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Copy to:  
EMT Directors  
Simon Taylor, EMT  
Sam Gibbins, SSWT

Ref: ORR\PR13\NR Financial Issues

26<sup>th</sup> September 2012

Dear Richard,

### **PR13 Consultation – Financial Issues for Network Rail in CP5**

Since the Rail Value for Money report has been published, the industry is determined to take up the challenge of improving cost efficiency and has started to develop proposals to tackle costs and focus on delivering value for money. One of the key objectives that the ORR has to achieve through the programme of work for the Period Review 2013 is to assess and determine what outputs Network Rail should deliver in CP5. Significantly, ORR has to decide how much revenue Network Rail needs in order to deliver the required outputs efficiently. ORR's review of Network Rail's financial issues for 2014 – 2019 must take into account the interaction with other areas of price control and financial regimes, which will have significant effects on the overall balance of risks and incentives that Network Rail is facing.

This response is sent on behalf of both East Midlands Trains and Stagecoach South West Trains. We have the following comments to the specific question raised in the consultation concerning the ex-ante approach to the indexation in CP5, and the treatment of industry costs.

**Q3.1: What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB for inflation. In particular, that we are proposing to set an ex-ante assumption for both general inflation and input price inflation in our determination of access charges for CP5?**

The regulatory determination of the cost of capital is dependent on the risk profile of the business, and therefore the treatment of risk and uncertainty will have an impact on the appropriate cost of capital allocated to Network Rail.

We believe that the current approach of dealing with inflation risk is adequate, even though it provides little incentives on Network Rail to manage the effects of inflation or on controlling its costs. It was suggested in the consultation that a pre-set indexation factor (ex-ante assumption) will incentivise Network Rail to manage the inflation risk more efficiently. It could only be achieved if the pre-determined indexation is set accurately close to the actual inflation.

We must be mindful of the practicality and the implication of the proposed approach in the longer term if any decisions are made to change the automatic adjustment approach. In the 5 years control period, there will be fluctuation in indexation and any difference between the actual and the forecast of inflation will create false signals to train operators and funders in relation to the pricing structure, particularly if the preset rate is lower than the actual inflation.

The accuracy of the pre-determined indexation will have critical implications on Network Rail's costs and train operators' access charges for the 5 years period. Although the difference can be logged up to CP6 in avoidance with yearly adjustment in CP5, train operators and funders in CP6 will be bearing more risk of paying a higher charge to fund the increase of revenue to NR if the actual inflation is higher than the forecast.

Despite the provision of 'deadband' and the mechanism of 're-openers' to re-open the price control, the proposed ex-ante approach is intricate and requires extra efforts for monitoring of the process throughout CP5. The intention is to incentivise NR to control its costs including managing the risk more efficiently. With the proposal of ex-ante assumption, it is difficult to evaluate the incentive effects once there is a difference between actual inflation and the forecast of inflation, and the measure of the level of efficiency will become problematic in terms of outperformance and underperformance.

**Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?**

With regard to the treatment of industry costs, e.g. BT Police and RSSB costs, it is crucial that Network Rail is incentivised appropriately to reduce their share of industry costs, but not at the expense of increasing the costs to others.

Network Rail's industry leadership role should be directed at managing the whole of the costs of BT Police and RSSB, so that they can be regulated on how well they manage the total cost rather than just their share of the cost.

We welcome the approach proposed in the consultation to treat these costs as for support costs and include them in the efficiency / performance assessment in CP5.

Regards,

Lanita Masi  
Track Access & Network Change Manager  
East Midlands Trains