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28 September 2006

See attached list

Dear Consultee

Periodic Review 2008 (PR08): The treatment of risk and uncertainty

Introduction

1. The periodic review 2008 (PR08) will determine Network Rail's outputs, net revenue requirement and access charges for Control Period 4 (CP4) (expected to be 1 April 2009 to 31 March 2014) based on the requirements of the Secretary of State and Scottish Ministers' high level output specifications (HLOSs) and statements of funds available (SoFAs) and the requirements of other customers and funders of the railway.

2. Our overarching objective for PR08 is to ensure an outcome that secures value for money for customers and funders, by determining the level of Network Rail's access charges and outputs in a way that balances the interests of all parties. The timetable for PR08 is set out in Annex A of our July 2006 consultation document on the incentive framework [1].

3. We have consulted on the high-level issues surrounding both the financial framework for Network Rail[2] and the incentive framework[3], with a view to

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[1] This is available at (http://www.rail-reg.gov.uk/upload/pdf/298.pdf).

[2] *Periodic review 2008, Initial assessment of Network Rail's CP4 revenue requirement and consultation on the financial framework,* Office of Rail Regulation, London, December 2005. This can be accessed on our website at http://www.rail-reg.gov.uk/upload/pdf/264.pdf.

[3] *Periodic review 2008, Enhancing incentives for continuous improvements in performance, a consultation paper,* Office of Rail Regulation, London, July 2006. This can be accessed on our website at http://www.rail-reg.gov.uk/upload/pdf/298.pdf

concluding on the high-level principles in our February 2007 Advice to Ministers and Framework for Setting Access Charges document[4].

4. In order to provide ministers with as complete advice as possible in February 2007 on the likely parameters of Network Rail's required net revenue allowance, we also intend to conclude on a number of technical issues regarding the incentive framework, and Network Rail's financial framework. As set out in our July 2006 consultation on the incentive framework, we intend to consult on these by letter.[5]

5. This is one of two letters we are publishing today in relation to the financial and incentives frameworks. We are consulting with you on the high-level principles that we should adopt with regard to risk and uncertainty. In particular, we set out the key types of risk that Network Rail faces, and the options for allocating those risks efficiently between the company, its lenders, customers and funders.

6. This letter does not cover all the specific risks that Network Rail faces, for example tax and pensions. These detailed issues will be addressed later in the review. It is important that our conclusions on these other issues are consistent with our high-level principles and in particular the amount of surplus that we allow Network Rail to cover risk and our approach to the use of re-openers.

7. Once we have concluded on the principles, further work will be required to determine the detailed design and specification of the appropriate mechanisms

8. Other letters we are publishing today deal with our approach to determining an allowance for amortisation in the price control and the Issues and Options with regard to Network Rail's Initial Strategic Business Plan. All three letters are available in the ORR library and on our website (www.rail-reg.gov.uk).

Your views

9. We would welcome your views on any of the issues raised in this letter and, in particular, on:

- the principles to be used in deciding how risks should be dealt with;
- what risks Network Rail should bear and what risks customers and funders should bear;

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4 A full timetable for the periodic review process is provided in Annex A of our July consultation document on the incentive framework (http://www.rail-reg.gov.uk/upload/pdf/298.pdf).

5 The July 2006 paper said we would publish a letter on inflation. This letter covers the inflation issues we originally planned to raise in a separate letter.

- the use of access charges review re-opener provisions;
- the treatment of non-controllable costs;
- how inflation should be treated;
- the type of price control;
- the length of the control period; and
- the options for allocating interest rate risk.

10. Your responses should be sent to us by Friday 22 December 2006 in electronic format (or, if not possible, in hard-copy format) to:

Carl Hetherington
Head of Regulatory Finance
Office of Rail Regulation
1, Kemble Street
London WC2B 4AN
Tel: 020 7282 2110

Email: Carl.Hetherington@orr.gsi.gov.uk.

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

Issue and objectives

12. All businesses face risk and uncertainty with regards the effect of exogenous events on their costs and revenues. Regulated businesses such as Network Rail are no exception. However, the regulatory framework has a significant effect on how these risks are allocated between the company, customers and funders.

