21. Affordability of the HLOSs

Key messages in this chapter

- We have reviewed the financial forecasts provided by DfT and Transport Scotland to support their HLOSs.
- We have combined our determination assumptions of Network Rail's revenue requirements with the costs and revenues that the governments have forecast for franchised train operators and the amount of public funding that is available in CP5.
- On the basis of our latest analysis, we consider that both the England & Wales and Scotland HLOSs can be delivered for the public funds available (as set out in the SoFAs). However, we do not consider that we are able to conclude there is a material surplus for either England & Wales or Scotland.

Introduction

21.1 This chapter sets out our assessment of whether the England & Wales and Scotland HLOSs can be delivered for the public funds (SoFAs) available.

21.2 The chapter has the following structure:

(a) background and context;

(b) draft determination affordability assessment;

(c) final determination affordability assessment; and

(d) summary of the affordability position for England & Wales and Scotland.

Background and context

Our approach

21.3 Our affordability calculation is a whole industry calculation, i.e. we must consider franchised train operators, freight and Network Rail. It is based on:

(a) the information on franchise support costs and revenues that DfT and Transport Scotland have provided to us;

(b) our analysis of those forecasts; and

(c) our calculation of Network Rail's SoFA revenue requirements.

21.4 We need to ensure consistency between the basis of the SoFA and our analysis. The franchised operators pay access charges to Network Rail and, in producing their franchise subsidy forecasts, DfT and Transport Scotland included estimates of these costs. We have adjusted for these franchise payments to Network Rail.

DfT’s financial forecasts and our analysis

21.5 DfT provided us with commercially confidential data underpinning its financial forecasts, including:

(a) base revenues and costs for each of the franchised operators, before changes expected as a result of the HLOS;

(b) a risk analysis including the forecast impact of revenue sharing arrangements; and

(c) forecast incremental costs, mainly assumptions on new rolling stock required and the associated lease costs.

21.6 We were also provided with underlying policy assumptions, including the assumptions made by both governments on any increases in regulated fares over CP5. Unregulated fares are assumed to increase in line with regulated fares for forecasting purposes.

21.7 DfT excluded some capital programmes such as non-Network Rail parts of Crossrail and High Speed 2 from its SoFA because these are treated separately by DfT. DfT’s SoFA also does not reflect any funding provided by the Welsh Government.

21.8 We reviewed DfT’s analysis in terms of whether the assumptions made were reasonable.

21.9 As in PR08, we decided it was not sensible for us to produce our own passenger demand forecasts as this would just duplicate DfT’s role. Instead, we carried out a high-level check of DfT’s forecasts for their completeness and their reasonableness.

21.10 After we received Network Rail’s SBP, it became apparent that DfT’s calculation had underestimated the likely costs of depots and stabling and hence we assumed a further capital cost of £224m. We calculated the funding impact of this expenditure for CP5 as if it had been added to Network Rail’s RAB.

21.11 We found DfT’s assumptions on franchise revenues to be reasonable. DfT forecast revenues to rise by 3% per annum over CP5, which is below recent trends (over the last five years franchise revenue has grown by more than 50%).

21.12 Base franchise costs were assumed to be stable in CP5, which again we found to be reasonable. DfT considered efficiency improvements for franchise train operators, particularly in the light of the RVfM study.

21.13 We reviewed the efficiency assumptions and found them to be reasonable, based on examples of potential efficiency improvements that DfT provided. However, after the cancellation of the WCML franchise competition in October 2012, we asked DfT whether the initial assumptions were still reasonable, given the delays to the franchise letting programme and the increased emphasis on negotiating direct awards with existing franchises. DfT provided us with further evidence to support its numbers.

21.14 As HLOS capacity enhancements had not been fully defined at the time of the HLOS, DfT assumed that any additional revenue would broadly cover the operating costs of the additional rolling stock required, which is reasonable.

Transport Scotland's financial forecasts and our analysis

21.15 The financial forecasts are simpler in Scotland as there are only two franchises – the ScotRail franchise and the franchise for Caledonian Sleeper services. We carried out a similar assessment for Scotland as we did for England & Wales and concluded that the forecasts were reasonable.

Draft determination affordability assessment

Summary of our draft determination assessment

21.16 In our draft determination, our analysis showed that the total cost of the Scottish Ministers' specification was slightly above the funds available (£94m over CP5), while the Secretary of State's was slightly below (£22m over CP5).

21.17 Our England & Wales analysis showed a mix of positive and negative years, while the analysis for Scotland had four negative years. Although the overall figure for Scotland was negative, in our draft determination we said that we considered that the gap would be closed by the time of the final determination, partly because the exact funding levels for projects in CP5 had not yet been finalised and because other assumptions could change before our final determination. We also expected some re-profiling of expenditure and revenue for the final determination, which we considered would remove the negative years in England & Wales.

Summary of the responses to our draft determination

21.18 In its consultation response, DfT welcomed our finding that its HLOS was affordable within the funds available.

21.19 Whilst Transport Scotland acknowledged the funding gap of £94m in the draft determination against its SoFA, it welcomed our view that this gap would be closed by the final determination. It also stated that budget certainty was vital for the Scottish Government and that it looked to us to protect the Scottish Ministers' funding position and to ensure that our final determination provided an affordable and certain funding settlement, which must improve on the position set out in the draft determination.

21.20 Passenger Focus welcomed our finding that the HLOS for England & Wales was deliverable within the SoFA and noted our expectation that the current funding gap in Scotland would narrow.

21.21 Since the draft determination, we have received further information from Transport Scotland on the likely net public costs of franchising, which has allowed us to re-assess the risks around the SoFA calculations made by the Scottish Ministers, and this has increased the level of headroom for Network Rail funding.

21.22 Outside of their consultation response, both governments have confirmed that the financial forecasts supporting their SoFAs (e.g. including their franchised train operations assumptions), are still valid for our final determination assessment of affordability.

Our final determination affordability assessment

Network Rail's revenue requirement

21.23 We need to include Network Rail's revenue requirement in our affordability calculation. For our assessment we use Network Rail's SoFA revenue requirement[537]. This is the gross revenue requirement that we determine will be received from all funding sources less our assumptions for the income that Network Rail will receive from sources other than franchised passenger train operating companies, which offsets the gross revenue requirement. This 'SoFA other single till income' is principally from property rental and sales, freight charges, Crossrail charges and facility charges.

21.24 It is the SoFA revenue requirement – the level of Network Rail's revenue requirement that is funded by access charges (track and station) from franchised passenger operators, or grants paid by the governments 'in lieu' of track access charges – that is relevant for the level of public financial support for the railways, as set out in the SoFAs.

21.25 In our draft determination, we adjusted our affordability assessment to include funding for additional depots and stabling costs in CP5 for England & Wales because these costs were not included in the HLOS. We assumed these would be funded through the franchises. We have now included, in our determination of Network Rail's CP5 revenue requirement, £312m of enhancement expenditure on depots and stabling because we have agreed with DfT that Network Rail will fund and programme manage the delivery of this work in CP5. We discuss this issue further in our enhancements chapter (chapter 9). Given that funding for these costs is now reflected in Network Rail's revenue requirement, instead of being part of franchise costs, we have not made any further adjustments to our final determination affordability assessment.

21.26 Tables 21.1 and 21.2 summarise our final determination revenue requirement calculations in England & Wales and Scotland[538].

[537] This definition is consistent with the SoFA revenue requirement presented in Network Rail's IIPs, our May 2012 advice to ministers and Network Rail's strategic business plans.

[538] CP4 equivalents have not been included as this would not be a meaningful comparison because the HLOSs published in PR08 were different to those in PR13.

Table 21.1: Our final determination assessment of Network Rail's CP5 SoFA revenue requirement to deliver the HLOS – England & Wales

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Gross revenue requirement	5,492	5,573	5,693	5,865	5,948	28,572
SoFA other single till income	(440)	(487)	(535)	(581)	(627)	(2,670)
SoFA revenue requirement	**5,051**	**5,085**	**5,158**	**5,285**	**5,322**	**25,901**

Table 21.2: Our final determination assessment of Network Rail's CP5 SoFA revenue requirement to deliver the HLOS – Scotland

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Gross revenue requirement	608	630	651	660	655	3,204
SoFA other single till income	(26)	(27)	(29)	(32)	(35)	(150)
SoFA revenue requirement	**582**	**602**	**621**	**628**	**620**	**3,054**

Final determination affordability analysis

Overview of calculations

21.27 In our draft determination, we presented our affordability analysis in 2012-13 prices. We converted the funds available into 2012-13 prices from nominal prices (the governments published their SoFAs in nominal prices), using DfT's and Transport Scotland's own SoFA assumptions for CP5 inflation.

21.28 The affordability calculation depends on the inflation assumptions we use. For our final determination, we have tested the affordability calculation using both the original assumptions from the HLOSs and more recent forecasts. We have presented our affordability analysis below in three different ways:

(a) nominal prices. This is consistent with how the governments presented the funds available in their published SoFAs;

(b) 2012-13 prices, based on our final determination inflation assumptions. We have revised our inflation assumptions since the draft determination and so we consider that it is appropriate to show the impact of these assumptions in our affordability assessment; and

(c) 2012-13 prices, based on DfT's and Transport Scotland's own SoFA assumptions for CP5 inflation. This is consistent with our draft determination assessment.

21.29 Tables 21.3, 21.4 and 21.5 summarise our final determination calculation for England & Wales, using the three different price bases.

21.30 To calculate the affordability position for England & Wales, we followed these steps:

(a) starting from the SoFA (which was published in nominal prices):

   (i) for our 2012-13 prices comparison, we converted the SoFA into real prices (2012-13 prices); and

   (ii) for our nominal prices comparison, we converted our revenue requirement assumptions from 2012-13 prices into nominal prices;

(b) we deducted the franchise support payment from the total funds available;

(c) we added back the payments made by franchise operators to Network Rail as assumed by DfT; and

(d) the resulting total was then compared to our calculation of Network Rail's SoFA revenue requirement to calculate a 'surplus' or 'deficit' of funds.

Table 21.3: CP5 affordability calculation in nominal prices – England & Wales

£m (nominal prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA*	3,165	3,382	3,385	3,516	3,394	16,842
Less: Franchise support payment	(341)	(166)	(296)	(254)	(396)	(1,453)
Add: Franchise payments to Network Rail (as assumed in the SoFA)	2,127	2,218	2,278	2,411	2,476	11,510
Funds available for Network Rail	**5,633**	**5,766**	**5,959**	**6,181**	**6,265**	**29,804**
Less: Network Rail revenue requirement to deliver the HLOS	(5,359)	(5,551)	(5,800)	(6,144)	(6,357)	(29,212)
Surplus / (deficit)	**274**	**214**	**159**	**37**	**(92)**	**592**

*Note: In our draft determination, we restated the SoFA and franchise support lines for the expected financial impact of the DfT's decision to reduce fares growth in CP5 from RPI+3% to RPI+1%. This change did not affect the funds available to Network Rail but simply meant that a reduction in franchise support payments was offset by an increase in the SoFA. However, given that we now show the SoFA in nominal prices, we have decided to present the unadjusted SoFA so that there is a direct comparison to the published SoFA. For the avoidance of doubt, this is simply a presentational issue and has no impact on our affordability calculation.

Table 21.4: CP5 affordability calculation in 2012-13 prices (ORR inflation assumptions) – England & Wales

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA*	**2,983**	**3,098**	**3,010**	**3,024**	**2,841**	**14,957**
Less: Franchise support payment	(322)	(152)	(263)	(219)	(331)	(1,287)
Add: Franchise payments to Network Rail (as assumed in the SoFA)	2,005	2,031	2,026	2,074	2,073	10,209
Funds available for Network Rail	**5,310**	**5,282**	**5,300**	**5,316**	**5,245**	**26,452**
Less: Network Rail revenue requirement to deliver the HLOS	(5,051)	(5,085)	(5,158)	(5,285)	(5,322)	(25,901)
Surplus / (deficit)	**258**	**196**	**142**	**32**	**(77)**	**551**

*Note: See the note to Table 21.3.

