
1. Introduction

Purpose of this document

- 1.1 The 2013 Periodic Review (PR13) is the process through which we determine the outputs that Network Rail is expected to deliver, the efficient cost of delivering those outputs, and the access charges the company can levy on train operators for using its network to recover those costs.
- 1.2 It covers the period from 1 April 2014 to 31 March 2019, which is called CP5 (control period 5). PR13 also establishes the wider 'regulatory framework' for CP5. This includes the financial framework within which Network Rail will operate and the incentives that will act on both it and train operators (and through them on suppliers and rolling stock companies) to deliver and outperform our determination.
- 1.3 This document sets out our draft determination on PR13. It includes our overall judgements and decisions on:
 - (a) the outputs that Network Rail must deliver in CP5;
 - (b) how much Network Rail needs to spend to deliver its outputs and its other commitments, including the interest it must pay on its debt;
 - (c) the financial framework within which Network Rail will operate in CP5;
 - (d) the incentive mechanisms to encourage Network Rail and its industry partners to deliver and outperform our determination; and
 - (e) the affordability of what the Scottish Ministers and the Secretary of State want the railway to deliver in Scotland and England & Wales respectively, as set out in their high level output specifications (HLOSs).

Structure of this document

- 1.4 The structure of this document is shown in Table 1.1 below.

Table 1.1: Structure of this document

Chapter & Title		Description and purpose
Introduction and background		
1	Introduction	Gives an overview of the purpose and structure of this document.
2	Background and context	Sets out the legislative and regulatory background to PR13 and the wider context for the industry.
Outputs, efficient expenditure, deliverability and health & safety		
3	Output framework	Sets out the outputs that Network Rail will be required to deliver during CP5 and the framework of enablers and indicators.
4	Overview of efficient expenditure	Gives a brief overview of how we assess efficient expenditure, and sets out the crosscutting issues and assumptions that apply across different areas of expenditure.
5	Support expenditure	Describes our assumptions on the level of efficient expenditure for Network Rail's support costs (e.g. human resources and insurance).
6	Traction electricity, industry costs and rates	Describes our assumptions on what Network Rail will need to spend on purchasing the electricity it uses and that it sells on to train operators (e.g. to power trains), the costs of funding industry groups and rates.
7	Operations expenditure	Describes our assumptions on the level of efficient expenditure required for Network Rail to operate and control its network infrastructure (e.g. through the signalling system).
8	Asset management: maintenance and renewals expenditure	Sets out our review of Network Rail's asset management proposals and our assumptions on the level of efficient expenditure required for Network Rail to maintain and renew its network efficiently.
9	Enhancements expenditure	Provides our decisions on the efficient enhancements required to deliver the high-level outputs set by the two governments, and our assumptions on costs. It also sets out the arrangements for the specific funds that the governments are making available.
10	Deliverability of engineering work	Sets out our decisions on Network Rail's ability to carry out the engineering work required to deliver its maintenance, renewals and enhancement programme.
11	Health and safety	Explains how we have ensured that our overall decisions on PR13 are consistent with Network Rail's obligations to maintain and improve health and safety.

Chapter & Title		Description and purpose
Financial framework and revenue requirement		
12	Financial framework	Explains our decisions on the financial framework that Network Rail must work within.
13	Impact of the financial framework on financial parameters	Sets out our assumptions on Network Rail's cost of capital, its financing costs, the level of the regulatory asset base (RAB) and net debt levels at the start of CP5 and other important financial information. These assumptions are used to calculate Network Rail's revenue requirement.
14	Network Rail's revenue requirement	Summarises the revenue that Network Rail will require in CP5 to deliver its outputs in England & Wales and Scotland.
Incentives framework, access charges and other income		
15	Overall incentives	Gives an overview of the importance of the incentive framework that we put in place through PR13 which will apply to Network Rail and other industry parties.
16	Access charges	Sets out the decisions we have made on the charging framework for CP5, including the overall level of particular charges.
17	Network grant	Describes the options that we have identified for the level of the network grant payments that we will allow Network Rail to receive from DfT and Transport Scotland in lieu of fixed track access charges.
18	Other single till income	Sets out our assumptions on the amount of income we expect that Network Rail will be able to receive from sources such as property.
19	Financial incentives	Sets out our decisions and proposals on financial incentives to encourage greater efficiency, innovation and incentivise Network Rail to be more responsive to demand from its customers for additional network capacity.
20	Possessions and performance regimes	Provides our decisions on the financial compensation regimes in Schedules 4 and 8 of track access contracts.
Affordability, implementation, monitoring and impacts		
21	Affordability of the HLOSs	Explains our assessment of the affordability of the two governments' high-level output specifications (HLOSs) in relation to the statements of funds available (SoFA).
22	Implementation of our determination	Describes the process for how we will implement the decisions in our determination.

