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20 December 2007

Dr Malcolm Reed
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Dear Malcolm

Periodic review 2008 - likely affordability of your high level output specification

1. We have now reached a stage in our appraisal of the industry's strategic business plan where we can give you an initial view on the likely affordability of your high level output specification given the public funds that you are making available for the railway sector in the next control period.
2. **I am pleased to be able to tell you that we consider it is likely that your overall output specification can be accommodated within the overall funds you have committed to the railways in Scotland for the period 2009-14. However our consideration is based on an assumption that there is flexibility to consider the tier one and two specifications and associated public resources together.**
3. Our view is based on a number of other important assumptions that I summarise below. We are happy to take your staff through our work to date and explain in more detail these assumptions.
4. Of course our review work on the strategic business plan continues and the situation could change. We will update you if our further work changes materially the position set out in this letter. As you know, we will not come to a firm conclusion on these issues until our draft determination, currently planned for early June next year. Despite the reassurance you can take from our initial work you might find it prudent to develop a contingency plan. This would involve you identifying what are the lowest priority outputs in your specification and/or any scope for increasing the funding from the public purse, so that if the affordability situation deteriorates you are in a position to respond quickly to our formal notice.

Our approach to this initial assessment

5. At this stage of our review of the strategic business plan we have calculated high and low estimates that we believe will encompass the most likely costs of maintaining and operating the railway in Scotland and delivering the improvements set out in your high level output specification (taking the tier one and two outputs separately and then in combination). We have translated these into a possible revenue requirement range for Network Rail. We have taken your estimates of the costs you are likely to incur in supporting the franchised train operator.

6. We have paid particular attention to the high estimates so that there is very low likelihood that our draft determinations in June will be above these estimates

Our appraisal of the strategic business plan

7. We have now carried out our initial assessment of all the information provided by Network Rail in the strategic business plan, including the detailed supporting information. The plan is a clear and substantial improvement on the earlier initial strategic business plan Network Rail submitted to us in June 2006. For Scotland, Network Rail has increased its earlier estimates of the work necessary to maintain some of its assets, affecting some of the numbers that underpinned our earlier advice to you in February this year. Our assessment of this continues.

8. The plan, together with the update of parts of it we will require from Network Rail in early April, will provide us with an adequate basis for our determinations next year. That said, from our preliminary work, we consider the current plan significantly overstates the revenue Network Rail will require in the next control period.

9. Our focus at this stage is on what Network Rail needs to do to deliver its component of your output specification. The main differences between Network Rail's view and our high estimate are:

- reduced **maintenance and renewals** work and associated expenditure where we consider it is not required to deliver the specification,
- greater **efficiency savings** on operating, maintenance and renewals expenditure,
- on the tier two enhancements we have assumed a small range around the costs of Airdrie-Bathgate and the Glasgow airport rail link,

- a lower **return on the regulatory asset base** reflecting the lower assumed expenditure on renewals and enhancements.

10. For our low estimate we have assumed, compared to our high estimates, lower expenditure needs and higher scope for efficiency savings. These in turn lead to lower overall returns on the regulatory asset base.

11. We have assumed that **all capital investment is added to the regulatory asset base** and remunerated through amortisation charges and the return on the asset base year by year. This follows standard regulatory practice and is what Network Rail assumed in the strategic business plan. We note that you had assumed that part of the enhancement capital investments would be funded on what is often called a 'pay as you go' basis (that is a pound of capital investment is funded by a pound of income in the same year). You will be aware that this difference in assumptions does have a material effect on the revenue requirements.

12. As I noted at the beginning we have taken account of your estimates of the costs you are likely to incur in supporting the franchised train operator. These include a very small range for lease charges based on the rolling stock numbers that you and Network Rail have supplied us.

13. Overall, with our high estimates, we consider the reasonable upper limit for Network Rail's revenue requirement to deliver your output specification for 2009-14 is £2.7bn (split just under £2.7bn for tier one and £60m for tier two). Our low estimates and associated financial assumptions are some £500m less. These numbers compare with the £2.8bn estimate in the strategic business plan.¹ Against your tier 1 public funding commitment of £3.2bn our range is £3bn to £3.5bn, and against your tier 2 commitment of £0.4bn our assumed requirement is £0.1bn (our range is very narrow around this).²

Likely affordability of your high level output specification

14. Based on our work to date and using the assumptions I have summarised above we consider that even for our high estimates the total public funds available are just adequate for the control period as a whole for the tier one and two outputs taken together. However as I outlined earlier our consideration is based on an assumption that you have the flexibility to look at the tier one and two specifications and associated funding together.

¹ The definition of revenue requirement used corresponds with the one you used in preparing your SoFA. Specifically it excluded other income received from third parties e.g. property income

² All these figures are in 2006-07 prices

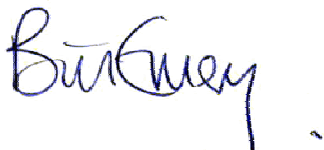
Without this flexibility if our determinations follow closely our current high estimates then there would be a significant affordability issue with your tier one outputs.

15. We have identified that there could be surpluses and deficits for individual years. Since the annual deficits are relatively small and outweighed by surpluses in other years, we believe it is appropriate to assume that your output specification can still be secured either through some re-phasing of activities within period or short term financing wholly within Network Rail's control.

16. There are no affordability issues with our low estimates. However our low estimates are both very challenging and have not provided for your Tier 3 outputs and a number of what could be very worthwhile initiatives identified by the industry and Network Rail. Part of our work in the next few months will be to test these initiatives more thoroughly to see if some of them are economically justified and affordable and could be included in our regulatory requirements for the next control period split appropriately between the respective countries.

17. I am copying this letter to Iain Coucher at Network Rail, George Muir at the Association of Train Operating Companies and Graham Smith at the Rail Freight Operators Association. I am also placing a copy on our website so that all interested parties are kept informed as we pass this important milestone on our periodic review.

Yours sincerely



Bill Emery