Table 21.5: CP5 affordability calculation in 2012-13 prices (DfT inflation assumptions) – England & Wales

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA	**2,929**	**3,051**	**2,944**	**2,941**	**2,764**	**14,628**
Less: Franchise support payment	(316)	(150)	(258)	(213)	(322)	(1,258)
Add: Franchise payments to Network Rail (as assumed in the SoFA)	1,969	2,000	1,981	2,017	2,017	9,984
Funds available for Network Rail	**5,213**	**5,201**	**5,183**	**5,170**	**5,103**	**25,870**
Less: Network Rail revenue requirement to deliver the HLOS	(5,051)	(5,085)	(5,158)	(5,285)	(5,322)	(25,901)
Surplus / (deficit)	**162**	**115**	**25**	**(115)**	**(219)**	**(31)**

*Note: See the note to Table 21.3.

21.31 Tables 21.6, 21.7 and 21.8 summarise our calculations for Scotland. To calculate the affordability position for Scotland, we followed these steps:

(a) starting from the SoFA (which was published in nominal prices):

(i) for our 2012-13 prices comparison, we converted the SoFA into real prices (2012-13 prices);

(ii) for our nominal prices comparison, we converted our revenue requirement assumptions from 2012-13 prices into nominal prices;

(b) as Transport Scotland's published SoFA reflected only the funds available for CP5 infrastructure spending (and also incorporated payments made by franchise operators to Network Rail), we did not need to adjust the SoFA to determine the total funds available;

(c) we have included an adjustment for the further information that we have received from Transport Scotland since the draft determination, on the likely net public costs of franchising[539]; and

(d) the resulting total was then compared to our calculation of Network Rail's SoFA revenue requirement to calculate a 'surplus' or 'deficit' of funds.

Table 21.6: CP5 affordability calculation in nominal prices – Scotland

£m (nominal prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA	**639**	**664**	**664**	**672**	**684**	**3,323**
Adjustment	(3)	8	26	49	45	125
Total funds available for Network Rail	**636**	**672**	**690**	**721**	**729**	**3,448**
Less: Network Rail revenue requirement to deliver the HLOS	(618)	(658)	(699)	(730)	(741)	(3,445)
Surplus/ (deficit)	**19**	**15**	**(9)**	**(9)**	**(12)**	**3**

Table 21.7: CP5 affordability calculation in 2012-13 prices (ORR inflation assumptions) – Scotland

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA	**602**	**608**	**591**	**578**	**573**	**2,952**
Adjustment	(3)	8	23	42	38	108
Total funds available for Network Rail	**600**	**616**	**613**	**620**	**610**	**3,059**
Less: Network Rail revenue requirement to deliver the HLOS	(582)	(602)	(621)	(628)	(620)	(3,054)
Surplus/ (deficit)	**18**	**13**	**(8)**	**(8)**	**(10)**	**5**

[539] This has allowed us to re-assess the risks around the SoFA calculations made by the Scottish Ministers and has increased the level of headroom for Network Rail funding.

Table 21.8: CP5 affordability calculation in 2012-13 prices (TS inflation assumptions) – Scotland

£m (2012-13 prices)	2014-15	2015-16	2016-17	2017-18	2018-19	Total
SoFA	**605**	**612**	**596**	**587**	**581**	**2,981**
Adjustment	(2)	5	21	41	37	102
Total funds available for Network Rail	**603**	**618**	**617**	**628**	**618**	**3,083**
Less: Network Rail revenue requirement to deliver the HLOS	(582)	(602)	(621)	(628)	(620)	(3,054)
Surplus/ (deficit)	**21**	**15**	**(4)**	**(0)**	**(2)**	**29**

Summary of the affordability position for England & Wales and Scotland

21.32 Taking into account the assumptions underlying our analysis, the total cost of the Scottish Ministers' specification, in both nominal prices and 2012-13 prices (using both Transport Scotland's and our own CP5 inflation assumptions), is slightly below the funds available. Similarly, the cost of the Secretary of State's specification is below the funds available in nominal prices and in 2012-13 prices, using our own CP5 inflation assumptions. However, using DfT's CP5 inflation assumptions to restate the SoFA, the specification is slightly higher than the funds available.

21.33 The England & Wales and Scottish numbers show a mix of positive and negative years. We have discussed the phasing of the affordability position with both governments and we understand that this funding profile does not cause significant budgetary issues for either government.

21.34 Given the uncertainty of inflation forecasting, particularly over the medium-term, and taking our affordability analysis in the round, we consider both HLOSs to be affordable, given the funds that have been made available in CP5.

21.35 We said in the draft determination that, if it appears there will be a surplus at the time of the final determination we would agree with the relevant government how this should be treated. Depending on the inflation assumptions used, the overall affordability position can be marginal and there can be small deficits in some years. Hence we do not feel able to conclude there is a material surplus for either England & Wales or Scotland.

22. Implementation of our determination

Key messages in this chapter

- The implementation of PR13 will require the amendment of track and station access agreements and Network Rail's network licence. We will start the statutory process to do this on 20 December 2013.
- In July 2013, we consulted on the amendments we proposed to make to access contracts and the network licence (based on the draft determination). We also sought the views of Network Rail and each train operator on what bespoke provisions in their track access agreements (if any) should roll-forward to CP5. We will take the comments we received into account when we finalise the provisions.
- In the event of a delay to the statutory implementation process, a contingency plan is in place to ensure that the main access charges that fund the running of the railway are not disrupted.

Introduction

22.1 This chapter sets out how we will implement our PR13 determination. It gives an overview of:

(a) the background to the statutory implementation process and the access agreements that are within the scope of PR13;

(b) the process for making changes to access agreements and the network licence to give effect to this determination; and

(c) contingency arrangements if there is a delay to implementation.

The implementation process – background

22.2 As an access charges review, PR13 ultimately involves the review and amendment of the amounts payable under, and associated provisions within, access agreements between Network Rail and its customers ('beneficiaries'). This includes the charges levied for the use of the track or stations, the possessions and performance compensation regimes, and efficiency benefit sharing mechanisms. Our overall decisions on PR13 will therefore need to be implemented through changes to track and station access agreements. We will also need to amend Network Rail's network licence (through which we hold it to account) so that it reflects key policy decisions.

22.3 The process for implementing access charges reviews is set out in Schedule 4A to the Railways Act 1993, which requires us to issue a series of notices:

(a) a review initiation notice;

(b) review notices;

(c) notices of agreement; and

(d) review implementation notices.

22.4 A review initiation notice formally sets out our intention to carry out an access charges review. On 15 March 2012, we issued a review initiation notice relating to both track and station access agreements[540].

22.5 Once we have reached our conclusions (i.e. our final determination) in an access charges review, we then issue review notices which begin the implementation phase of the access charges review. These must:

(a) state our conclusions and the reasons why we have reached those conclusions. We will do this by incorporating our published final determination document into the notice;

(b) specify the changes which we propose to make to any access agreements for or in connection with giving effect to our final determination;

(c) state the date on which we propose that each of those changes should come into operation; and

(d) specify a period of not less than six weeks from the date of issue of the review notices in which Network Rail may object to any of the proposed changes.

22.6 We will send a copy of the review notices containing revised provisions to Network Rail, each affected beneficiary, the Scottish Ministers, the Secretary of State and HM Treasury. We intend to issue the review notices on 20 December 2013. At the same time, we will approve the price lists produced by Network Rail that set out the charges to be paid by train operators that are incorporated into access contracts. We will publish the review notices on our website after making any appropriate redactions.

22.7 Consistent with previous practice, our review notices will also include a provision providing that if we approve or direct amendments to an access agreement after we have served the review notice but before it comes into effect, then those later amendments will come into effect subject to the changes we propose in the review. If there is any conflict between the changes we propose in the review notice and the changes we have approved or directed subsequently, the latter will take precedence.

22.8 Any access contracts entered into after the date we issue our review notices cannot be included within the scope of the notice. Nonetheless, from the start of CP5, the provisions in these contracts will need to be consistent with PR13. We will therefore ensure there are arrangements in those contracts to enable this to happen. We will

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[540] Our review initiation notice issued on 15 March 2012 is available at: http://www.rail-reg.gov.uk/pr13/PDF/review-initiation-notice.pdf.

also need to make similar arrangements for those contracts that may be entered into shortly before the review notice is issued.

22.9 If Network Rail objects to any review notice, we may issue a new review notice or make a reference to the Competition Commission. Should we issue a new review notice, then Network Rail would have a further period of not less than six weeks to make any objections to the new notice.

22.10 If Network Rail does not object to the review notices, we must serve a 'notice of agreement' on each beneficiary to an access agreement. The beneficiaries then have a period of 28 days to give notice to terminate their access agreements, should they wish to do so.

22.11 Following the expiry of this 28 day period, we will publish the review implementation notice, stating that our determination is to be implemented as proposed in the review notice. Through this process, the changes are implemented directly into the track and station access agreements specified in the review notice.

22.12 We intend to implement our PR13 determination on 1 April 2014. Our timetable is shown in Table 22.1 below.

Table 22.1: Key dates for the implementation process

Date	Milestone
November 2013	We issue a statutory consultation on our proposed modifications to Network Rail's network licence to update it for CP5. (Some 'core PR13' licence changes relating to condition 3 and part of condition 4 will, however, be made through the review notices we issue in December.)
By 8 November 2013	We circulate to passenger train operators the Schedules 4 and 8 values that we plan to include in their track access contracts for CP5. This will give them the opportunity to advise us if there are any errors before we implement them. (See chapter 20 for further details.)
21 November 2013	Deadline for Network Rail and those freight train operators with a market share of 5% or more of total freight train miles run to submit agreed levels of Schedule 8 liability caps to us for inclusion in their track access contracts. (See chapter 20 for further details.)
20 December 2013	We issue review notices, beginning the formal implementation of PR13. Network Rail publishes its CP5 price lists.
7 February 2014	Deadline for Network Rail to object to the review notices.
After 7 February 2014	If Network Rail does not object to our review notice, we issue a notice of agreement to beneficiaries of access contracts.
March 2014	We issue review implementation notices.
31 March 2014	Delivery plan published by Network Rail.
1 April 2014	Implementation of PR13 determination.

Changes to access agreements and the network licence

Consultation on proposed contractual changes to access agreements

22.13 PR13 will require changes to various aspects of passenger, freight and charter track access agreements (principally the access charges in Schedule 7 and financial compensation regimes in Schedules 4 and 8 where these exist, and will include operator specific information such as payment rates and benchmarks in Schedule 8). As part of these changes, in each track access agreement we will reference the new price lists so that these have effect.

22.14 PR13 will also require amendments to the station access agreements to incorporate changes to the stations long term charge (including changes to the indexation provisions) and the recovery of Stations Information and Security Systems (SISS) costs. These changes are discussed in more detail in chapter 16.

22.15 On 12 July 2013, we consulted Network Rail and its access beneficiaries on how we proposed to implement PR13 through changes to access contracts[541] (based on the decisions set out in our draft determination).

22.16 We also consulted on changes to the multilateral rules governing the use of on-train metering of traction electricity (the EC4T Metering Rules). These rules are currently incorporated into the track access contracts of train operators who are billed using meters. Amongst other things, we proposed to widen the scope of the EC4T Metering Rules to include the volume and cost reconciliation (wash-up) processes, which currently sit within individual track access contracts. The EC4T Metering Rules would then become the 'Traction Electricity Rules' and be incorporated into the contracts of all operators of electric trains. Chapter 16 sets out more detail on the Traction Electricity Rules.

22.17 Following our July 2013 consultation, we issued a number of further related consultations on implementation, including:

(a) proposed changes to charter track access contracts to implement our draft policy conclusions on the structure of charges and performance regime for charter operators[542];

(b) proposed contractual drafting to implement possible options for the capacity charge, following a process of engagement with the industry over the summer[543]; and

[541] *Consultation on implementing PR13*, July 2013, available at http://www.rail-reg.gov.uk/pr13/consultations/pr13-implementation.php.

[542] *Consultation on proposed changes to charter track access contracts*, September 2013, available at http://www.rail-reg.gov.uk/pr13/consultations/implementing-charter-operators.php.

(c) proposed contractual drafting relating to the cost reconciliation process for traction electricity[544].

22.18 We would like to thank all the parties who responded to these consultations. We will be making refinements to the drafting to reflect, where appropriate, the points made. We will also consider the extent to which any further focused engagement would be desirable as we begin to finalise the provisions and take into account any further changes required to give effect to this determination.

Network Rail's price lists

22.19 In April and May 2013, Network Rail published initial drafts of its CP5 price lists and invited comments on them for accuracy[545]. Network Rail then issued updated versions of these on 12 July 2013 to reflect the proposed decisions in our draft determination. It again invited comments, providing a further opportunity for interested parties to engage before the finalisation of the price lists. These final price lists, reflecting the decisions in this final determination, will be published by Network Rail on 20 December 2013.