Chapter & Title		Description and purpose
23	Monitoring, enforcement and reporting	Sets out our approach to monitoring in CP5, covering the delivery of Network Rail's outputs and its health and safety and financial performance. Also outlines our approach to monitoring and enforcement.
24	Review of wider impacts	Sets out our assessment of how the overall package in the draft determination, if implemented, would impact on key stakeholder groups beyond Network Rail.
Annexes		
Annex A	Specific consultation questions	Sets out a small number of questions on which we would be particularly interested in stakeholders' views
Annex B	Decision on a freight specific charge for biomass	Describes our consideration of the responses to our February 2013 consultation on whether to apply a freight specific charge to biomass and our further analysis of the issues (see chapter 16 on access charges).
Annex C	Summary of other single till income	Reconciles the total other single till income Network Rail will receive – totalling up the access charges paid by freight and open access operators (set out in chapter 16) with the other single till income in chapter 18.
Annex D	Route-level data	Sets out our assumptions on route-level expenditure requirements and indicative route level revenue requirements.
Annex E	Funding of enhancement projects	Summarises our conclusions on the funding of enhancement projects.
Annex F	Further detail on the effect of the financial framework on the level of access charges	Sets out the level that access charges would be if we had not allowed any payment of network grant and the revenue requirement if we had not used the adjusted weighted average cost of capital approach (i.e. if we had used the cost of capital in the calculation of access charges).
Annex G	Comparison of PR13 to the Rail Value for Money study	Compares our determination to the levels of expenditure and savings projected by the Rail Value for Money study.
Annex H	List of consultancy and independent reporter studies	Lists the reports by our consultants and the independent reporters that have fed into this determination.
Annex I	PR13 stakeholder engagement	Sets out the consultations we have carried out in connection with PR13 since May 2011 and the main stakeholder engagement associated with these.
Annex J	ORR's statutory duties	Lists the statutory duties that we must have regard to when carrying out our functions.
Abbreviations and acronyms		

Consultancy and reporter studies

- 1.5 A full list of associated reports by consultants and the reporters that we have used to inform our decisions is set out in annex H and the reports themselves (or executive summaries of them) will be placed on our website shortly after publication of this draft determination²⁸.

Price base

- 1.6 All values in this document are in 2012-13 prices unless otherwise stated.

Responses to this document

- 1.7 We welcome comments on any aspect of this document, but there are some specific areas where we have raised specific issues for stakeholders to consider. These are set out in annex A.
- 1.8 Please send your response in **electronic format** by close of business on **Wednesday 4 September 2013** to:

draft.determination@orr.gsi.gov.uk

Alternatively, if it is not possible to email, please send in hard-copy to:

Valentina Licata
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN
Tel: 020 7282 2171

- 1.9 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 sending us a scanned copy of your response; and
 - (b) ensure that the PDF's security method is set to 'no security' in the document properties.

²⁸ <http://www.rail-reg.gov.uk/pr13/publications/consultants-reports.php>.

1.10 If you send a written response, you should indicate clearly if you wish all or part of your response to remain confidential to ORR and explain why. 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, which 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.

Draft determination conferences

1.11 We will be hosting three conferences to discuss our draft determination. These will be in London (19 June 2013), Glasgow (24 June 2013) and Cardiff (16 July 2013). Please see our website for further details²⁹.

Process for the remainder of PR13

1.12 Table 1.2 below sets out the remaining high-level milestones for PR13. Please note following our draft and final determinations, Network Rail will produce the draft and final price lists setting out the exact access charges to be paid. This reflects the legal responsibilities for ORR to set the charging framework (and the specific charging rules governing the determination of charges) and for Network Rail as the infrastructure manager to set the access charges based on this framework.

Table 1.2: Timetable for the remainder of PR13

Formal review phase	
12 June 2013	We publish our draft determination.
12 July 2013	Network Rail publishes its draft price lists based on the charging framework set out in our draft determination. This will provide an opportunity for stakeholders to review and comment to Network Rail on the draft price lists (as once approved in December 2013 these are fixed for CP5 unless ORR re-opens the determination).
12 July 2013	We issue our consultation on changes to access contracts and the network licence to implement PR13. This will seek views on the changes we propose to make to track access contracts (mostly in Schedules 4, 7 and 8), station access agreements and network licence provisions to implement our determination.
July 2013	We publish our draft long-term regulatory statement.

²⁹ <http://www.rail-reg.gov.uk/pr13/getInvolved/DD-launch-events.php>.

Formal review phase	
4 September 2013	Deadline for responses to our consultations on our draft determination and proposed changes to track access contracts and network licence provisions.
31 October 2013	We publish our final determination, setting out our final decisions on policy issues, expenditure and outputs for CP5.
December 2013	Network Rail publishes its draft delivery plan.
Implementation phase	
20 December 2013	Final access charges (price lists/charge schedules) produced by Network Rail are audited and approved by us.
20 December 2013	Review notices are served which start the formal implementation of PR13. The review notices set out the proposed changes to track and station access contracts and the network licence.
7 February 2014	Network Rail will then have until 7 February 2014 to object to the review notice. If it objects, then we would either issue a revised notice or make a reference to the Competition Commission.
February 2014	If Network Rail does not object, we will issue a 'notice of agreement' shortly after 7 February 2014. This will give beneficiaries to track and station access contracts (e.g. train operators) 28 days within which to give notice that they wish to terminate their access contracts, should they wish to do so.
March 2014	Assuming we issue a notice of agreement in February 2014, we would then expect to issue our review implementation notice in March. This confirms that the periodic review will be implemented on 1 April 2014.
By 31 March 2014	Network Rail publishes its delivery plan for CP5.
1 April 2014	Our PR13 determination is implemented and CP5 begins.