13. The way in which risk and uncertainty are treated affects a number of issues, including the:

- incentives on Network Rail to behave efficiently and innovatively, as both creditors and managers will generally aim to minimise the effect of risk and the likelihood of it materialising;

- rate of return that the company requires to accommodate fluctuations in cash flow;

- balance sheet buffer, i.e. the difference between the regulatory asset base and net debt; and

- price at which Network Rail is able to raise risk capital as creditors will require a premium to accept greater risk.

14. Ensuring that the risks are borne by the appropriate party is crucial if value for money is to be obtained by Network Rail's customers and funders.

15. Our objectives in designing the approach include the need to:

    - allocate appropriate risks to Network Rail where it is best placed to manage them and provide appropriate compensation and, where appropriate, have regard to cash flow implications;

    - incentivise Network Rail to secure continuous improvements in cost efficiency and value for money;

    - enable Network Rail to take appropriate risks in seeking innovative approaches to delivering material and sustained year-on-year improvements in performance and safety;

    - enable Network Rail to accommodate fluctuations in cash flow; and

    - enable Network Rail to raise risk capital at an appropriate cost (see the July 2006 paper on incentives for more details).

16. In deciding how to allocate risk, the main principle to be used is that, as far as possible, risk should be borne by the party best able to manage it. Exposing Network Rail to risks it is unable to manage efficiently is unlikely to provide value for money because it will increase the company's cost of capital.

Type of risks faced

17. Network Rail faces relatively little risk on the revenue side. Of the revenues Network Rail presently receives from track access charges and direct Government grant, 91% is fixed, i.e. is independent of cost and volume changes. The other 9% is variable with respect to the volume of traffic[6]. All income from grants and charges is protected from general inflation by the indexation of access charges[7] and grants to the general level of price inflation in the economy[8].

18. The relative certainty of revenues and the way in which the variable charge is calculated[9] mean that Network Rail's profits are broadly unaffected by changes in either (i) the number of vehicles running over the network, or (ii) the number of passengers/volume of freight transported. This means that, while Network Rail shares in industry cost risk, it does not share in revenue risk. This issue and potential ways in which Network Rail might be sensitised to changes in whole-industry revenues are discussed further in our July consultation paper on the incentives framework.

19. The majority of exogenous risks faced by Network Rail are on the cost side. Much of the exogenous risk is, at least to some extent, controllable by the company, for example through good planning and procurement or the use of hedging or insurance. However, there is likely always to be an element of risk that is truly uncontrollable, for example changes in law.

20. Exogenous risks relating to cost include:

- inflation;
- changes to non-controllable items of expenditure;

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6 The percentage of Network Rail's income from variable charges could change as a result of the PR08 determination but this will merely reflect the variability of costs with respect to traffic volumes.

7 The traction electricity charge is indexed to the average price of electricity to moderately large consumers as published by the Department of Trade and Industry rather than a general price index like RPI. Network Rail is considering the appropriate CP4 approach to profiling the price element of traction electricity charges as part of its charges proposal. For further detail see *periodic review 2008, structure of track access and station long term charges,* Office of Rail Regulation, London, June 2006. This can be accessed on our website at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8146.

8 Network Rail also receives other income e.g. from stations, depots, property and freight, Some of this income is also subject to RPI adjustment each year e.g. station long term charge income.

9 Variable charges are set to reflect the wear and tear costs associated with the running of individual vehicles. Network Rail should therefore be indifferent to changes in traffic volume based on the variable charge alone.

- external events which could not reasonably have been foreseen, such as a prolonged period of extreme weather conditions;

- changes in law, such as new safety or environmental legislation or a change in tax legislation;

- changes in the regulatory environment e.g. changes to the licence;

- interest rate risk, where movements in financial markets affect the company's cost of capital; and

- costs and outputs that are too uncertain at the time of the periodic review for a robust view of the required revenues in relation to those costs/outputs to be made. For example, in Control Period 3 (CP3) we allowed for and conducted an interim review of Network Rail's efficient signalling costs.

21. It is important to note that each of these risks could have either a positive or negative impact on Network Rail's costs and may not be symmetrically distributed, which could affect our approach to the treatment of these risks.