Consultation on bespoke provisions within track access agreements

22.20 Most existing track access agreements are broadly consistent with our model contracts, but many contain bespoke provisions. For example, facility charges for investments paid for by the train operator, or additional charges to recover the cost of an operator running services beyond the normal opening hours of a route. As part of PR13 implementation, we will be replacing the new model provisions in each agreement. We would therefore need to make special provision for any bespoke provisions that need to be continued into CP5.

22.21 Accordingly, in July 2013, we sought to confirm which bespoke provisions should be retained in CP5 and which were no longer needed or appropriate. To do this, we carried out a review of the consolidated versions of the access agreements provided to us by Network Rail and then wrote to Network Rail and each train operator in July 2013 setting out our proposed approach. We asked them to advise us if they disagreed with us or if we had missed any key provisions.

22.22 We are grateful to all those who responded to us. We will take account of the points made to us and may liaise further with affected parties where required.

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[543] *Consultation on contractual provisions to implement options for the capacity charge in CP5*, September 2013, available at http://www.rail-reg.gov.uk/pr13/PDF/implementing-pr13-capacity-charge.pdf.

[544] *PR13: consultation on contractual wording for EC4T cost reconciliation*, October 2013, available at http://www.rail-reg.gov.uk/pr13/consultations/implementing-ec4t-cost-reconciliation.php.

[545] *Structure of charges: publication of draft CP5 price lists*, Network Rail, May 2013, available at http://www.networkrail.co.uk/PublicationofdraftCP5pricelists.pdf.

Changes to Network Rail's network licence

22.23 As set out in chapter 12, we plan to update and amend licence condition 3 (financial indebtedness) of Network Rail's network licence to:

(a) reflect our policy on maximum levels of financial indebtedness for each year of CP5;

(b) make the CP5 year 5 maximum level of financial indebtedness roll forward into CP6 until CP6's levels are set; and

(c) update the FIM fee.

22.24 We also intend to amend licence condition 4 so that it more clearly reflects our policy on when Network Rail may pay a rebate to the governments or a dividend, as set out in chapter 12. Both these sets of changes are directly related to our PR13 determination.

22.25 We also propose to make improvements to other Network Rail network licence conditions. These will be either less significant updates or clarifications which we think will make the licence more fit for purpose in CP5.

22.26 We consulted on the proposed drafting of changes to the network licence in July 2013[546].

Process for amending the network licence

22.27 There are two processes that we can use to implement licence changes, as follows:

(a) **schedule 4A of the Act** provides for us to amend any 'linked licence' (i.e. linked to the access agreements in respect of which we are carrying out PR13) through a review notice.

We plan to use this process for the amendments to condition 3 and the parts of condition 4 that are directly related to PR13. We will do this through the review notices we expect to issue on 20 December 2013; and

(b) **section 12 of the Act** sets out the process for amending licences with the consent of the licence holder and requires a minimum 28 day statutory consultation.

We will use this process for the other changes we propose to make to the licence. Having taken into account stakeholders' responses to the July 2013 consultation, in November 2013 we will start a 28 day statutory consultation on the modifications we intend to make. Subject to this consultation and Network Rail's consent, we intend that the licence changes will take effect no later than 1 April 2014.

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[546] See chapter 8 of *Consultation on implementing PR13*, July 2013, available at http://www.rail-reg.gov.uk/pr13/consultations/pr13-implementation.php.

Contingency planning for a delay to the statutory implementation process

Background

22.28 There is a risk that the implementation process for PR13 could be delayed. As set out above, Network Rail has the right to object to our review notices. If it does, we can issue new review notices and restart the implementation process, or we can refer the matter to the Competition Commission. In either scenario, the impact on timescales would mean that PR13 could not be implemented in time for 1 April 2014. The process could also be delayed by other events, such as a judicial review[547].

22.29 The Act does not specify what should happen in this scenario. In practice, it would mean a significant gap in Network Rail's funding because certain key charges (in particular the fixed charge paid by franchised operators) would not automatically roll-forward.

22.30 There are two broad options for addressing this: introduce a provision to either (1) roll-forward CP4 charges or (2) implement our PR13 determination (pending the ultimate resolution of the cause of the delay). In either case, depending on how the delay to implementation is resolved, there may be a need to issue new review notices with new charges and terms.

22.31 We do not think that the rolling forward of CP4 charges in operators' contracts would be viable because:

(a) many of the charges in CP4 were profiled, and there is no reason to suppose that the charges payable for the final year of CP4 relate logically to the appropriate revenue which Network Rail should receive from 1 April 2014 onwards; and

(b) the charges set for CP4 relate to the delivery of outputs specified in the PR08 final determination. Network Rail should be committed to the new outputs for CP5.

Our proposed contingency plan

22.32 On 17 April 2013, we wrote to Network Rail, train operators and other relevant parties proposing a contingency plan based on implementing the amendments specified in our PR13 review notices on 1 April 2014, notwithstanding a delay to the process for any reason[548]. This would then provide for Network Rail to start the delivery of

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[547] For the remainder of this chapter, we use a Network Rail objection to our review notice as the example, but a delay could be due to other reasons.

[548] *Consultation on contingency planning for PR13 implementation*, April 2013, available at: http://www.rail-reg.gov.uk/upload/pdf/pr13-contingency-planning.pdf.

regulated outputs as per our determination, with the revenue stream set by the determination.

22.33 Under this arrangement, if ultimately the Competition Commission disagreed with our determination, we would have to take its findings into account in the changes we propose to be made to access agreements.

22.34 In our letter, we suggested operators of regular scheduled passenger services (franchised and open access operators) and Network Rail agree to amend their contracts to include a provision that would provide for this arrangement. This was on the basis that their agreements contain provisions that would time out at the end of CP4 if PR13 implementation were delayed.

22.35 We proposed that freight and charter passenger operators did not need to enter into this arrangement as the provisions in their contracts would not 'time out' at the end of CP4, and would be uplifted by inflation in the event of a delay. However, we asked freight and charter operators whether they would want to make the amendment in any case.

22.36 We discussed this arrangement with the Competition Commission and it raised no objections to it. It also noted that the plan would not in any way undermine Network Rail's statutory right to object to our review notice, nor would it prejudice the ability of ORR to take action following an objection such as issuing a new review notice or making a reference to the Competition Commission.

22.37 Following our consideration of the responses to the consultation letter, we confirmed in our draft determination that we would proceed with this contingency arrangement for operators of regular scheduled passenger services (i.e. franchised and non-franchised open access TOCs). On 9 August 2013, we issued a letter to Network Rail and the relevant train operators requesting that they enter into a template amendment to implement the contingency arrangement by 15 October 2013[549].

[549] Available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-contintency-plan-2013-08-09.pdf.

23. Monitoring, enforcement and reporting

Key messages in this chapter

- We will monitor and report on Network Rail's performance in CP5 and enforce where necessary. This will give stakeholders assurance it is meeting its obligations and delivering what it has been funded to do.
- Our monitoring will be risk based, proportionate and forward looking. We will monitor a wider range of outputs, indicators, enablers and other aspects of delivery than in CP4; this particularly reflects our concerns with Network Rail's asset management. We will review the way we monitor midway through CP5. We are willing to adapt our approach, for example where Network Rail can satisfy us that its own monitoring is effective.
- The crucial difference in terms of regulation between outputs and enablers / indicators is that if Network Rail is likely to fail, or fails, to deliver an output we would consider whether this amounts to a licence breach and we may take enforcement action against the company (outputs are often referred to as 'regulated outputs'). A failure to deliver either an enabler or an indicator would not in itself be considered as a potential licence breach. However, either may indicate trends which raise concern about Network Rail's likely future compliance with an output that we may want to take licence enforcement action to address.
- There are established industry processes by which Network Rail, TOCs and FOCs work together to deliver good performance; we can intervene if Network Rail falls short.
- We will enforce the delivery of outputs where we need to. Our approach to enforcement will continue to reflect the principles of better regulation and our enforcement policies. As well as enforcing compliance with Network Rail's licence, we will enforce health and safety law.
- Network Rail must agree operational performance targets with each franchised train operator. We will treat these as outputs alongside the national performance outputs. Most franchised England & Wales TOCs should reach 90% punctuality (measured by PPM) by the end of CP5 (and nationally PPM should be 92.5% or more). Punctuality for Virgin Trains and East Coast should reach at least 88% but with a more challenging CaSL target, reflecting the particular characteristics of those services. Alongside the overall 90% PPM minimum for First Great Western's services, Network Rail should also deliver a PPM of at least 88% for its high speed services by the end of CP5.

Key messages in this chapter (continued)

- We will use our PR13 determination as the baseline for measuring Network Rail's financial performance, and will focus on total financial performance rather than just some elements of expenditure. We will work with Network Rail to specify and publish our detailed approach before the start of CP5.
- We will continue to publish independent, objective reports about Network Rail's delivery in CP5, including: our Network Rail Monitor; our annual efficiency and finance assessment; and our advice to Network Rail's remuneration committee.
- We will publish more information at the Network Rail route level to help local decision makers and establish a whole industry scorecard.
- There will be improvements in financial reporting in Scotland.

Main changes since the draft determination

- In relation to the framework for monitoring financial performance in CP5, in a joint work programme we are discussing with Network Rail our requirements for the accuracy of its reporting systems and how performance should be adjusted where required outputs have not been delivered. We expect to conclude on these matters in our regulatory accounting guidelines (RAGs), which will be published by the end of March 2014.

Introduction

23.1 One of our key responsibilities is to provide assurance to Network Rail's customers and funders that Network Rail is meeting its obligations and delivering what it has been funded to do.

23.2 This involves monitoring, enforcing and reporting on Network Rail's compliance with both health and safety law and with its licence obligations. This chapter sets out our approach to these tasks in PR13. We have considered four particular aspects:

(a) how we will monitor Network Rail's delivery of economic and health and safety obligations;

(b) how we will enforce delivery, especially of operational performance outputs where we need to update our approach;

(c) how we can improve the monitoring of Network Rail's financial performance; and

(d) what we should report, particularly about the whole industry context.

We address comments from our draft determination consultation on each of these areas in the sections below.

Monitoring in CP5

23.3 In CP5, our monitoring across all areas will continue to be risk-based, proportionate, targeted and forward looking. Where possible we will anticipate and head-off issues, ensuring Network Rail is managing risks effectively before they become problems.

23.4 The crucial difference in terms of regulation between outputs and enablers / indicators is that if Network Rail is likely to fail, or fails, to deliver an output we would consider whether this amounts to a licence breach and we may take enforcement action against the company (outputs are often referred to as 'regulated outputs'). A failure to deliver either an enabler or an indicator would not in itself be considered as a potential licence breach. However, either may indicate trends which raise concern about Network Rail's likely future compliance with an output that we may want to take licence enforcement action to address.

23.5 We will monitor whether Network Rail is likely to deliver the outputs we set. We will consider all the outputs detailed in the output framework chapter (chapter 3), including new ones for CP5 such as those around Network Rail's asset management and the reduction of risk at level crossings.

23.6 We will continue to monitor Network Rail's compliance with its obligations under health and safety law.

23.7 We will also monitor:

(a) indicators to better understand the reasons for forecast and actual trends in outputs and the risks faced. Many of these are highlighted in chapter 3. For example, we will compare the volumes of work done maintaining and renewing the network against Network Rail's delivery plan. This will be a particular challenge in the case of civil engineering works where we need Network Rail to first develop much better plans for the later years of CP5. Similarly, we will monitor Network Rail's project design and development milestones as indicators. However, Network Rail recognises it has a great deal to do to develop these quickly for the early GRIP projects where the scope of the project is not well defined;

(b) where we have established ring-fenced funds, whether Network Rail is delivering schemes efficiently and on time and that planned benefits are realised. Schemes may have economic, environmental, social and safety benefits;

(c) whether Network Rail is financially sustainable and operating within the financial boundaries set by our determination;

(d) progress with the enablers we have identified that underpin longer term improvement. These include customer service maturity and continuous improvement of Network Rail's management of safety; and

(e) the whole industry context in which Network Rail works.