Outstanding work

- 1.13 We have set out a number of areas in this document where we need to do further work between now and publication of our final determination. This includes work to finalise the payment rates in the Schedule 8 performance regime and a consultation in July 2013 on changes to access contracts and the network licence to implement PR13.
- 1.14 Alongside this consultation in July 2012, we will issue a draft of the notice that we will issue with our final determination setting out our requirements for Network Rail's delivery plan. In short, this plan will set out how Network Rail will meet its obligations

under the PR13 final determination³⁰. The delivery plan is discussed elsewhere in this document and will be key to enabling other industry parties, such as suppliers, to plan for CP5. Network Rail intends to consult on a draft of its delivery plan in December 2013.

Draft long-term regulatory statement

- 1.15 We will shortly be publishing our long-term regulatory statement. This is intended to set PR13 in the context of a longer term time frame, looking at issues such as longer term financial sustainability and the further alignment of incentives to deliver even greater value for money.
- 1.16 Following consideration of stakeholder responses, we will publish our final long-term regulatory statement shortly after our final determination in the autumn.

³⁰ This notice will be issued under condition 1 of Network Rail's network licence, which requires it to prepare a delivery plan in line with such format and structure, and to such standard and level of detail and in accordance with such requirements as we set out in a notice or in guidelines. We must serve any such requirement on Network Rail at least five months before the plan is required, and have consulted it on the content of that notice.

2. Background and context

Key messages in this chapter

- The PR13 process and our decisions have to reflect legal requirements and our statutory duties. In reaching our decisions we have considered all our statutory duties and weighed them as we consider appropriate.
- We established our PR13 objective at the outset of PR13 and we have set out the wider impacts we expect our review to have.
- PR13 consists of a number of ‘building block’ calculations and decisions, which together make up a package.
- We have made two separate determinations, one for England & Wales and one for Scotland, reflecting the different responsibilities for setting strategy and for funding, although the two are linked as Network Rail is a GB-wide company.
- Our PR13 work has been part of a broader programme of industry reform and will help to push forward further reform.
- Our work on PR13 has involved a substantial amount of consultation and discussion across the industry and more widely, and we have received helpful inputs across all areas of our work.

Introduction

2.1 This chapter provides background to the overall PR13 process, including our objectives, the legal framework and our broader regulatory approach.

Legislative framework

2.2 PR13 follows the statutory procedure for conducting an access charges review set out in Schedule 4A to the Railways Act 1993 (the Act)³¹. Schedule 4A requires the Scottish Ministers (for Scotland) and the Secretary of State for Transport (in respect of England & Wales) to provide us with information about what they want to be achieved by railway activities in Scotland and England & Wales during the control period and the public financial resources that are, or are likely to be, available for the achievement of those activities. They do this by each producing a ‘high level output

³¹ The Railways Act 1993, available at <http://www.legislation.gov.uk/ukpga/1993/43>.

specification' (HLOS), setting out what they want the railway to deliver, and a 'statement of funding available' (SoFA), setting out how much public funding they intend to commit to the railways in the period.

- 2.3 We have to decide if there is enough funding to deliver the outputs sought by the two governments.
- 2.4 Network Rail has a legal obligation under the Health and Safety at Work etc. Act 1974 to maintain and, where reasonably practicable, improve safety and we must be satisfied that it will be able to meet these obligations given our settlement. Where relevant we have also taken into account the Railways Infrastructure (Access and Management) Regulations 2005³² (the "Access and Management Regulations") which set out the principles we must follow when we establish the framework in which Network Rail must set access charges.
- 2.5 We must have regard to our public interest statutory duties which are mostly set out in section 4 of the Act (see annex J). These include duties to have regard to any general guidance given by the Scottish Ministers and Secretary of State (statutory guidance). Our duties are not in any order of priority and it is for us to decide how to weigh these when reaching our decisions. In reaching our decisions, we have considered all of our statutory duties and weighed them as we considered appropriate.
- 2.6 All our decisions on the overall PR13 settlement are made as part of a 'balanced package' for CP5. So, we may deliver a settlement that is regarded as more challenging in certain areas and relatively less challenging in others, but which should be considered and judged as a whole. We consider that our duties point us to delivering a package that:
- (a) is challenging but achievable for Network Rail in terms of efficiency, value for money and deliverability;
 - (b) works for the long-term as well as the short-term – i.e. is sustainable;
 - (c) improves health and safety; and
 - (d) provides appropriate protections in respect of risk.

³² Available at <http://www.legislation.gov.uk/uksi/2005/3049/contents/made>. These regulations were amended in 2009 by the Railways Infrastructure (Access and Management)(Amendment) Regulations 2009, available at <http://www.legislation.gov.uk/uksi/2009/1122/contents/made>.

2.7 The package also balances the short and longer term needs of passengers, freight customers and train operators.

Our PR13 objective

2.8 Following our May 2011 consultation, we confirmed our PR13 objective in May 2012³³. This 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.