22. Network Rail also faces a variety of management risks and uncertainties, such as the risk that it makes poor investment decisions or fails to drive out inefficiencies as rapidly as expected. However, these are endogenous to Network Rail, being a function of management effectiveness. We therefore think that it is appropriate for Network Rail to bear such risks as it is best placed to manage them and should be incentivised to do so efficiently.

The current framework

23. We currently set a hybrid price/revenue cap for Network Rail for a period of five years. The company's allowed price/revenue trajectory is fixed in advance for the control period based on a number of assumptions and expectations. In isolation, such an approach places all risk and uncertainty with the business and its investors, at least for the term of the control period.

24. However, in line with regulatory best practice, we include a number of mechanisms specifically aimed at sharing risks and uncertainties appropriately between parties. In particular:

    - allowed revenues are indexed to a general level of inflation in the UK economy as measured by the Retail Price Index (RPI);

- a volume driver is included so that total access charges rise with the volume of traffic (i.e. through the variable charges);

- the allowance provided for items of expenditure deemed to be non-controllable by Network Rail is not subject to an efficiency adjustment;

- general re-opener provisions exist to enable an interim review to be triggered in the event that:

    - cumulative expenditure on operations, maintenance, renewals and envisaged enhancements deviates from the amount assumed at the 2003 Access Charges Review (ACR2003) by 15% or more; or

    - circumstances lead us to consider there has been a material change in circumstance, and in the light of this, there is a compelling reason to review charges;

- specific re-openers (see Part 7 of Schedule 7 of 7of franchised passenger operators track access contracts[10]) also exist for:

    - possessions expenditure;

    - signalling expenditure;

    - West Coast Route Modernisation; and

    - structure of charges through the re-opener relating to improving incentives for the efficient use of the network.

- the efficient cost of additional enhancements required by funders may be logged up and remunerated at the next periodic review; and

- where a change of law occurs, Network Rail may, subject to our approval, levy an additional charge[11] on franchised train operators (which would then affect their funders through provisions in the franchise agreements).

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[10] The template schedule 7 can be accessed on our website at http://www.rail-reg.gov.uk/upload/doc/sched7_apr04.doc.

[11] This charge can be positive or negative as appropriate.

25. Network Rail is also provided with a rate of return that allows for a surplus over and above its expected financing costs to compensate it for the risks we have allocated to it and to enable it to accommodate and manage fluctuations in cash flow.

Establishing a framework for CP4

26. We intend only to make amendments to the CP3 risk and uncertainty framework where this will improve clarity and/or promote appropriate incentives in light of both the increasing maturity of the rail industry, including Network Rail's improved understanding of costs and cost drivers, and the financial and incentives frameworks that will be put in place for CP4.

27. The remainder of this section examines the following:

- the type of price control;
- the length of the control period;
- managing fluctuations in costs;
- inflation and indexation of allowed revenues;
- dealing with non-controllable costs;
- the use of re-openers;
- dealing with incremental investment;
- the options for allocating interest rate risk.; and
- other uncertain items.

The type of control

28. Under incentive-based approaches to regulation, such as the hybrid revenue/price cap employed for Network Rail, the company is typically protected from general inflation and volume risk, but is exposed to other risks and uncertainties unless explicitly stated otherwise. The purpose of this approach is to provide strong incentives on the company to reduce costs by managing effectively the risks that are within its control.

29. While other regulatory models e.g. rate of return regulation, could in theory be considered for CP4, we have already proposed the retention of the current

incentive-based approach in our July 2006 consultation paper on the incentive framework. Therefore, this letter does not consider the issue further.

30. There are, however, a number of different types of incentive-based regime. For example, a pure revenue cap would provide even greater certainty of revenues for Network Rail (as well as certainty to TOCs and funders over costs), but would also reduce the incentive to accommodate volume growth and remove the role of variable charges in providing appropriate signals to train operators, funders and suppliers.

31. We believe that the current hybrid revenue/price cap approach achieves an appropriate balance between providing certainty of funding and appropriate incentives on industry parties. We therefore intend to retain the approach for CP4.

The length of control period

32. In deciding on the length of the control period, we need to balance the need to provide appropriate incentives on the company to operate and invest efficiently with the increased uncertainty involved in forecasting output requirements and costs further into the future.

33. The current control period is five years and most other UK regulators use this time period for the length of the control period.