23.8 In CP5 we will also be monitoring much more route level information than in CP4. It is for Network Rail to manage its routes and other business units but we will expect the company to provide disaggregated information wherever appropriate. This will be valuable in helping us understand how Network Rail is performing as a business, the variations in performance, efficiency and safety we see across the network and for benchmarking. It will help us make rail industry delivery more transparent, and should facilitate greater local involvement in the funding and specification of the railway.

23.9 Network Rail has expressed its clear concern that our monitoring in CP5 will be burdensome and complex and at odds with our emphasis on outputs in CP4. It estimated we would routinely monitor 3,700 measures in CP5. We accept that, overall, we will be monitoring more in CP5. This mainly reflects how we are setting new outputs and indicators for asset management where we have had concerns about Network Rail's progress, and our increased focus on route information as a leading indicator for the delivery of outputs, such as train operator level performance outputs. We consider the monitoring framework properly reflects the complexity of the network, the scale of the investment being made and the expectations of Network Rail's customers and funders.

23.10 We will seek to minimise the regulatory burden on Network Rail by using the information it already uses for its own purposes wherever possible. Indeed, almost all of the outputs, indicators and enablers we are setting for CP5 are already produced by the company. Network Rail is keen to work with us to facilitate us using its own assurance processes where this will be effective and efficient.

23.11 Our framework provides extra and earlier assurance in those areas where the company's recent record suggests there are particular risks to delivery in the next five years. Where we are assured that these risks are well managed, we would expect to monitor less – we have already done this for enhancement projects in CP4 where we have mainly focused on those at risk of non-delivery and monitored other projects less. Longer term, we would like to see the need for monitoring delivery to diminish. This might come about as Network Rail convinces us it can deliver the progress needed with commitment and pace. In time our role could then shift more towards supporting and encouraging Network Rail and its stakeholders as they work together to deliver. We will review our approach at the midpoint of CP5. We are willing to adapt our approach, for example where Network Rail can show its own monitoring is effective.

Enforcement in CP5

23.12 Our approach to enforcement in CP5 will continue to reflect the principles of better regulation, i.e. to be proportionate, transparent, consistent, targeted and accountable. We will act in line with our published enforcement policies.

23.13 If Network Rail is failing, or is likely to fail, to deliver an output we will consider whether to take licence enforcement action. We can do this because we consider the delivery of outputs to be the reasonable requirements of Network Rail's customers and funders, and its licence requires it to do everything reasonably practicable to meet such requirements.

23.14 If Network Rail is not complying with its health and safety obligations we will consider whether to take enforcement action under health and safety legislation. This may include prosecution and/or the serving of enforcement notices.

Enforcing TOC operational performance

23.15 In the past we have made a separate policy statement on enforcing operational performance at the individual TOC level, most recently in June 2010. Our approach until the end of CP5 is set out in this section.

23.16 Throughout CP5, we expect Network Rail to engage with passenger TOCs to develop and agree a Joint Performance Improvement Plan (JPIP), or an equivalent replacement, to be in place by 1 April each year (we are actively engaged in the current industry-led Performance Planning Reform Programme). Each JPIP should cover the next two years. Each JPIP should include a PPM commitment, and also a CaSL commitment for those TOCs franchised by DfT. We will treat these, for the first year of each JPIP, as regulatory outputs.

23.17 JPIPs should also include performance indicators such as delay minutes and any other measures Network Rail and TOCs consider appropriate.

23.18 In the event Network Rail cannot agree a JPIP with a TOC we would expect to set an interim requirement taking the second year of the last agreed JPIP as our starting point (for the first year of CP5 this means the second year of the 2013-14 JPIPs). For franchised TOCs we would also work with the relevant franchising authority to ensure the JPIP process worked smoothly and a JPIP was agreed as soon as possible.

23.19 For franchised TOCs, JPIPs should be consistent with the franchise contract so far as possible. Network Rail will, as now, provide performance projections to inform potential franchise bidders and JPIPs should be updated in-year if needed to reflect franchise change. We will work with the franchising authorities to ensure that, in new franchise agreements, the performance targets specified for the TOC are aligned with Network Rail's outputs to encourage a more collaborative or alliance based approach to improving performance for passengers.

23.20 Network Rail will need to explain each year how delivery of the individual JPIPs relates to delivery of the required national performance. We expect it to have robust governance arrangements in place so that whenever the JPIPs taken together do not give us confidence the national requirements will be met, it develops clear and convincing plans to bridge any gap, which it must then deliver.

23.21 There are established industry processes through which Network Rail, TOCs and FOCs work together to deliver good train performance. While we can hold Network Rail to account, funders can hold their operators to account. We will work with the funders to ensure these performance management processes work well and we have a shared understanding of industry performance risks. We may intervene if called on by third parties such as an operator, a funder, Passenger Focus or London TravelWatch. We will not, however, wait for a complaint if our own monitoring suggests action is needed to address performance issues.

23.22 Achievement of the national annual output targets will almost inevitably mean that some TOCs will exceed their individual JPIP targets while others underperform. This is particularly likely where the sum of the JPIPs is very close to the national target. This means there is no justification for us to intervene automatically if a JPIP output were not being achieved. However, this would mean that Network Rail could achieve its national outputs while some TOCs experienced significantly worse performance. Therefore, we consider that we should specify a floor level for PPM and CaSL below which we will intervene. Above the floor, we will not normally intervene unless some other output is at risk (for example, the minimum PPM in year 5).

23.23 Network Rail suggested a floor for England & Wales PPM of 90% with no regulatory intervention as long as performance remained above this level. We have not accepted this proposal as there are big differences between individual TOC performance and the nature of their services, and Network Rail is unlikely to agree the same JPIP targets with every TOC.

23.24 Instead we are setting a floor 2 percentage points below the PPM (MAA) commitments made in each JPIP. We consider this is an appropriate floor given the uncertainty in the figures that make up PPM, the greater variability in PPM at individual TOC level and performance in CP4. Similarly where a CaSL commitment is made we are setting a cap at 0.2 percentage points worse than the JPIP target; below this level we will not normally intervene unless some other output is at risk.

23.25 In our draft determination, we proposed no England & Wales franchised TOC should exit the control period with a PPM (MAA) of less than 90%, reflecting a concern that no TOC should be “left behind”. Network Rail was concerned that setting this output for all such operators might unduly constrain the industry and not deliver value for money. East Coast and Virgin Trains supported a lower PPM requirement given the significance of other measures such as cancellations and long delays to their passengers. First Great Western supported a minimum requirement for the high speed part of its services.

23.26 We have decided that most franchised England & Wales TOCs should reach a punctuality of at least 90% PPM by the end of CP5 (with First Great Western’s high speed services reaching at least 88% PPM, in addition to the minimum 90% PPM for its services overall). The exceptions are Virgin Trains and East Coast which will need to reach 88% PPM but with a correspondingly more challenging CaSL target. We will treat these requirements as outputs and require Network Rail to agree targets in the relevant JPIPs at least at this level for the last year of CP5. This should not significantly impact the CP5 national outputs as the poorest performing TOCs run relatively few services and therefore have a relatively small impact on national PPM.

23.27 In summary, we will intervene when:

(a) Network Rail and a TOC cannot agree a JPIP; or

(b) Network Rail's plans or actions to deliver at least 88% PPM for East Coast and Virgin Trains (and First Great Western's high speed services) and at least 90% PPM for every other England & Wales franchised TOC in the last year of CP5 are inadequate; or

(c) Network Rail's plans or actions to deliver the national performance outputs are inadequate (including where Network Rail needs to bridge a gap between the sum of the JPIPs and the national outputs); or

(d) performance for an individual TOC is, or is likely to be, worse than the relevant floor/cap levels.

23.28 Where we intervene, we will follow a staged approach of review, investigation and escalation which may ultimately lead to formal enforcement action. We may require new or updated recovery plans, the formation of a recovery board, or some other form of assurance from Network Rail.

23.29 As now, in deciding whether and how to intervene we will focus on systemic and/or serious issues. We will work with the established industry processes where possible, taking account of how the commitments made dealt with the greater uncertainty associated with forecasts at the TOC level.

23.30 We will also consider the impact of poor performance on passengers and what was or will be done for them. In particular, we will look at the numbers, causes and effect of so-called 'bad days' on passengers and assess Network Rail's response[550]. While some bad days are probably unavoidable, Network Rail can reduce their frequency and impact through its planning and service recovery. The CaSL measure captures the key elements of such days – trains cancelled or part cancelled and those delayed by 30 minutes or more.

23.31 Network Rail has raised the issue of how we handle the impact of traffic growth on performance. We acknowledge growth significantly above or below the levels assumed at the start of CP5 could impact the delivery of performance outputs. We will take actual traffic growth into account when assessing Network Rail's performance, where it varies by more than 2.5 percentage points from Network Rail's assumptions.

[550] These are days when significant parts of the network are severely disrupted, for example by major infrastructure failure or extreme weather.

This reflects the extra traffic growth experienced in CP4 and our view that it is reasonable to expect Network Rail to accommodate that degree of variation.

Financial monitoring

23.32 This section outlines our approach and measurement of financial performance and covers:

(a) why we monitor financial performance;

(b) the definition of financial performance;

(c) our experience in CP4;

(d) a summary of our draft determination;

(e) responses to our draft determination;

(f) our comments on those responses;

(g) our determination; and

(h) the joint ORR/Network Rail work programme.

Why we monitor financial performance

23.33 It is important that Network Rail is incentivised to financially outperform our determination. It is also important for us to establish whether or not Network Rail has outperformed our determination because:

(a) reducing costs, in a safe and sustainable way, is essential if the rail industry is to provide improved value for money for its customers and funders;

(b) in the absence of shareholder pressure, reputational incentives such as our assessments of Network Rail's financial performance are important;

(c) our assessment of Network Rail's financial performance underpins the route-level efficiency benefit sharing mechanism (REBS); and

(d) it reveals important information to inform future periodic reviews.

23.34 We report on Network Rail's efficiency and financial performance in our annual efficiency and finance assessment[551] and our Network Rail Monitor publications[552]. We also require Network Rail to report on financial issues in its regulatory financial statements.

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[551] These may be accessed at http://www.rail-reg.gov.uk/server/show/nav.2050.

[552] These may be accessed at http://www.rail-reg.gov.uk/server/show/nav.293.

Definition of financial performance

23.35 In our 2006 policy statement[553] we defined:

(a) financial outperformance as "any underspend achieved while delivering the output targets specified in the access charges review and not compromising the long-term asset condition and serviceability of the network". The burden of proof is on Network Rail to show that an underspend it claims as outperformance meets the tests below; and

(b) financial underperformance as "any underspend while failing to achieve required output targets and/or compromising long-term asset condition".

23.36 In order to assess whether any underspend or overspend is outperformance or underperformance we:

(a) identify and quantify the causes of any underspend or overspend;

(b) assess whether Network Rail has delivered its required outputs ('robustness' test); and

(c) assess whether any changes in the scope of work (i.e. changes in volume) are likely to impact on the long-term asset condition and serviceability of the network ('sustainability' test).

Our experience in CP4

23.37 Several measures of efficiency and financial performance were used in CP4:

(a) a comparison of income and expenditure to the PR08 determination;

(b) real economic efficiency measure (REEM);

(c) efficiency benefit sharing mechanism calculation; and

(d) financial value added (FVA).

23.38 The different ways these measures are calculated has resulted in complexity and confusion in communicating Network Rail's financial performance in CP4. In particular, comparing Network Rail's financial performance to both our PR08 determination and Network Rail's delivery plan in CP4 has been overly complicated and has worsened transparency.

23.39 Our monitoring of financial performance in CP4 has mainly focused on Network Rail's operating, maintenance and renewals (OM&R) expenditure. However, focusing on OM&R can lead to perverse incentives. For example, were Network Rail to invest in an information management scheme that increases its income and is efficient, this would be reported as an inefficiency as our assessment would only take into account the increase in cost and not the increase in income.

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553 *Monitoring and treatment of Network Rail's underspend and efficiency*, January 2006, available at: http://www.rail-reg.gov.uk/upload/pdf/273.pdf.

23.40 Our assessments of Network Rail's financial performance for renewals and maintenance expenditure have been difficult in CP4 because of issues with Network Rail's reporting. This has been for a number of reasons including:

(a) significant levels of variability in projected renewals volumes and costs in delivery plans compared to actual volumes and costs, implying instability in the renewals delivery process;

(b) lack of auditable evidence to justify that underspend was efficient; and

(c) uncertainty about the sustainability of Network Rail's asset management policies, in particular for its civils assets.