2.9 We also recognised the importance of industry reform in helping to deliver our objective, and that PR13 would itself be an important facilitator of industry reform, through:

- (a) providing a **clear focus on what matters to passengers, freight customers and taxpayers** – particularly improving value for money;
- (b) encouraging a **more disaggregated approach** – increasing transparency and access to information, facilitating greater localism, and supporting more disaggregation in the industry (for example through Network Rail devolution) will allow a more comparative approach to regulation and a better understanding of costs, revenues and subsidy across the industry;
- (c) **alignment of incentives** – improving the interfaces between the different players in the industry, for example, by facilitating alliances, efficiency benefit sharing at the route-level and bespoke arrangements where these improve whole industry working, will drive greater value for money for customers and taxpayers; and
- (d) **greater contestability** – ensuring that there is more effective use of market mechanisms in the industry will deliver further efficiencies.

³³ *Setting the financial and incentive framework for Network Rail in CP5*, May 2012, available at <http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf>.

- 2.10 It is important to see the periodic review in the context of our broader ongoing regulation and regulation beyond CP5. Our five strategic goals, which we recently confirmed following consultation, apply across all of ORR's functions including PR13³⁴. They are consistent with our PR13 objective, particularly in relation to moving towards a more dynamic and commercially sustainable industry. We will shortly publish our long-term regulatory statement, which will set this out in further detail.
- 2.11 At the beginning of PR13, we said that if we were successful in achieving our PR13 objective, the outcome should be a railway in CP5 and beyond 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.
- 2.12 In our final determination, we will set out how we will measure progress against these outcomes.

Progress with PR13

- 2.13 We began PR13 in May 2011, with a wide ranging consultation on our objective and general approach to PR13. Since then we have carried out a substantial amount of work across all areas covered by the review. This has included extensive stakeholder engagement, including specific consultations on particular policy areas and workshops, which have informed our thinking. Annexes H and I set out the documents

³⁴ ORR *Business Plan 2013-14*, April 2013, available at <http://www.rail-reg.gov.uk/upload/pdf/business-plan-2013-14.pdf>.

we have published and the main stakeholder engagement activity we have carried out. We are very grateful for the time people have spent in helping our work, in responding to consultations, attending events, in bilateral discussions and in terms of analytical work.

- 2.14 In September 2011, Network Rail and its industry partners published the Initial industry plans (IIPs)³⁵. These set out what the industry considered should be delivered in CP5 and beyond, and at what cost. After reviewing these, in March 2012 we issued our ‘advice to ministers’ to the Secretary of State and Scottish Ministers³⁶. This, in particular, provided the governments with our view on how much the railway was likely to cost in CP5 and helped to inform their HLOSs and SoFAs.
- 2.15 Following this, the HLOSs and SoFAs were published in the summer of 2012. Network Rail then developed its strategic business plan (SBP) for CP5 setting out how it would deliver the HLOSs and how much this would cost. The SBP documentation (which included separate plans for England & Wales and Scotland, as well as plans for the devolved routes) was submitted to us in January 2013³⁷. We then carried out our detailed assessment of it to inform our determination. To aid our analysis, we sought stakeholders’ views on the SBP and received around 170 responses in total³⁸. We are grateful to those who took the time to respond.
- 2.16 Alongside the main SBP documentation, Network Rail and its industry partners published two industry strategic business plans (ISBPs) – one for England & Wales and one for Scotland³⁹. These were the culmination of work by the industry to present a more joined-up approach to planning which we were keen to see following PR08. As well as providing valuable wider industry context, the ISBPs set out the industry’s

³⁵ *Initial industry plan: Proposals for Control Period 5 and beyond*, September 2011, for both England & Wales and Scotland are available at <http://www.networkrail.co.uk/iip.aspx>.

³⁶ *Advice to Scottish Ministers on Network Rail’s costs and outputs in CP5*, ORR, March 2012, available at <http://www.rail-reg.gov.uk/pr13/pdf/pr13-advice-to-ministers-scotland.pdf>. Advice to Secretary of State on Network Rail’s costs and outputs in CP5, ORR, March 2012, available at <http://www.rail-reg.gov.uk/pr13/PDF/pr13-advice-to-ministers-ew.pdf>.

³⁷ Network Rail’s strategic business plan documentation, and the industry strategic business plans are available at <http://www.networkrail.co.uk/publications/strategic-business-plan-for-cp5/>.

³⁸ See <http://www.rail-reg.gov.uk/pr13/Publications/strategic-business-plan.php>.

³⁹ *Industry strategic business plan (England & Wales / Scotland): Industry’s response to the high level output specification for CP5*, January 2013, available at <http://www.networkrail.co.uk/publications/industry-strategic-business-plan-for-cp5/>.

formal response to the HLOSs and how it would respond to the challenges it faces in CP5, including how it will deliver greater value for money.

Regulatory approach

How we determine access charges

- 2.17 Through the periodic review, we assess the efficient level of expenditure that Network Rail needs to run its business and deliver the regulated outputs. We determine how much revenue it needs, including an allowed return on its regulatory asset base (RAB). The net revenue requirement takes into account other income that Network Rail receives (such as commercial income from property). Net revenue is received from access charges and network grant from government (see paragraph 2.25). It is then for Network Rail to determine the exact charges to be levied on users of its network based the charging framework and rules we set.
- 2.18 The access charges paid by Network Rail's customers that are within the scope of PR13 include⁴⁰:
- (a) track access charges by franchised passenger train operators, open access passenger train operators and charter passenger train operators;
 - (b) track access charges paid by freight train operators; and
 - (c) station long term charges paid by the users of franchised stations⁴¹ and the 17 Network Rail 'managed' stations.