34. One argument for a longer control period, e.g. 10 years, is that it would better align with long term industry planning and capital investment, and provide greater certainty to Network Rail’s suppliers, potentially reducing the possibility of peaks and troughs in work, that could otherwise lead to inefficient procurement.

35. However, we consider that we can, and have, largely addressed these longer-term considerations with a five-year control. For example, our investment framework provides clarity for new investments, which generally have time horizons significantly in excess of the number of years remaining in the control period at the time of initiating the investment. Also, when we consider issues at a periodic review we consider the impact on long term decision making and/or investment.

36. In addition, while Network Rail is improving its knowledge of costs and cost drivers, we would still have concerns as to whether this knowledge is sufficiently robust to warrant a longer control period.

37. A shorter control period might be appropriate if there was considerable uncertainty around key components of Network Rail’s net revenue requirement. However, there may be material disadvantages due to the disruption to investment planning and incentives, and the increased uncertainty to customers and funders.

38. On balance, we propose to continue to use a five-year control period. This is because five years is generally considered to be long enough to provide appropriate incentives on companies and certainty to customers and funders, but also short enough to reflect difficulties in forecasting key elements of the review (e.g. expected costs) without needing to build in excessive financial surpluses to accommodate risk or make excessive use of interim reviews. We assume a five year control period will be used when considering the other issues in the remainder of this letter.

39. We recognise, however, that the long lead time for some types of investment means that the periodic review process may disrupt planning to the extent that there is uncertainty about the level of funding in the run up to final determination. This has the potential to reduce the efficiency of investment. We can address this issue later in the review by possibly providing early conclusions for some types of expenditure, once we have a clearer idea of the capital investment that will be included in CP4.

Managing normal fluctuations in costs

40. In ACR2003, we provided Network Rail with a surplus above its expected cost of debt service which enabled it to bear a reasonable level of normal business risk without triggering other mechanisms designed for more significant changes in circumstances. Providing Network Rail with a surplus which can be used to fund cost shocks gives greater certainty to customers and funders as to Network Rail's overall funding requirement for the control period.

41. The important issue from the risk and uncertainty point of view is that the surplus is commensurate with the risks that Network Rail will be bearing in CP4. The issue of an appropriate method for setting Network Rail's rate of return is discussed in detail in our July 2006 incentives document.

Inflation and indexation of allowed revenues

42. At both the 2000 periodic review and ACR2003, we set Network Rail's income in real terms. This means that each of the individual elements of revenue are first calculated in a real price base (e.g. 2002/03 prices) and then indexed to reflect actual inflation (defined as the growth in the RPI).

43. This methodology has the effect of ensuring that Network Rail is compensated for general inflation (over which it has no control) in the final determination. For example, if we allow Network Rail £100 revenue in real prices and inflation is 10% between the price base year and the future, it will receive £110 in the relevant year.

44. Indexing Network Rail's allowed revenues to RPI enables the company to pass general inflationary risk to customers and funders. Most regulators across the utility sector in the UK and overseas have adopted this approach because it leads to an

efficient allocation of risk between companies and their customers[12] which reduces the company's cost of capital.

45. We therefore propose to continue to protect Network Rail from general inflation risk.

46. Indexing Network Rail's revenues in this way does, however, leave the Government with budgetary uncertainty as it does not know in advance, exactly what the level of inflation and therefore the required level of funding, will be in each of the years of CP4. This is an important issue for Government.

47. A possible approach, that would protect Network Rail from inflation risk whilst also providing some certainty to government as to its funding for Network Rail over the control period, would be to include an ex-ante inflation assumption in allowed revenue and then log up/down any differences between this assumption and actual inflation to be taken into consideration at the next periodic review. However, because of the way in which government protects franchised train operating companies from changes in the real level of charges, such an approach is only likely to provide greater overall budgetary certainty for government in relation to the element of Network Rail revenues paid through direct Government grants.

48. We would welcome your **views on the issue of general inflation risk.**

49. There are other general inflation indexes that could be used instead of RPI, for example the Harmonised Index of Consumer Prices (CPI). We will consider fully whether there is any merit in adopting an alternative index. However, we are currently inclined to continue to use RPI as CPI is unlikely to provide a more accurate index for measuring the inflationary effects on Network Rail and the use of the RPI is consistent with other regulatory precedent.

