how a geographically disaggregated variable usage charge would interact with a scarcity charge, and the speed at which any changes could be sensibly implemented.

Consultation questions

6.64 Annex F provides more detail on the issues relating to charges. At this stage we have not formed a view on the best way forward in some areas and hence our consultation questions are aimed at exploring the options in more detail. Our questions for consultation are below. As noted above, we have consulted on some of these before, but as circumstances have changed we are asking for views again (and seeking views in the context of this wider document). To save you time, if your views are the same as for the previous consultation please just state this. Our consultation questions are:

(a) Do you consider that our charging objectives remain appropriate?

(b) What are your views on the geographical disaggregation of variable usage charges?

(c) What are your views on introducing a charge levied to reflect network scarcity?

(d) What are your views on a reservation charge (assuming it would be set to be financially neutral for freight operators)?

(e) Should passenger open access operators pay charges that exceed variable costs. How should charges be calculated?

(f) What are your views on the proposals to improve incentives to reduce traction electricity consumption?

(g) Should we put a cap on certain freight charges in advance of our determination and should these be linked to other changes?

(h) Do you have views on the interactions between these possible changes and when they should be implemented - for example whether some changes should only be introduced after other changes have 'bedded in'?

Establishing the level of efficient expenditure

6.65 Network Rail spends money on operating, maintaining and renewing the railway, and on enhancements. In deciding how much money Network Rail needs to spend we have to consider what work needs to be carried out (‘volumes’) and how much work should cost (unit costs).

6.66 Because of the developments on industry reform we will be carrying out this analysis at the operating route level and well as separately for England & Wales and Scotland.

6.67 We will be publishing a document at the end of June 2011 which will explain our approach to establishing the level of efficient expenditure for CP5, including the methods we intend to use, the range of studies we intend to undertake and the work we will be expecting Network Rail to do.