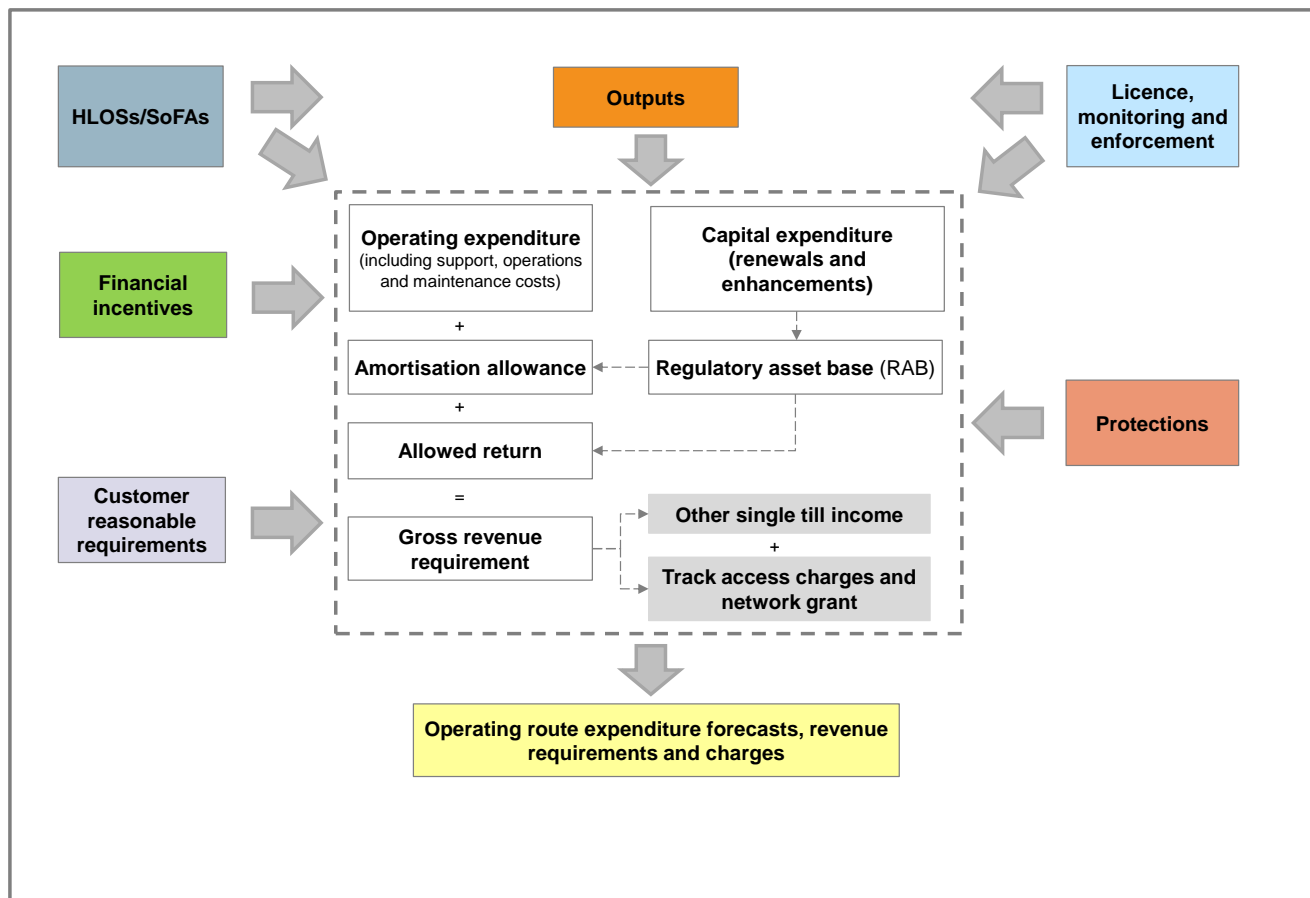
Building block methodology

- 2.19 Our approach to establishing the regulatory framework is based on the standard 'building block' methodology widely used by regulators. The periodic reviews/access charges reviews undertaken for Network Rail (and Railtrack) in 2000, 2003 and 2008 have used this broad approach. Figure 2.1 illustrates the overall regulatory framework and the building block model.

⁴⁰ Access charges not within the scope of PR13 are those in access contracts either exempt from regulation (such as the non-stopping Paddington to Heathrow services operated by Heathrow Express) or those that do not contain a contractual reopener permitting a periodic review by ORR of the charges (such as depot access agreements and connection contracts)

⁴¹ The exception to this is those stations managed by the Greater Anglia franchise which are outside the scope of PR13. This follows the transfer of responsibility of maintenance and repair from Network Rail to the franchise during CP4.