50. Using a general inflation index to adjust Network Rail's allowed revenues does leave the company exposed to any difference (positive or negative) between changes in the general level of prices and changes in prices specific to its cost base (i.e. input prices).

51. Input price inflation is a normal business risk. However, Network Rail has less ability to respond to changes in these costs through price changes than an unregulated company.

52. Although Network Rail is able to manage the impact of input price inflation on its cost base and is best placed to do so, we recognise that there will always be some

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[12] Note that in the context of Network Rail, it is both customers and public sector funders who bear inflation risk.

element of input price inflation that is effectively beyond the company's control. It may therefore be appropriate to consider options for risk sharing, including:

- indexing revenues to a price index that is believed to reflect more accurately Network Rail's input mix;
- retaining RPI indexation but making an explicit adjustment to revenues for expected deviations in input price inflation. This is the approach that Network Rail has presented in its Initial Strategic Business Plan[13];
- keeping RPI indexation and logging up/down the variation between RPI and input prices for consideration at the next periodic review, subject to an efficiency test;
- keeping RPI indexation and providing some protection through a specific input price re-opener; and
- keeping RPI indexation and providing protection for input price inflation via a general re-opener, for example the present 15% re-opener.

53. Ofwat and Ofgem have generally adopted the approach described in the last bullet of the above paragraph, though Ofwat for some companies, has included in their price control a revenue adjustment based on the construction price index (COPI) to protect them against construction price risk.

54. In practice, it is hard to separate the management of input price risk from other aspects of the management of a company's cost base. For example, it is difficult to separate changes in the price of raw materials from the charges incurred by suppliers/contractors. Network Rail can also to some extent predict inflationary periods and plan its work programme to take those factors into account (for example, where possible avoiding the delivery of major enhancements in the South East close to the 2012 Olympics). It can also enter into long-term contracts or hedge cost risk, and/or exert buyer power in the market.

55. We intend to undertake further analysis to understand the materiality and controllability of input price inflation more fully, and the extent to which the current approach of indexing revenues to RPI appropriately protects Network Rail from the

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13 Network Rail (June 2006), Initial Strategic Business Plan Control Period 4, is available on Network Rail's website at http://www.networkrail.co.uk/documents/3347_Initial%20Strategic%20Business%20Plan.pdf.

external inflationary pressures it faces and incentivises it to manage input price risk efficiently. However, our initial thinking is that it would be more efficient for Network Rail to continue to bear input price inflation risk since it is at least partly controllable.

56. **We would welcome** your **views on how input price inflation should be appropriately managed.**

Non-controllable costs

57. Some items of Network Rail's costs, particularly items of operating expenditure, can be non-controllable by the company, i.e. it is unable significantly to influence the underlying cost. At ACR2003, we concluded that a number of operating costs fell into this category. The most material items were: traction electricity[14]; cumulo rates; and British Transport police.

58. Where the uncertainty surrounding these costs is material, it may not be appropriate for Network Rail to bear the risk. A number of alternative options are available to deal with this type of cost risk, including:

- assuming an ex ante level and then, recognising that there is upside as well as downside risk to Network Rail, leave the risk with the company;
- using an automatic pass-through of the costs to Network Rail's customers and funders customers; or
- assuming an ex ante forecast in CP4's allowed revenue and log up/down any variations from this level for consideration at the next periodic review.

59. For CP3 we adopted the third of these approaches, on the basis that the degree of uncertainty surrounding the level of non-controllable costs was not sufficiently material.

60. **We would welcome** views **on the appropriate approach for dealing with such cost risk for CP4.**

The use of re-openers

61. The revenue that we allow Network Rail in CP4 should be sufficient for it to deliver the required outputs on the basis it operates economically and efficiently, taking into

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[14] Traction electricity costs are at least partly controllable through efficient procurement and minimising leakage, etc. We are considering appropriate incentive mechanisms to promote efficient behaviour as part of our structure of costs and charges work.

account normal fluctuations in costs and revenues. The automatic volume driver provided by the variable charge and the logging up mechanism for investment should also mean that the company is largely protected from unanticipated shifts in demand.