23.41 We have adjusted our assessments of Network Rail's financial performance in CP4 to take account of Network Rail not delivering PPM regulatory outputs (robustness test above) and concerns about aspects of Network Rail's asset management (sustainability test above). This has been difficult because Network Rail has not established a clear link between expenditure and performance given the diverse activities it undertakes to operate and maintain the national rail infrastructure.

Summary of our draft determination

23.42 Given the problems that we have had reporting on Network Rail's financial performance in CP4, we set out in our draft determination the key areas of the financial monitoring framework. These areas were:

(a) the CP5 baseline;

(b) whether we should focus on Network Rail's total financial performance or a subset such as support, operations, maintenance and renewals costs;

(c) how we should treat financing costs and input price changes;

(d) how we should treat renewals performance;

(e) consistency with our RAB roll forward policy;

(f) how we should treat material one-offs (for example, if a machine had been assumed to be leased but Network Rail decided to buy it, or if there is a change in law such as to national insurance rates);

(g) how we should present our assessment of financial performance;

(h) the effect on financial performance of Network Rail not delivering outputs; and

(i) the effect on financial performance of Network Rail not having appropriate systems and processes to support claimed savings.

Responses to our draft determination[554]

23.43 Network Rail emphasised that savings should be presumed to be efficient unless they have been achieved in a way which is demonstrably unsustainable or at the expense of other requirements. Network Rail considered that the variance analysis should be based on a high level 'top-down' approach rather than on a detailed bottom-up assessment of how savings have been achieved.

23.44 Network Rail agreed that additional measures are required to explain variances in financing costs. However, Network Rail was concerned about how reporting financing costs against market rates could work in practice. It wants to work with us to develop appropriate measures.

23.45 Network Rail considered that the volume incentive should be included in the measure of financial performance.

23.46 Network Rail also wanted us to base our efficiency in CP5 on an unadjusted 2013-14 to be more comparable.

23.47 Other respondents thought that it was important for us to hold Network Rail to account and that transparency is critical in the reporting of financial performance. Respondents thought that this is important to build confidence in Network Rail and the industry to move forward, as well as ensuring Network Rail is meeting its obligations and delivering what it has been funded to do.

23.48 TOCs wanted any adjustments to financial performance to be designed with good incentive properties. They also requested an improved approach to engagement with them by Network Rail and us prior to the start of CP5.

Our comments on the responses to our draft determination

23.49 We do not agree with Network Rail that a high-level 'top-down' approach to assessing Network Rail's performance is appropriate in CP5, because we consider that the burden of proof should be on Network Rail to demonstrate that underspend represents outperformance rather than deferral of work.

23.50 This requires Network Rail to be able to demonstrate that it has delivered its required outputs and that its financial performance is sustainable. We will work with Network Rail to identify the most appropriate way of doing this, and in particular establishing the level of confidence that we require in its reporting whilst ensuring that the process is not overly burdensome. We expect to conclude on this in the RAGs before the start of CP5.

23.51 We do not agree that we should base our efficiency reporting in CP5 on an unadjusted 2013-14. At the moment, we adjust for the expected financial penalty and

[554] This section excludes responses on the robustness of reporting systems and measurement of output adjustments which are discussed separately in the joint ORR / Network Rail work programme section below.

other issues in 2013-14 in our presentation of our CP5 efficiency assumptions. Presenting efficiency assumptions on an unadjusted basis would make our efficiency reporting less transparent as the comparison to our determination would be more difficult. However, expenditure that Network Rail has incurred in each year going back to 2001-02 will be reported on an unadjusted basis on our website, to allow comparisons over time.

Our determination

23.52 This section covers the areas where we have made decisions for CP5 in this determination. This is followed by a section on the joint ORR/Network Rail programme which highlights the areas still to be finalised before the start of CP5.

CP5 baseline

23.53 For CP5 we have decided that Network Rail should report on a measure of total financial performance that compares Network Rail's financial performance against our PR13 income and expenditure assumptions. This will:

(a) be more transparent;

(b) better reflect the regulatory settlement that Network Rail is incentivised to deliver;

(c) better support efficiency sharing mechanisms, which are underpinned by the financial assumptions in our determination; and

(d) restrict Network Rail's ability to potentially move the goal posts through frequent large-scale changes to its delivery plans.

23.54 Given the assumptions underpinning our determination will probably be less detailed than Network Rail's own delivery plan, we will be transparent to ensure that Network Rail understands the basis of our determination. We will provide the relevant data underpinning our determination to Network Rail to ensure it can understand our baseline to report its actual performance against.

23.55 Using Network Rail's delivery plan is unlikely to provide a clearer baseline as there needs to be an auditable reconciliation from the determination to the delivery plan, which for CP4 was not clear. Also, the lack of detailed unit cost and volume baseline data in Network Rail's plans has been a problem for us in CP4. In addition, the maintenance assumptions in Network Rail's PR13 SBP were not underpinned by volume and unit cost information[555].

Total financial performance

23.56 We will include all income and expenditure categories that we have assumed are controllable by Network Rail in the measurement of total financial performance in CP5, with the exception of expenditure on civils renewal volumes and spend to save schemes. We agree with Network Rail that the volume incentive should be included in

[555] As important as Network Rail's delivery plan is, it is not a substitute for our determination.

this measure. Including all income and expenditure categories that we have assumed are controllable should better incentivise Network Rail to improve its efficiencies in areas other than OM&R and reduce confusion amongst stakeholders[556].

23.57 As summarised in Figure 23.1 and Figure 23.2 below, our planned approach for Network Rail's reporting of total financial performance is structured as follows:

(a) first, all income and expenditure that is not controllable by Network Rail is excluded;

(b) second, the variances between Network Rail's actual income and expenditure compared to our determination (i.e. the baseline) will be calculated on a line-by-line basis. These variances may need to be adjusted for the mechanisms outlined in the financial framework chapter (chapter 12) on civils, early GRIP enhancements, projects with specific protocols/arrangements and spend to save schemes. Any adjustments will be transparent;

(c) third, the reasons for the variances between actual income and expenditure and the determination will be identified. In particular, variances caused by deferring or accelerating capital expenditure compared to the profile assumed in our determination will be separately identified from any financial outperformance or underperformance;

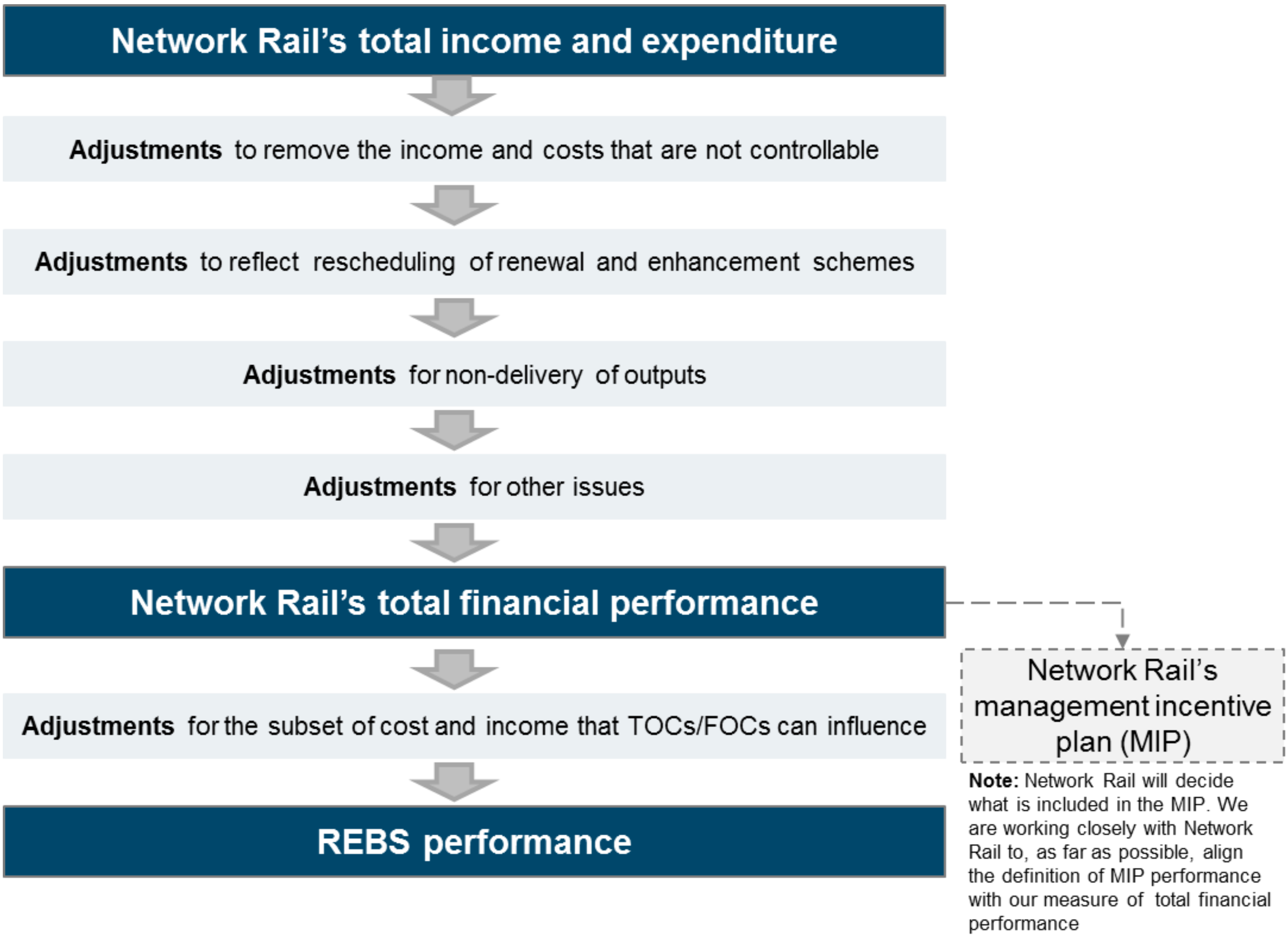
(d) fourth, financial performance will be adjusted for the non-delivery of outputs. This will also involve assessing the extent to which Network Rail has met its required outputs and maintain the long-term asset condition and serviceability of the network in accordance with its licence and our determination. Whilst it is not practicable to prescribe our approach for every possible circumstance, the basis of these adjustments will be set out, as far as possible, in our CP5 RAGs;

(e) fifth, financial performance may be adjusted for other issues such as claimed financial outperformance that has not been supported by appropriate systems and processes; and

(f) sixth, we will decide how Network Rail's financial performance should be reflected in the calculation of any payments under the REBS mechanism.

[556] The concept of total financial performance is similar to Financial Value Added (FVA) which Network Rail developed in CP4 as a measure of financial performance against its 2009 delivery plan for CP4.

Figure 23.1: Process for calculating financial performance



The treatment of financing costs and input price changes

23.58 Changes to Network Rail's financing costs and input prices can have a significant effect on Network Rail's total financial performance. As we consider these to be controllable by Network Rail, we have decided that they should be included in our measure of total financial performance.

23.59 Including financing costs and input prices in the measure incentivises Network Rail to manage these issues efficiently. It is also consistent with our approach to risk and uncertainty. However, this approach may appear to reward Network Rail for factors that may, to some extent, be outside of its control. For example, Network Rail's financing costs are sensitive to changes in market interest rates.

23.60 To better inform stakeholders about Network Rail's total financial performance, in addition to comparing Network Rail's financing costs to our PR13 determination, Network Rail's actual interest rates will be compared to market rates. An analysis will also be undertaken on the effect of market factors on input prices. We will work with Network Rail to identify the best way to undertake and present the analysis for financing costs and input prices.

The treatment of renewals

23.61 We have considered what aspects of renewals could be included in the CP5 financial performance measure. The main options that we considered were:

(a) include all renewals. This would provide Network Rail with the strongest incentive to deliver renewals efficiently;

(b) include only some aspects of renewals. This would allow us to exclude cost savings which are contentious and difficult to evaluate, for example volume savings which are more likely to impact on the long-term asset condition and serviceability of the network; and

(c) exclude all renewals. This would reflect our serious concerns about the quality of Network Rail's reporting of renewals savings in CP4, but would not incentivise Network Rail to deliver renewals efficiency.