Figure 2.1: Overview of the regulatory framework



2.20 The key features of the building block methodology are:

- 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;
- we assess the capital expenditure on **renewals** and **enhancements** that Network Rail needs to undertake in the control period. This expenditure is added to the RAB in the year in which it is incurred. But the income Network Rail receives is not on a PAYG basis. Instead Network Rail receives an **amortisation allowance** (which covers the depreciation on the assets); and

(c) the **allowed return on the RAB** that we calculate and allow Network Rail to recover through access charges. This therefore covers, amongst other things, the cost of financing the company's **capital expenditure** programme⁴².

2.21 Adding up all the income needed by Network Rail to fund these elements produces what we call the '**gross revenue requirement**'.

2.22 In PR13, we are using the 'single till' approach. This means that income (which we call 'other single till income') that we expect Network Rail to earn on activities such as commercial property is deducted from the total costs of the network (i.e. from the gross revenue requirement)⁴³. This then leaves us with the '**net revenue requirement**'.

2.23 With the exception of the fixed track access charges, the regulated track and station access charges paid by train operating companies to Network Rail are set to recover particular costs. Most track access charges are set to reflect the costs that vary with traffic, the exception currently being the 'freight-only line' charge, which recovers some additional costs associated with freight traffic. The regulated station charges recover costs for station maintenance, repair and renewal.

2.24 The fixed track access charges, paid only by franchised passenger operators, are set to recover Network Rail's net revenue requirement, i.e. Network Rail's revenue requirement net of other track access charges and other single till income.

2.25 However, the arrangements in CP4 provide for both governments to pay money directly to Network Rail (through 'network grant') to reduce the amount of access charges paid by franchised train operators. We have discussed the pros and cons of

⁴² In PR13, we are calculating the allowed return using the adjusted weighted average cost of capital ('adjusted WACC') approach as explained in detail in chapter 12. In simple terms, this approach recognises that Network Rail's debt is government-backed and it does not pay dividends. Therefore, for CP5 we fund our forecast of Network Rail's efficient financing costs. Also, recognising financial sustainability issues, we provide further revenue to Network Rail by including additional amortisation. In CP5, the return on the RAB will include a payment to government for the financial guarantee Network Rail receives on its debts.

⁴³ The alternative 'dual till' approach would involve a separate price control for Network Rail's activities in each market that it operates in – effectively treating each of these as a separate business. After consultation, we decided that there was not a strong case for establishing separate 'tills' as we felt it was unlikely to drive improvements in Network Rail's performance. We were also concerned about unnecessary complexity and the potential to distract the industry from maximising the benefits to the industry of Network Rail's commercial activities. Our decision to retain the single till approach is set out in paragraphs 3.46-3.56 of Setting the Financial and Incentive Framework for Network Rail in CP5, May 2012, available at <http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf>.

network grant in a number of our PR13 publications⁴⁴ and we concluded in December 2012 that we would, in principle, allow network grants to be paid in England & Wales and Scotland⁴⁵.

Duration of the control period

2.26 We confirmed in 2012⁴⁶ that we intended to retain a five year control period. CP5 will therefore run from 1 April 2014 to 31 March 2019. This followed a consultation⁴⁷ which considered the merits of shorter and longer periods in terms of incentives for Network Rail, certainty for customers and funders as well as the reliability of long-term forecasts of revenues. We concluded that five years provided an appropriate balance between planning, uncertainty, incentives and risk.

Disaggregation of price controls within Great Britain

2.27 In PR13 we make a distinct – but linked – set of decisions for Scotland and for England & Wales. This broadly means:

- (a) we make a separate determination of the outputs and revenue requirement for each (in the context of the separate HLOSs and SoFAs). This includes separate RABs and notionally separate debt (and financing costs) and corporation tax 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 (the main difference is that there is a separate ‘re-opener’ for Scotland);
- (d) outperformance or underperformance⁴⁸ is ultimately retained or borne entirely separately by customers and funders in each area (although not necessarily within the control period); and

⁴⁴ *Periodic review 2013: first consultation*, May 2011, paragraphs 6.42-6.44, available at <http://www.rail-reg.gov.uk/pr13/consultations/orr013.php>.

⁴⁵ *Financial issues for Network Rail in CP5: decisions*, December 2012, available at <http://www.rail-reg.gov.uk/pr13/PDF/pr13-financial-issues-decisions-dec12.pdf>.

⁴⁶ Paragraphs 3.23-3.38 of *Setting the financial and incentive framework for Network Rail in CP5*, May 2012, available at <http://www.rail-reg.gov.uk/upload/pdf/financial-incentive-framework-cp5.pdf>.

⁴⁷ *Periodic review 2013: first consultation – annexes*, paragraphs E.39-E.50, available at <http://www.rail-reg.gov.uk/pr13/PDF/PR13-first-consultation-annexes.pdf>.

⁴⁸ See paragraph 23.33 for an explanation of out- and underperformance.

(e) some separate monitoring and enforcement, e.g. separate financial assessments.

2.28 At present, the Welsh Government is not a principal funder in the same way that the Scottish Ministers and Secretary of State are under the existing statutory process for an access charges review. Therefore, we cannot make a separate set of decisions for Wales as we do for Scotland. We have however engaged with Welsh ministers and officials during PR13 on issues relating to the Welsh rail network and specific matters of concern to them relating to CP5. Should there be further devolution in Wales, we would discuss with the Welsh Government how this should be taken account of in future periodic reviews.