62. However, providing Network Rail with a surplus within allowed revenues that is sufficient to compensate Network Rail for all possible risk is unlikely to represent value for money. Consequently, we believe it is appropriate to provide a mechanism that compensates Network Rail for exogenous events that result in exceptional changes (either up or down) in costs faced.

63. Such changes in costs are most likely to result from:

- significant external events which could not reasonably have been foreseen;
- changes in law (which might qualify for an automatic pass through of costs to customers/funders); or
- changes in the regulatory environment.

64. In line with our ACR2003 approach and with other regulators, for CP4 we expect to include re-opener provisions to trigger an interim review of access charges[15] in the event of exceptional changes in cost beyond Network Rail's control. These provisions and the circumstances in which they apply need to be clearly defined in order to provide Network Rail together with its creditors, customers and funders with as much certainty as possible. This clarity is particularly important if Network Rail is to raise risk capital at an appropriate cost[16].

65. This raises the issue as to whether both the current general re-opener provisions are required going forward. The intention of having both of them in place for ACR2003 was to cover risks that had an immediate financial effect on the company and also cover those risks that possibly did not have such an immediate effect, for example a change in circumstances that affected outputs. However, the way they are defined means that both conditions could be met by the same event. We could

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[15] An interim review does not automatically mean a change in access charges. Instead it is an opportunity to review whether changes to outputs and/or access charges should be made. The implementation of any changes can then be made to all track access contracts through the access charges review process.

[16] See for example paragraph 5.5 of the document set out in footnote 2.

retain both re-openers for CP4 to maintain the current coverage and clarify how they would work together.

66. One alternative option could be to set a single re-opener based on a specific percentage deviation in actual costs from those assumed in the regulatory determination (as per the current 15% re-opener). An approach similar to this one is used by Ofwat for its re-opener provisions. One of the advantages of this approach is that it is transparent and easy to operate. One of the main disadvantages, however, is that the company may have a perverse incentive to overspend deliberately when it is close to the re-opener level[17].

67. Another alternative option would be to have a single, more flexible re-opener that is based on a ‘material change in circumstances’ type test. This more flexible type of re-opener is more similar to the approach used by Ofgem. This type of re-opener has the advantage of avoiding the perverse incentive to overspend associated with the threshold deviation in costs. However, it has the disadvantage that it is less transparent in that it is not as clear that an event has triggered a ‘material change of circumstances’ as it is that the costs of the company have exceeded a numeric threshhold. This issue could potentially be largely mitigated by an appropriate definition of ‘material change in circumstances’.

68. The appropriate level for a re-opener would depend on both the level of risk associated with Network Rail’s cash flows and the allowed rate of return provided. Our initial thinking is that it would be set at a level sufficiently high to ensure it is triggered only in exceptional circumstances and the cost of risks below this level would be covered by the allowed return.

69. PR08 will set separate price controls for Scotland, and for England and Wales. We therefore need to consider whether it is appropriate to have a re-opener based on the position in both countries jointly or separate re-openers operating in each country. Our initial thinking is that it is appropriate to have separate re-openers for Scotland and for England and Wales but for them to be based on the same underlying principles. This would be to protect funders as much as Network Rail.

70. We would welcome your views on:

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[17] It is important to note that just because an access review is being re-opened that does not necessarily mean that the company will receive more revenue.

- **the type of re-opener(s) that should be used; and**

- **our intention to provide separate re-openers for Scotland and for England and Wales that based on the same underlying principles.**

Dealing with incremental investment

71. Improving performance and increasing the capability of the rail network to meet the needs of rail passengers and freight users will sometimes depend on investment. Some major schemes will be the subject of specific discussion with the major funders: the Secretary of State and Scottish Ministers. But schemes promoted by other funders and third parties - including Passenger Transport Executives (PTEs), train operators, local authorities or similar bodies - are also important. Network Rail should also identify and promote schemes itself, particularly schemes to improve its performance or to meet safety requirements and to deliver extra capacity needed to deliver the HLOSs.

72. We set out our policy framework for investments in October 2005[18]. This framework aims to facilitate the efficient delivery of value for money improvements to the railway, by addressing barriers to efficient development and delivery of schemes. The framework should also ensure that Network Rail takes a consistent approach to investment proposals: this is important for potential investors so that they can be certain about what they can expect from Network Rail and are clear about the terms on which they can expect to do business with Network Rail.