23.62 Given the importance that we have placed on Network Rail becoming more efficient in CP5, we have decided to recognise all aspects of renewals in the scope of the financial performance measure. However, this decision is subject to us being confident that Network Rail has appropriate reporting systems and processes in place that will identify financial outperformance/underperformance. This is explained further below.

Ensuring consistency with the RAB roll forward policy

23.63 Our approach for measuring financial performance for capital expenditure is inconsistent with our RAB roll forward policy in CP4. For example, if Network Rail outperforms its renewals expenditure target by £100, we recognise the full £100 saving when calculating financial performance. However, our RAB roll forward policy in CP4 allows Network Rail to keep only £25 of the saving as the risk of outperformance/underperformance is shared between Network Rail and its customers and funders.

23.64 We have retained the 25% incentive rate for renewals and enhancements in our approach to the RAB roll forward for CP5. This means that there will be a difference between the amount of money that Network Rail outperforms/underperforms by and how much of that money it retains/bears. When measuring financial performance we therefore need to consider whether we include the efficient underspend fully as outperformance, i.e. in the above example do we include the £100 or the £25?

23.65 The approach we used for CP4 reflected our objective of making the EBSM as straightforward as possible. However, this is not consistent with the reward Network Rail receives through the RAB roll forward policy. For example in the EBSM, for the £100 of outperformance, because of the RAB roll-forward policy, Network Rail would keep £25. However, Network Rail would have to pay TOCs/FOCs £25, which would mean that it would keep £0 for a renewals saving that it has delivered.

23.66 REBS is a more commercial approach than EBSM and we need to ensure that the incentive on Network Rail is appropriate in CP5. We have therefore decided that our definition of financial performance should be consistent with our policy for rolling forward the RAB, in particular the treatment of logging up or down underspend/overspend on renewals and enhancements expenditure. Therefore, using the above example, Network Rail would keep £18.75 (75% of the £25) for the outperformance.

23.67 The advantage of this approach is that it aligns Network Rail's financial reward/penalty for renewals and enhancements expenditure (through the RAB roll forward mechanism) with the basis for calculating REBS payments. This should improve the incentive on Network Rail to make REBS work. It also de-risks the renewals part of REBS for the TOCs.

23.68 The disadvantage of this approach is that as REBS payments will not be based on the cash saving it may make it more difficult to understand. One of the issues that we discussed at an industry workshop in July 2013 was whether in setting the REBS baselines this approach could overcomplicate REBS. Generally, our preferred approach was well received at the workshop and as long as the calculation is transparent, it was not thought that it would overcomplicate REBS.

Non-delivery of regulatory outputs

23.69 We have adjusted Network Rail's financial performance in CP4 to take account of Network Rail's non-delivery of required regulatory outputs, e.g. for PPM. For CP5 we have identified two main options for how to handle Network Rail not delivering its regulatory outputs:

(a) hurdle approach: Network Rail would be unable to report financial outperformance if it has not met all (or materially all) regulatory outputs; and

(b) adjustment approach: Network Rail's financial performance would be adjusted to reflect the impact of not delivering regulatory outputs.

23.70 The hurdle approach would send a clear message about the importance of Network Rail delivering its regulatory outputs. However, this approach could incentivise Network Rail to invest in uneconomical initiatives to achieve these outputs. Network Rail does not think that the hurdle approach is appropriate because it does not recognise the company's need to balance its various different requirements.

23.71 The adjustment approach would incentivise Network Rail to make better decisions about the trade-offs between delivering its required outputs and providing value for money to customers and funders. This is the approach that we used in CP4.

23.72 Given the perverse incentives that could exist with the hurdle approach we have decided to continue to use the adjustment approach in CP5. The way that we will determine the adjustments is discussed below.

Treatment of material one-off changes to Network Rail's income and costs

23.73 Material one-off changes to Network Rail's income and costs can distort Network Rail's reported financial performance. Material one-offs could include:

(a) one-off changes in costs, e.g. changes in tax law, such as an increase in national insurance contributions; and

(b) a decision by Network Rail to buy an asset rather than to lease it.

23.74 To ensure consistency, we have decided that our assessment of Network Rail's financial performance should be consistent with our PR13 financial framework, in particular our approach to risk and uncertainty. That is, if we consider that a cost is controllable, all changes in that cost should be included in financial performance. This would include material one-off changes. However, for potential windfall gains on issues like VAT rebates, where Network Rail is saying that the issue is so uncertain that it cannot provide a reasonable estimate of the potential gain, we will assess these case by case at the time.

23.75 The issue of how to treat a buy/lease decision is similar to the issues involved with spend to save schemes, i.e. we do not want to incentivise Network Rail to take inefficient decisions. Therefore, both our RAB roll forward policy and our approach for financial performance reporting will hold Network Rail neutral to such changes to avoid creating perverse incentives.

Presentation of financial performance

23.76 Our current view on how total financial performance could be presented in CP5 is shown in Figure 23.2.

23.77 We consider that reporting on a single total performance measure in monetary terms (i.e. £m) would be clearer than reporting efficiency savings in percentage terms as the materiality of a percentage saving is not clear. However, we recognise that it is useful to have a time series of efficiency data available, so we will continue to publish information in our supporting documentation showing the percentage improvement in the efficiency of support, operations, maintenance and renewals expenditure.

23.78 We are considering the most appropriate way of reporting the financial effect of the non-delivery of outputs and we will conclude on this in our RAGs.

23.79 Network Rail's financial performance will need to be reported separately for each operating route to support the calculation of REBS payments. Although this will increase the reporting requirement on Network Rail, it will also increase transparency about Network Rail's financial performance at a route level.

Figure 23.2: Possible presentation of CP5 financial performance statement

	Actual	PR13 determination	PR13 variance	Adjustments for phasing of capital expenditure	Adjustments for outputs not delivered	Other adjustments	Financial performance	Percentage performance
	(A)	(B)	(C)=(B-A)	(D)	(E)	(F)	(G)=(C-D-E-F)	(G)/(B)
Income								
Variable charges								
Other single till income								
Expenditure								
Operations								
Support costs								
Other								
Maintenance								
Renewals								
Enhancements								
Schedule 4&8								
Financing costs								
Corporation tax								
Total								

Notes to Figure 23.2: This excludes income and expenditure deemed not controllable. 'Other' includes: traction electricity costs less amounts that are not transmission loses and Network Rail's own electricity costs; British Transport Police; RSSB; and Reporter's fees.

23.81 Further details on how Network Rail reports total financial performance and how we plan to present our assessment of Network Rail's financial performance will be set out in our RAGs which we will publish before the start of CP5.

Joint ORR / Network Rail work programme

23.82 We have agreed with Network Rail that further work is required to specify our requirements for the accuracy of Network Rail's reporting systems and how performance should be adjusted where outputs are not delivered. We expect to conclude on these matters by the end of January 2014 and we will document our conclusions in our RAGs and in a plain English user guide which, will be published prior to the start of CP5.

Reporting systems and processes

Background and summary of our draft determination

23.83 As a result of our concerns about the robustness of Network Rail's reporting of efficiency improvements in CP4, in our draft determination we set out that before we would allow an aspect of Network Rail's activities to be included in our definition of total financial performance in CP5, Network Rail would be required to:

(a) successfully implement a package of improvements on asset management. This would include capability, asset policies, asset register, data quality, condition reporting and unit cost information;

(b) justify an efficiency by positive management actions and be able to explain how its new approach is consistent with the delivery of its required outputs and its health and safety obligations, is sustainable in the short, medium and long-term and is consistent with whole-life cost minimisation; and

(c) achieve a minimum confidence grade on its reporting of those costs.

Responses to our draft determination

23.84 Network Rail was concerned that these requirements could cause a significant regulatory burden, particularly as Network Rail did not think this information or this level of robustness was necessary for its own internal purposes. Network Rail was also concerned that confidence gradings used by independent reporters are subjective and it often does not agree with the assessments of independent reporters.

23.85 Network Rail considers that there should be a presumption that savings represent efficiency improvements unless the savings have been achieved in a way which is demonstrably unsustainable or at the expense of other requirements. Network Rail also noted that using the approach we set out in our draft determination will incentivise it to pursue the schemes for which it can most easily demonstrate efficiencies rather than the schemes which may result in the largest savings.

Our comments on the responses to our draft determination

23.86 We do not agree that a high-level approach to assessing Network Rail's performance is appropriate in CP5 as we consider that the burden of proof should be on Network Rail to robustly explain its financial performance, including that this is sustainable.

23.87 We recognise that there are different ways in which Network Rail can demonstrate that its reporting systems and processes are robust and that the key issue is how Network Rail can provide confidence in its reporting. As part of the joint programme of work we have agreed to work with Network Rail to clarify this.

Adjustments for non-delivery of regulatory outputs

Background and summary of our draft determination

23.88 As part of the assessment of financial performance in CP5, financial performance will need to be adjusted if outputs are not delivered. Given the lack of a clear causal link between inputs and outputs, judgement needs to be applied to the effect of non-delivery of outputs on financial performance. We recognise that there are many different ways that the adjustments could be valued. In CP4 we have taken a simple cost-avoided approach to be consistent with Network Rail's calculation of financial outperformance. Network Rail is proposing a valuation approach in CP5.

Responses to our draft determination

23.89 Network Rail proposed that before making any adjustment, there should be an assessment to consider whether the variance is within a reasonable threshold to recognise natural variations in planning and actual performance. It noted that this is particularly important where there is no upside as a result of outperformance.

23.90 Network Rail proposed an approach for calculating any adjustments based on an assessment of the impact on stakeholders of Network Rail having not delivered an output, i.e. an approach that reflects the value that has been lost to society. Network Rail's proposed approach for adjusting financial performance is summarised below:

(a) train performance – societal value of delay based on Schedule 8 benchmarks. A methodology could be developed that takes into account the relationship between PPM and delay that is reflected in the CP5 Schedule 8 benchmarks. The original societal rates varied for regional, London and South East and long distance services and it should be straightforward to mirror this approach. It would also need to take into account the impact of both TOCS and Network Rail on PPM. The approach would be equivalent to the volume incentive based on a predetermined adjustment to the RAB (or opex memorandum account);

(b) network availability – societal value of delay based on Schedule 4 benchmarks;

(c) enhancements – based on impact of delay on specific stakeholders;

(d) enabling measures – as these are not outputs there is no obvious means of calculating the lost value or impact on cost. It is therefore likely that any adjustment would reflect some form of penalty, which could potentially be predetermined (subject to adjustments to reflect reasonable changes in Network Rail's improvement plans); and

(e) sustainable management – adjustment should reflect the impact of today's management of the infrastructure on future costs compared to current expectations.

23.91 Other respondents noted that a valuation approach seemed appropriate as long as this was transparent and resulted in positive and meaningful incentives for Network Rail. They also noted that it will be important to have clear guidelines about how we would adjust for non-delivery of outputs.

Our comments on the responses to our draft determination

23.92 We will consider Network Rail's comments on thresholds for variances in the round with our assessment on adjustments for non-delivery of outputs in the RAGs.

23.93 As noted above, we recognise there are numerous ways to value output adjustments and that this will necessarily require the use of judgement. For example, we and Network Rail recognise it is difficult to calculate the financial consequences of unsustainable asset management as the effect of today's decisions will not be known with certainty for a long time.

23.94 The key issue is to ensure that any adjustments to financial performance for non-delivery of outputs are made in a way that is consistent with how other variances between actual income and expenditure and our PR13 baselines are assessed.

Next steps

23.95 We have recently set up a joint work programme with Network Rail to examine the 'reporting systems and processes' and 'adjustments for non-delivery of regulatory outputs' issues. We intend to conclude on these matters in our RAGs, which will be published before the start of CP5.

Reporting

23.96 In CP5, we will continue to publish overall assessments of Network Rail's delivery of outputs and its financial performance at least annually. This will include our Network Rail Monitor and our advice to Network Rail's remuneration committee. We will also publish an annual report about health and safety across the industry, including Network Rail.

23.97 By providing objective, clear and reliable information we will help Network Rail's customers, members and other stakeholders to better understand its performance, help to drive improvements and hold it to account.

23.98 As in CP4 we will continue to publish summaries of any audit reports we commission on aspects of Network Rail's delivery (or the full document where possible). But we will also publish more information about Network Rail's performance at the individual route level.

Whole industry scorecard

23.99 In our outputs consultation we proposed to establish a whole industry scorecard for CP5. This would allow us to report Network Rail's progress in the context of progress against the outcomes we want to achieve and wider industry trends. This idea had widespread support.