2.29 Whilst we are not carrying out separate determinations for the nine Network Rail routes in England & Wales, we have carried out much of our analysis at the route level. In this document, we are publishing a substantial amount of route level data, partly to explain our analysis, partly because some of it has an impact on the new regional efficiency benefit sharing mechanism, and partly to improve transparency. It is of course for Network Rail, as the regulated company, to manage the delivery by its routes and other business units.

Assumptions about Network Rail

2.30 Network Rail is a company limited by guarantee (CLG) and has members instead of shareholders. These members do not have any significant equity capital⁴⁹ and hence are not as strongly incentivised as shareholders would be to drive Network Rail's financial performance. This has an important bearing on the incentives and protections for risk that we put in place for Network Rail. We have assumed in our determination that this CLG status will continue throughout CP5.

2.31 Network Rail currently benefits from the 'financial indemnity mechanism' (FIM). This provides that Network Rail's debt is guaranteed by the UK Government (effectively transferring risk from Network Rail to the UK Government)⁵⁰. Network Rail pays a fee to the UK Government (the 'FIM fee') to reflect the benefit it receives from the FIM.

⁴⁹ Each member has a nominal investment of £1.

⁵⁰ This guarantee enhances Network Rail's credit, allowing it to raise debt at gilt rates (i.e. UK Government interest rates) plus a relatively small margin.

2.32 In PR08, we provided for Network Rail to begin to raise unsupported debt (i.e. without the benefit of the FIM), which would provide stronger incentives and increase external scrutiny (as unsupported debt holders would want to assure themselves that Network Rail could deliver). However, Network Rail has not raised any unsupported debt in CP4 and we have not assumed that the company will raise unsupported debt in CP5.

Re-openers

2.33 Re-openers are mechanisms that can be used to re-open the price control (i.e. our determination) in certain situations to allow changes to be made to the revenues that Network Rail is allowed to recover. For example, where material events have happened that are beyond reasonable management control or could not have reasonably been foreseen. Hence, through re-openers financial consequences of some elements of the risks that Network Rail faces are transferred to Network Rail's funders and customers.

2.34 We have consulted on the re-openers that should apply in CP5. Our general approach is to retain two of the re-openers from PR08⁵¹. The first would permit the determination to be re-opened if there are material changes in circumstances for Network Rail or in relevant financial markets. This re-opener applies to events in England & Wales and Scotland. The second applies to Scotland only and permits a re-opening if Network Rail's expenditure in Scotland is forecast to be more than 15% higher than our determination over a forward looking period of three years. In each case we would need to determine whether the terms of the relevant re-opener had been met and, if so, we would then consider whether there is a compelling case for an interim review in light of our statutory duties.

PR13 and the wider context

The Rail Value for Money study

2.35 Around the time that we began PR13, the conclusions of the Rail Value for Money (RVfM) study, that we commissioned jointly with DfT, were published⁵². This identified a number of barriers to efficiency in the industry, which if addressed could lead to

⁵¹ The precise wording of the re-openers will be consulted on in our July 2013 consultation on the changes required to access contracts and the network licence to implement PR13.

⁵² *Realising the Potential of GB Rail: Final Independent Report of the Rail Value for Money Study*, May 2011, available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.10401>

savings of between £2.5bn (the 'low' end) and £3.5bn (the 'high' end) by 2018-19 (in 2008-09 prices). Of these potential savings, between £1.8bn and £2.8bn were identified as being within the control of Network Rail to achieve, and between £0.6bn and £1.2bn for the rest of the industry (2008-09 prices).

- 2.36 The issues that needed to be addressed to deliver these efficiencies included: sub-optimal interfaces between industry parties and processes; poorly aligned incentives; the way in which major players in the industry had operated – for example, Network Rail's centralised approach and insufficient focus on the needs of its customers; the legal and contractual frameworks; supply chain management; insufficient emphasis on whole-system approaches; and the relationships and culture within the industry⁵³.
- 2.37 The RVfM study was clear that to achieve the greater efficiencies, it would be necessary for the whole industry to play its part. This included ORR and the governments who would each need to facilitate the changes necessary to enable the industry to operate more efficiently.
- 2.38 The RVfM study informed our approach to PR13. In our first consultation, while we noted that PR13 could not address all the challenges faced by the industry, we were clear that it would provide a vehicle to achieve a number of improvements to deliver a better railway. We emphasised the need for greater alignment of incentives and the right approach to risk and reward, along with more joined-up industry planning and decision making across the supply chain.

Progress following the RVfM study

- 2.39 Since then, in parallel with PR13, the industry has acted on the RVfM study recommendations. In late 2011, the cross-industry Rail Delivery Group (RDG) was established, bringing together the owners of the passenger and freight train operating companies and Network Rail to provide leadership for the rail industry and drive forward reform. RDG is coordinating a number of workstreams through its working groups set up to find more innovative, efficient and joined-up ways of working. Alliances between train operators and Network Rail have been developed on a case-

⁵³ Pages 8-10, *Realising the Potential of GB Rail: Report of the Rail Value for Money Study – Summary Report*, May 2011, available at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.10401>

by-case basis, providing a framework for greater alignment between industry parties and improved decision making.