73. The framework sets out mechanisms for the treatment and funding of incremental investments that arise between reviews. In general, Network Rail should log up investments (which satisfy our published criteria[19]) that generate economic value for the rail industry, but which were not funded at the last relevant review. Network Rail bears the financing costs of such schemes until the next periodic review when the efficient cost of the schemes (including accrued financing costs) are added to the RAB, and therefore paid for through access charges.

74. Where additional obligations are imposed on Network Rail, such as new safety-related schemes, such schemes should also generally be funded through the logging-up process, but may in exceptional circumstances require additional short-term funding through an adjustment to access charges in advance of the next

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[18] ORR (October 2005), Policy framework for investments: conclusions, is available on our website at http://www.rail-reg.gov.uk/upload/pdf/255.pdf.

[19] See Chapter 3 of our October 2005 policy conclusions

relevant periodic review. There are two possible routes for achieving this short-term adjustment:

- if the additional obligations arise as a result of a change of law through the direction of a competent authority, there is a mechanism within the template track access contracts to adjust access charges; or

- if the additional obligations result in a significant additional financial burden on Network Rail, there are re-opener provisions implemented by ACR2003 so that adjustments to access charges can be made.

75. We would welcome your views **on the approach to dealing with incremental investment outlined above.**

Dealing with interest rate risk

76. In setting Network Rail's allowed return, we need to assess Network Rail's financing costs over CP4 on the basis it operates economically and efficiently. An important driver of Network Rail's financing costs is the underlying market conditions. These underlying market conditions are largely beyond Network Rail's control, although they can be efficiently managed, for example through hedging.

77. In determining allowed revenue the approach we and other regulators have taken to date is to fix the allowed rate of return for the control period. This places on Network Rail the risk of movements in the underlying financial markets, i.e. that the cost of capital changes. Regulators have typically allowed for this risk by taking a relatively cautious approach to determining the allowed return in order to limit the company's exposure to the downside.

78. Although we believe that interest rate risk should remain with Network Rail as it is best placed to manage it, there may be an argument for indexing a part of the allowed return to a pre-determined benchmark in order to reduce the level of interest rate risk. Such an approach should enable us to use a less cautious approach to determine the allowed return, potentially improving value for money.

79. There are a number of ways in which this might be achieved, including:

- indexing part of the allowed return to a defined and transparent debt market benchmark; or

- providing an allowed return that embeds a cost of debt towards the bottom end of the estimated range for the cost of debt but providing a mechanism for compensating Network Rail in the event that a defined and transparent debt market benchmark rises above a pre-determined level.

80. There are a number of practical difficulties with the above approach that should not be underestimated, not least establishing an appropriate benchmark.

81. We would also need to consider the implications for budgetary certainty for Government. Logging up/down adjustments for the difference between the ex ante assumption and the outturn during the control period might improve budgetary certainty but this would need to be discussed with Government.

82. We intend to undertake further analysis to assess the appropriateness of these approaches, particularly with respect to the practical difficulties involved e.g. whether an appropriate benchmark can be determined.

We would welcome your views on whether there is merit in indexing a part of the allowed return in either of the ways noted above in order to reduce interest rate risk.

Uncertain items

83. Where there has been significant uncertainty about the appropriate level of a particular cost item at previous access charges reviews we have, in a limited number of cases, provided a different treatment. As noted above, at ACR2003 for example, we provided for an interim review of signalling costs in CP3.

84. We are not aware of any issues that need treating in this way in CP4.

Next steps

85. We aim to publish our conclusions on principles for the treatment of the risks raised here in our February 2007 'Advice to Ministers and Framework for Setting Access Charges' document.

86. If you have any questions about this letter please contact Carl Hetherington on (020) 7282 2110 (Carl.Hetherington@orr.gsi.gov.uk).

Yours sincerely

John Thomas
Director of Regulatory Economics

List of Consultees

Association of Train Operating Companies

Department for Transport

Freight Operating Companies

Freight Transport Association

HM Treasury

Network Rail

National Assembly for Wales

Passenger Focus

Passenger Transport Executives

Rail Freight Group

Rail Industry Association

ROSCOs

Train Operating Companies

Transport for London

Transport Scotland