23.100 In our draft determination we confirmed our intention and proposed a structure, saying that we intended to publish the scorecard annually. It would work best at a national or 'funder' level.

23.101 In response, one freight operator said that the scorecard should include commentary to explain the factors driving trends in different freight sectors. There was also a comment that the scorecard might be developed to add further value within the industry and help decision-making.

23.102 We recognise that the scorecard, as proposed, will be of most immediate value to us in our monitoring of Network Rail. We also recognise that the scorecard would need some explanatory text to help interpret trends. Our proposal covered the freight market overall – we did not propose to report on individual freight sectors. However, if others wish to help develop the scorecard further to be useful to a wider audience, we are happy to discuss this.

Our decision

23.103 In view of the clear overall support for a whole industry scorecard we will, as proposed, establish a template for CP5 using either the same structure we suggested in Table 23.1 below or one similar to it.

Table 23.1: Whole industry scorecard: Great Britain, England & Wales and Scotland

Output framework						
Outcomes	Passenger satisfaction	Freight market share	Support for the economy	Connectivity		Direct greenhouse gas emissions - traction energy
Measure	% [557]	%	No single measure - but read-across from 'Industry finances' and 'Connectivity'	Number of services timetabled [558]		grams CO_2: per passenger km and per net freight tonne
Current frequency of availability	6-monthly	annual	-	-		annual
Volumes	Passenger journeys	Passenger km	Freight tonnes lifted by market	Freight net tonne moved by market		
Measure	number [559]	km	tonnes	tonne km		
Current frequency of availability	quarterly	quarterly	quarterly	quarterly		
Supply	Passenger train km	Passenger vehicle km	Freight train km	Freight vehicle km		
Measure	km	km	km	km		
Current frequency of availability	4-weekly	annual	annual	annual [560]		
Industry finances	Ticket revenue	Freight revenue	Other revenue	Costs	Subsidy	
Measure	£ million	£ million	£ million	£ million	£ million	
Current frequency of availability	quarterly	quarterly	annual	Annual	annual	

557 Potential sub-measure for scores at major stations.

558 Potential joint measure for journey time indicator.

559 Potential sub-measures for '*Passenger Assist*' bookings and/or *Disabled Persons Railcard* as accessibility indicators.

560 Data available but not currently provided to ORR on a regular basis.

23.104 We already receive most of the data needed for a scorecard. We agree with views that the scorecard should not add any regulatory or administrative burden and where further data is needed beyond what we already collect, we will only use data that is already collected elsewhere. For ‘passenger vehicle km’ and ‘freight vehicle km’, this will require Network Rail to extract and report data it holds in its billing system.

23.105 ATOC has confirmed that it can provide us with data for Passenger Assist booking requests and/or sales of the Disabled Persons Railcard to help show how accessible the railway network is becoming.

23.106 We intend to publish the scorecard annually (reflecting the annual availability of much of the data), probably in our Network Rail Monitor given its purpose is to put Network Rail’s performance in a wider industry context.

24. Review of wider impacts

Key messages in this chapter

- In reaching our decisions, we have had regard to the impact of our determination on those groups that will be affected by it.
- The impacts are caused by the effects of our decisions on outputs such as train service reliability and enhancement projects. But the impacts also come about through our decisions on financial incentive mechanisms, which often affect the whole industry.
- Overall, our determination will deliver significant benefits for passengers, freight customers, passenger and freight operators, taxpayers and funders. These benefits come mainly through the improvements to the network to be delivered by Network Rail and the reduction in its revenue requirement.
- In 2014, we will be commissioning an independent review of the process for PR13 to identify what worked well and what could be improved for the next periodic review.

Introduction

24.1 Elsewhere in this document we have set out our assessment of the impact of our determination on Network Rail and on rail safety. We have also discussed the impact on the UK and Scottish governments in terms of the delivery of HLOS requirements for the money available.

24.2 This chapter sets out our assessment of the wider impact of our determination on:

(a) passengers;

(b) passenger train operators;

(c) freight customers;

(d) freight train operators;

(e) geographic areas in Great Britain;

(f) the railway supply chain; and

(g) local, regional and devolved funders of the railway.

24.3 We have had regard to the relevant wider impacts in reaching our decisions on the overall package.

24.4 Under the Equality Act 2010, ORR is required, when exercising its functions, to have due regard to the need to:

(a) eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under that Act;

(b) advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it (relevant protected characteristics are – age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex; sexual orientation); and

(c) foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

24.5 We have concluded that the relevant impacts and potential impacts of this review relevant to this duty principally concern the effect on passengers. Our assessment of these is set out below.

Overview of impacts

Passengers

24.6 As part of the review we have undertaken a considerable amount of work to understand what matters to passengers. This has included in-depth discussions with Passenger Focus and London TravelWatch about Network Rail's SBP. We have also drawn on our wider work beyond the specific scope of the review, for example, our work looking at passengers' experience of buying tickets, working with train operating companies to understand how they handle complaints and deal with passengers more generally, and working with our consumer expert panel.

24.7 We have taken into account the work that Passenger Focus has done to understand passenger views, most notably in the National Passenger Survey but also through more focused research. We have had regard to the priorities that Passenger Focus's research has indicated that passengers value the most in those areas which we are able to influence through our periodic review. These are value for money, punctuality, reliability and there being sufficient train services at the time passengers want to use them[561]). Our determination takes account of these passenger priorities as follows:

(a) providing extra capacity to accommodate growth and provide new and improved journey opportunities. Major projects such as the Great Western upgrade, Crossrail, Thameslink, the Edinburgh-Glasgow improvement programme and Northern Hub will be key to this, alongside a large number of smaller scale capacity enhancements;

(b) the criteria for governance of the ring-fenced investment funds which will explicitly include securing passenger benefits. This builds and improves on the

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[561] *Passengers' priorities for improvements in rail services*, Passenger Focus, available at http://www.passengerfocus.org.uk/media/f0f44dda1a6af4f3c8940c7623b57102d9783155/rail_priorities_for_improvement.pdf.

arrangements in place for CP4 and should provide greater focus on the needs of passengers, with their representatives having a greater say in the selection of projects to be funded. We will also be monitoring the benefits delivered to passengers through the ring-fenced funds to ensure that these are used properly;

(c) for those enhancement schemes that are at an early stage of development (see chapter 9), the process for confirming the detailed scope of each project will include specific provision for train operator input on behalf of passengers;

(d) improving levels of train service reliability despite the major programme of renewal and enhancement, and requiring improvement on the current worst performing services. This will see all but two of the franchised train operators in England & Wales achieving a minimum of 90% of trains on time (as measured by PPM) by 2019. Two long distance operators, Virgin Trains and East Coast, will have a different arrangement, with a dual PPM and CaSL target[562] for 2019. This reflects that customers on these services typically value the assurance that their journey will not be significantly delayed or cancelled more highly than the assurance that there will not be minor delays. First Great Western's 90% PPM minimum includes both its long distance and commuter services, but we are also setting a separate 88% PPM minimum for its long distance services;

(e) a reduction in levels of train service disruption due to engineering works despite the scale of the investment programme. We recognise that this is a particular concern of passengers through Passenger Focus's research;

(f) ring-fenced funds providing for continued investment in station enhancements. This includes around £100m (2011-12 prices) specifically earmarked for further improvement in accessibility for disabled passengers and others with reduced mobility in England & Wales, and part of the £30m (2011-12 prices) Scottish Stations Fund for this purpose in Scotland. We have retained the Station Stewardship Measure relating to the overall condition of stations as an output requirement for Network Rail to deliver;

(g) the passenger journey time fund, which will improve journey times on routes in England & Wales;

(h) specifically for the East Coast Main Line there will be ring-fenced funding to reduce journey times and increase capacity;

(i) the funding for Network Rail's operating strategy should facilitate improvements to passenger information during disruption;

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[562] CaSL (Cancellations and Significant Lateness) measures passenger trains which are either cancelled (including those cancelled en route), miss one or more scheduled stops, or arrive at their scheduled destination more than 30 minutes late. Virgin Trains will have an end CP5 minimum of 88% PPM and 2.9% CaSL, and East Coast 88% PPM and 4.2% CaSL.

(j) improvements to the volume incentive, under which Network Rail benefits financially from increased rail usage, will give the company a stronger incentive to work with train operators to improve service levels for passengers; and

(k) the overall package, including in particular the approach on asset management, will improve the reliability and quality of the railway over the longer term, including its resilience in the face of climate change.

24.8 In considering the implications of this review for our equality duty, we have taken the view that all passengers will benefit from many of the improvements. However there will be specific benefits in respect of the protected characteristics of age, disability and pregnancy and maternity. These will arise particularly from improved accessibility at stations from the specific ring-fenced funds required by the HLOS and also the schemes which will facilitate introduction of new more accessible rolling stock.

24.9 The increase in payment rates in the Schedule 4 and 8 possessions and performance regimes will strengthen the financial incentives on Network Rail to plan and deliver engineering work efficiently and more quickly and to improve performance. This will benefit passengers through a reduction in planned and unplanned service disruption. This is because Network Rail will have to pay more compensation for each possession it arranges, or minute of lateness it causes. There will also be a reduction in the compensation that train operators receive through Schedule 4 for the cost of operating replacement bus services. This will reduce the risk that train operators agree to possessions which involve the use of replacement buses without having fully explored whether alternative timetable solutions are available which cause less disruption to passengers.

24.10 We will be publishing more information of interest to passengers on the quality of their train services, through an extended range of published indicators, including for example, the impact of engineering works on passengers. This will better enable passengers and their representatives to understand what is being delivered and seek improvement.

24.11 Through including the National Passenger Survey measures of overall satisfaction as an indicator in our output framework, we will monitor the impact of our determination on passengers. More specifically we are reviewing how to measure the benefits to passengers (including those with protected characteristics) that are delivered through improvement projects.

24.12 In terms of what this means for passenger fares, we do not regulate these. Network Rail's revenue requirement is funded through access charges paid by train operators and network grant paid direct by the governments. It is for the franchising authorities to decide the balance between fares and taxpayer subsidy and to regulate fares for franchised train operators (open access passenger operators set their own fare structure).

24.13 However, Network Rail's revenue requirement is reducing compared to PR08 which means that access charges and network grant will be lower. In terms of the like-for-like costs of operating, maintaining and renewing the existing network (including support costs), there will be a reduction of around £2bn compared to PR08.

Passenger train operators

24.14 Through our determination, franchised and open access passenger train operators will benefit from the improvements that their customers will receive, as outlined above. In addition, they will benefit from:

(a) the improved approach to joint performance planning (where Network Rail works with train operators), which should better reflect the needs of train operators in terms of local opportunities and constraints;

(b) the incentives to work together with Network Rail to improve the efficiency and delivery of the railway (such as through our REBS mechanism discussed in chapter 19) and where appropriate to develop alliances to drive out efficiencies that Network Rail, acting alone, may not achieve. For franchised operators, this is particularly important because their franchise agreements (regulated by their franchising authority) currently limit the extent to which they are exposed to changes in charges made at a periodic review. This blunts the incentive effect of the changes we make, limiting cost-reflectivity and the inducement on train operators to work with Network Rail to reduce its costs. However, the new REBS mechanism we are introducing will provide an incentive for those franchised train operators that participate in REBS to work with Network Rail to identify sustainable efficiencies that can be made in the running of the network. TOCs will then be able to share in the financial benefits arising from this;

(c) the incentives to work together with Network Rail to improve specification and effectiveness of the enhancement programme through the enhancements efficiency benefit sharing mechanism set out in chapter 9; and

(d) the improvements to the volume incentive that will encourage Network Rail to take a more commercial approach to managing network capacity. This should enable more services to be operated on the network and for train operators to increase their revenue.

Access charges

24.15 Average total franchised passenger variable charges will increase by 36% from CP4 to CP5 in real terms, as a consequence of the substantial increase in the capacity charge. (In our draft determination, the equivalent figure was 1% as we were consulting on retaining the CP4 capacity charge rates.) However, franchised operators are currently protected from the changes we make to charges at periodic reviews. In most cases this is through schedule 9 of franchising agreements, which holds train operators neutral through ex-ante changes to subsidy or premia made at the beginning of the control period. Hence, there will not be a significant impact on existing franchised operators arising from this increase.