- 2.40 Overseen by RDG, the industry has produced the ISBPs for CP5 and the Rail Technical Strategy. These were developed respectively by the cross-industry Planning Oversight Group and the Technical Strategy Leadership Group. These set out the industry's overall approach for CP5, including on crosscutting issues such as the roll-out of new technology, the need for innovation and further integration of the different elements of the supply chain, as well as how the industry will respond to climate change.
- 2.41 DfT has announced a new approach to franchising and a new franchising timetable, with 12 franchises scheduled to be let during CP5⁵⁴. Transport Scotland has confirmed its approach to its next round of franchising, with two separate ScotRail and Caledonian Sleeper franchises to be let in the first year of CP5.
- 2.42 Network Rail itself has taken significant steps to reform, most notably devolving responsibility from its centre to its ten operating routes. This was a fundamental and welcome change which provides the foundation for further reform. It enables closer working relationships between each route and its customers, more local decision making and also scope for better regulation.

The importance of continuing industry reform

- 2.43 Demand for rail is forecast to continue growing. This is good news for the industry. However, the challenge will be for it to provide the extra capacity required to accommodate this demand whilst at the same time driving down costs and providing a better service, both to give customers the value for money that they expect and to put the industry on to a more financially sustainable footing.
- 2.44 Given Network Rail's central role in the industry, its continuing transformation will be essential to securing this outcome. In CP5, we want to see it build on the changes it has already made to forge more responsive relationships with its train operator customers. This will require a more commercial and collaborative approach to its

⁵⁴ *Rail franchise schedule*, DfT, March 2013, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/170565/rail-franchise-schedule.pdf.

engagement with its industry partners to unlock whole industry efficiency and better performance.

- 2.45 An example of where this will be crucial will be the CP5 enhancements programme. By working more closely with its customers and suppliers on the specification of enhancement projects, the costs of delivering improvements to the network should be minimised. At the same time, it will help ensure that ultimately those enhancements deliver infrastructure over which Network Rail's customers wish to operate more services, increasing Network Rail's income and providing a better service to passengers and freight customers.
- 2.46 For this to happen, it is vital that Network Rail and its partners have effective and aligned incentives – to encourage them to work together to reduce costs and to make the most of the capacity available. Improving the cost reflectivity of access charges paid by train operators to Network Rail is particularly important in this respect. Where the costs incurred in delivering a service are reflected in the charges paid, the price signals provide information that leads to more efficient behaviour. This should lead to more efficient usage – e.g. train operators will be encouraged to reduce the wear and tear their trains cause to the network.
- 2.47 Further disaggregation and transparency will also drive better outcomes, leading to decision making closer to the customer.
- 2.48 Greater transparency in respect of the operational and financial performance of Network Rail's devolved routes will provide a reputational incentive to improve. It will also enable a greater understanding of performance, costs and subsidy, empowering Network Rail's customers to hold it to account. This in turn should facilitate greater local involvement in the funding and specification of the railway – such as through devolution of franchising, and decision making more attuned to the needs of customers.
- 2.49 Further disaggregation will also allow us to make greater use of comparative techniques in the way we regulate, enabling us to compare the different business units within Network Rail and opening up a wider range of comparators beyond this.

Beyond PR13

- 2.50 We have been clear that CP5 will act as a stepping stone – a period during which Network Rail, with its industry partners, follow-up recent reforms with further

transformation to lay the foundations of a more 'normal' and sustainable industry in CP6 and beyond. As well as working with the industry to implement our PR13 determination, we will work with Network Rail, RDG and others to support and facilitate further reform in CP5.

- 2.51 In PR13, we have taken account of the limited extent to which the incentives we set through a periodic review are felt by franchised passenger operators because of the provisions protecting them from regulatory changes which are set out in their franchise agreements with DfT and Transport Scotland. Whilst we understand the rationale for this protection, ideally franchised passenger operators would be more exposed to changes in charges made during a periodic review – in the same way that freight and open access passenger operators are. The decision to relax this protection is for the franchising authorities to make and we have engaged with DfT and Transport Scotland to discuss how this could be brought about.
- 2.52 During CP5, we will be taking forward with RDG a more fundamental review of the structure of charges which will inform the next periodic review. This will take account of reforms in the industry such as route-level disaggregation.
- 2.53 The ISBPs developed for CP5 were underpinned by the route utilisation strategies that have been developed by the industry over recent years. We will support Network Rail and its industry partners in building on this progress with the next generation of route strategies and the integration of this with the cross-industry work on technical strategy.
- 2.54 We will also shortly be consulting on our long-term regulatory statement which considers how the industry may evolve beyond CP5 and our role.

Relationship between PR13 and High Speed 2

- 2.55 The UK Government has committed to the staged construction of a high-speed rail line (HS2). The first stage (London to Birmingham) is expected to open in 2026. Further stages have been proposed beyond this to Manchester and Leeds (which would open during the 2030s), and to Scotland. Construction of the first stage is expected to start during CP5.
- 2.56 Our draft determination does not specify any outputs in respect of the construction of HS2. However, it does specify a development fund for enhancements in CP6 that is intended to include, in part, necessary development work for the linkage of the

existing network to HS2. We would expect Network Rail in CP5 to ensure that, when renewing and enhancing its network, it takes account of potential connections and interfaces with HS2 to ensure that costs in the longer term are minimised.