24.16 For open access, due to the measures we are taking to mitigate the impacts of increases in the capacity charge, the average variable charges will stay approximately constant from CP4 to CP5 in real terms.

24.17 See chapter 16 for more detail on the changes to charges being made through PR13.

Schedules 4 and 8 possessions and performance regimes

24.18 The increase in traffic on the network and revenue, and updated evidence on the sensitivity of passenger demand to disruption, mean that the financial impact of possessions and lateness on passenger operators has increased. This is reflected in the CP5 Schedule 4 and 8 payment rates. This means that train operators will be better protected against the risks around Network Rail's performance and possession management.

24.19 Conversely, passenger operators will face greater Schedule 8 risk around the impact of their own performance on other train operators. This will have more of an impact on those passenger operators whose services have a greater interaction with those of other operators. Ultimately, this is a risk that train operators can control, and one in which they should be exposed to. Overall, we expect the benefit to train operators of the additional protection from the increase in Schedule 4 and 8 payment rates to outweigh this risk.

24.20 Our update of Schedule 8 benchmarks will affect passenger operators. For example, if, for a particular service group, the Network Rail benchmark decreases in terms of average minutes of lateness, the train operator will be better off as it will receive compensation in respect of a better level of Network Rail performance than it would have done previously.

24.21 Franchised passenger train operators will also be required to pay Network Rail a different amount of Schedule 4 access charge supplement (ACS) than in CP4. On average, the ACS will be higher, but it will vary across train operators. The increase is primarily as a result of the increase in Schedule 8 Network Rail payment rates.

24.22 Franchised train operators are typically held neutral by franchising authorities to the changes we make during a periodic review to the Schedule 4 payment rates and ACS, and the Schedule 8 benchmarks and payment rates. The payments that flow between the franchising authority and train operators at this stage depend in part on the bid assumptions made by train operators in relation to performance and possessions.

24.23 Train operators are in general exposed to the marginal incentives of Schedules 4 and 8 during each year. So if, under Schedule 8, Network Rail outperforms its benchmark, the bonus the train operator pays Network Rail will be based on the CP5 Schedule 8 Network Rail payment rate.

24.24 Changes to Schedule 8 for open access passenger operators are the same in structure as for franchised passenger operators but since they are not franchised they are not held neutral by franchising authorities to changes we make during a periodic review. Open access passenger operators will benefit from increased Schedule 4 payment rates when there are very long possessions or sustained disruption, without there being an equivalent change in the Schedule 4 access charge supplement.

24.25 For charter passenger train operators we estimate that, overall, the package we will be introducing in relation to Schedule 8 and the capacity charge will result in them being, on average, slightly better off than they are currently.

Freight customers

24.26 Our latest survey of potential and existing freight customers, which we published in September 2013[563], indicates that the priorities for freight customers in the domestic market are price, followed by service quality (e.g. punctuality) and then access to the mainline network. Under our determination freight customers will benefit from:

(a) continued enhancement of the railway's capability to carry freight, particularly through continued investment in the Strategic Freight Network. Freight customer representatives will be actively involved in planning this;

(b) freight train performance tracked through a new measure which is more transparent and better meets customer needs;

(c) reduced service disruption due to engineering works; and

(d) as above, the improved incentives we are putting on Network Rail to take a more commercial approach to capacity. This should enable more services to be operated on the network.

24.27 Chapter 16 sets out more fully the impact of our determination on access charges paid by freight operators. Overall, in real terms, average freight charges are set to increase by around 21% on current levels by 2018-19, equivalent to 4% a year on average. For commodities not affected by the freight specific charge (i.e. everything other than ESI coal, spent nuclear fuel and iron ore), the corresponding increases are, on average, 6% on current levels by 2018-19 and 1% a year over CP5.

Freight train operators

24.28 Freight train operators will benefit from the improvements that their customers receive as discussed above. They will also benefit from:

(a) the incentives to work together with Network Rail to improve the efficiency and delivery of the railway, through our REBS mechanism. As for passenger operators, this will provide for FOCs to benefit financially where they work with

[563] Available at http://www.rail-reg.gov.uk/server/show/nav.3022.

Network Rail and deliver efficiencies that outperform our expenditure assumptions;

(b) the incentives to work together with Network Rail to improve specification and effectiveness of the enhancement programme through the enhancements efficiency benefit sharing mechanism set out in chapter 9; and

(c) the development of better measures of Network Rail's performance in planning and timetabling the network (its 'system operator' role) will help address a particular area of concern to freight operators such as how it plans engineering work and effective management of interfaces between different devolved routes and with adjoining networks.

Access charges

24.29 The access charges paid by freight operators are discussed under freight customers above.

Schedules 4 and 8 possessions and performance regimes

24.30 We have updated Network Rail's Schedule 8 benchmark as part of PR13. Schedule 8 is expected to be financially neutral during CP5 (i.e. net payments of zero), if Network Rail and freight operators perform in-line with our expectations. However, both the Network Rail benchmark and freight operator benchmark are less favourable to freight operators than the current ones. If we were to have continued with these, freight operators would have been expected to make money from Schedule 8 during CP5.

24.31 The Schedule 8 freight operator payment rate, which reflects the average impact of a minute of delay caused by a freight operator to another train operator, will increase for CP5. This is as a result of the increase in the passenger Schedule 8 Network Rail payment rate. While we expect net payments to be zero across freight operators as a whole, this rise increases the financial risk that freight operators face in relation to delays they cause to other trains.

24.32 We expect freight operators to benefit from the bonus payment rate being changed so that it is 100% of the compensation payment rate (as opposed to 50%). This will give them more certainty over the impact of improvements they make in their performance in respect of the Schedule 8 payments they make during CP5. It will also help ensure that Schedule 8 remains financially neutral if performance is at the expected level over each year as a whole.

24.33 Unlike franchised passenger operators, freight operators do not pay an access charge supplement to cover the expected cost of Schedule 4 compensation. There is also no Schedule 8 benchmark for cancellations. Instead freight operators receive compensation for cancellations caused by Network Rail or other train operators. Network Rail receives funding to cover the expected cost of both these elements of Schedules 4 and 8.

24.34 Schedule 4 payment rates will remain the same as in CP4 in real terms, so freight operators will be no better or worse off.

Geographic impacts

24.35 The geographic impacts of our determination relate principally to the large programme of enhancement projects being funded through this determination. This will boost capacity and the capability of the network and bring substantial benefits to train operators, passengers, freight customers and the national economy. The decisions on these projects reflect the requirements of the governments' HLOSs. Further detail on these schemes is set out in chapter 9. However, those areas that will particularly benefit are set out below.

(a) In the south east of England, Thameslink, Crossrail and East West Rail will provide new journey opportunities and better travelling experiences for passengers.

(b) The north of England will benefit from the North West electrification programme and the Northern Hub, a substantial set of capacity and journey time improvements between Manchester, Sheffield, Preston, Leeds and Bradford.

(c) A major programme of electrification, representing around 30% of enhancements expenditure, covers a significant portion of Great Britain, including Edinburgh – Glasgow, Manchester – Leeds – York, London – Bristol – Cardiff – Swansea, Welsh Valleys and London to Sheffield. These electrified routes will allow new or cascaded electric rolling stock to replace the current diesel trains. These will be quieter, pollute less and offer better acceleration and breaking, reducing journey times on many routes.

(d) Scotland will also benefit from the Borders Railway project which will connect Edinburgh through Midlothian to Tweedbank for the first time since 1969. There are also journey time improvement schemes that cover Aberdeen to Inverness and the Highland Main Line. As well as being electrified, the Edinburgh-Glasgow route will benefit from capacity improvements to allow longer trains and faster journey times.

24.36 There will also be improvements to safety, particularly through a reduction in the risk of accidents at level crossings through a £99m ring-fenced fund. Whilst not specifically for safety improvements, Scotland will also benefit from a £10m fund to provide for closing crossings. These funds will benefit those using level crossings and those using the railway. The level crossings this will apply to will be decided through the governance arrangements to be established for these funds.

24.37 The whole investment package will support economic growth and facilitate improved business, commuter and leisure journeys. It will also provide a greener transport option than road and aviation, and help relieve congestion on the road network.

Suppliers

24.38 The key benefits for the railway supply chain of our determination concerns its ability to plan:

(a) within CP5, where we have confirmed funding for Network Rail's renewal programme and a large part of the enhancement programme. To the extent that we have not been able to confirm this funding (for the full programme of structures renewals and for those parts of the enhancement programme still at an early stage of development), we have set timescales within which we expect the projects to be developed. We asked Network Rail to begin planning for its CP5 delivery plan earlier than was the case in CP4, and it will consult on this in December 2013, before publishing this by end of March 2014. This should reduce the risk of a discontinuity in orders early in CP5, as happened in CP4;

(b) beyond CP5, more effective whole-life asset management should enable greater long-term certainty of renewal requirements. The funding allowed for longer term planning and project development should enable early development of plans beyond 2019;

(c) we have authorised Network Rail to develop CP5 projects now in CP4, to ensure there are no undue delays in CP5;

(d) our decisions on R&D should facilitate more effective working between suppliers and Network Rail in this important area; and

(e) through Network Rail's move towards greater supply chain collaboration, suppliers will be more involved in the planning of enhancements, helping to drive greater value for money, particularly in those projects that have not yet been developed to GRIP 3 level.

24.39 We consider the package as a whole gives Network Rail strong incentives to work with its supply chain to improve longer term value for money on the railway.

24.40 The new programme management capability enabler (P3M3) that is being introduced for CP5 should lead to closer and more effective working with the supply chain.

Taxpayers

24.41 Our determination will deliver significant benefits for taxpayers. It will:

(a) facilitate sustainable economic growth and improved competitiveness through better connectivity for commuters, businesses, communities and the carriage of freight; and

(b) provide better environmental outcomes from reduced emissions and carbon savings, particularly through electrification and from the improvements to the network facilitating the transfer of road to rail.

24.42 As discussed previously Network Rail's revenue requirement is falling compared to PR08, which, other things being equal, reduces pressure on the public purse.

24.43 Taxpayers will also benefit from the changes to Schedules 4 and 8 possessions and performance regimes that protect train operators against the risk around Network Rail's performance and possession management, which they cannot control. This should help keep down the risk premia factored into franchise bids, or negotiations over extensions, reducing the consequential costs to taxpayers.

Local, regional and devolved funders

24.44 The main focus of our review as far as funders are concerned has been on the primary funders – the UK and Scottish governments. The determination does, however, have significant benefits for other funders such as the Welsh Government, passenger transport executives in the English city regions, Transport for London and local authorities. In particular they will benefit from the range of improvements to the network such as electrification of the Valley Lines in Wales, the Northern Hub, Crossrail and Thameslink.

24.45 We will build on the decentralisation of Network Rail to improve transparency of costs and subsidy at local level. This should provide better information for decision making, and facilitate greater local involvement in the specification and funding of services and of enhancements to the railway.

Monitoring of impacts

24.46 We will monitor the impact of the determination on the above groups, including:

(a) for passengers, through our monitoring of the indicators we are putting in place, through continuing engagement with Passenger Focus and London TravelWatch, and bespoke research;

(b) for freight customers, by continuing to carry out regular freight customer satisfaction surveys and engaging with the freight sector to monitor the impact of our determination on freight users;

(c) for train operators, through our continued focus on Network Rail's customer satisfaction surveys and the new measure of customer service maturity, and through continuing dialogue with train operators and owner groups;

(d) for suppliers, through further engagement with industry representatives including the Railway Industry Association (RIA) and the Civil Engineering Contractors' Association (CECA). We will use supplier perception surveys (both these carried out by Network Rail and those carried out by organisations such as RIA) to monitor the impact of our determination on the supply chain. If satisfaction levels dropped, we would want to understand the reasons for this; and

(e) for local, regional and devolved funders, through our dialogue with key stakeholders, including the Scottish and Welsh governments, the Local

Government Association, Transport for London, PTEs and PTEG. This will be particularly important in helping us to understand how well the process of the management and allocation of the ring-fenced funds has worked.

Independent review of PR13

24.47 A number of respondents to the draft determination suggested that we carry out an independent review of the PR13 process to identify both what worked well and what could be improved for future periodic reviews. We carried out such a review after PR08 and it has always been our intention that there should be a similar review for PR13. We can confirm that we will be commissioning an independent review of PR13 in 2014, which will seek the views of stakeholders. This will be important in informing the process for PR18.