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OFFICE OF RAIL REGULATION

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Paul Plummer Esq
Director, Planning & Regulation
Network Rail Infrastructure Limited
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Dear Paul

PR08 determination – clarification issues

I am writing to you to confirm our position on the specific issues of clarification you have sought on our determination of your outputs and funding for 2009-14 which we published on 30 October 2008.

(1) Focus on outputs and definition of sustainability etc

You sought further clarity from us on the output focused regime for the next control period and how we would assess compliance with your obligations around sustainability and asset stewardship with particular reference to activity level assumptions set out in either your plans or the determination.

We set out in our determination a key principle that you are free to manage your business efficiently and that we would expect you to respond to the changing needs of your customers and funders provided you deliver the outcomes and outputs we have set out in the determination (at a whole company level) and the disaggregated outcomes and outputs you commit to delivering in your delivery plan which you will submit to us and publish early next year.

On your specific issues I draw your attention to the following statements in our determination. The general approach to assessing your success in the control period is set out succinctly in the foreword:

> *As its regulator, we will assess Network Rail's success in the next control period by whether it achieves the outputs on time, as set out in our determination, and does so whilst meeting all its licence and statutory obligations (particularly its asset stewardship obligations). We would see this as the minimum and would expect Network Rail to work to outperform in delivering its outputs and efficiency improvement.*

We will monitor Network Rail's progress in delivering the outputs and we will report publicly on this. If in the light of the information we collect we consider Network Rail appears likely to fall short of the timely delivery of an output, we will not hesitate to take action to require the company to address promptly its shortcomings. We will consider a culpable failure by Network Rail to deliver a specified output as a serious breach of its obligations.

In paragraph 96 of the summary we set out the issues that we will focus our monitoring on.

Our monitoring will focus primarily on the following issues:

- *whether the industry is on course to deliver the HLOS safety requirement;*
- *whether Network Rail is delivering the other top level regulated outputs;*
- *whether Network Rail is on course to deliver the programme of works to support delivery of the HLOS capacity specifications, and the other enhancements being funded under this determination;*
- *whether Network Rail is managing its assets in line with the policies and activity programmes on which this determination is based;*
- *whether Network Rail is achieving the expected efficiencies in operating, maintenance, renewal and enhancement; and*
- *whether Network Rail is operating within the financial boundaries set by our determination.*

We recognise now that the fourth, fifth and sixth bullets read in isolation could imply that we would also assess your success by activity levels, compliance with your current asset policies, expenditure levels and operating within the financial boundaries. This is not the case as we make clear elsewhere in our determination, for instance in paragraph 5.3 we say:

In its response to our draft determinations Network Rail emphasised the importance of maintaining flexibility to vary activity volumes where this is necessary to deliver the regulated outputs efficiently. We agree; we are not defining activity volumes as regulated outputs, but we will include them as an important element of our monitoring activity in CP4 (see chapter 30).

In addition, in paragraph 5.17 we observe that you still need to ensure that your asset policies do indeed represent an efficient whole-life approach to managing the assets; clearly this may lead you to make changes to the policies.

And more particularly in chapter 30 we set out in some detail our approach to holding Network Rail to account. On the issues of sustainability and asset management I draw your attention to paragraphs 30.16 to 30.18:

As Network Rail's asset management regime matures it is reasonable to expect it to be able to plan its future workload with increasing precision and robustness. This determination is essentially based (with the exception of certain civil engineering activity) on Network Rail's own projected activity volumes. These, in turn, are based on its defined asset policies, and are those it currently believes are necessary to manage the network on a sustainable long-term basis.

> *We will monitor Network Rail's asset management using a dashboard of condition and performance indicators including targets that Network Rail will include in its CP4 delivery plan. We will also monitor the levels of renewals activity and compare them with the levels on which this determination is based. More details of the indicators and trajectories were presented in chapter 4.*
>
> *If asset condition falls materially below the trajectories in the delivery plan we will call on Network Rail to demonstrate clearly that it is nonetheless complying with its asset management licence obligations. We will use our discretion in investigating variances between actual and planned activity volumes; if we see significant cumulative variances emerging we will expect Network Rail to be able to provide a full explanation and to demonstrate clearly to us that it is managing the assets efficiently on a sustainable basis and acting in compliance with its network licence.*

Of course this was written on the expectation that your delivery plan would be consistent with your current asset policies and the activity levels that flow from these. If this is not the case (and we have acknowledged the arguments for reviewing your asset policies) we would expect you, within the first year of CP4, to confirm your planned activity levels for the five years and to provide the full explanations called for in the final part of paragraph 30.18 set out above. A well managed business would keep its asset policies under review and we expect you to do this during CP4. We recognise therefore that the policies may develop and this may give rise to changes to your delivery plan. We would expect you to be able to provide a full justification for these changes as we have set out above.

We also set out in our determination that you may make efficiency improvements in CP4 through unit cost or scope efficiencies. This represents a change in approach from the current control period where our efficiency judgements were related solely to assumptions about unit cost efficiency. As you know, an important part of our assessment of efficiency in PR08 was based on benchmarking Network Rail with other rail infrastructure managers in Western Europe on the basis of the potential for overall efficiency improvement. In delivering the efficiencies in CP4 you may, therefore, look to make changes in your asset policies and activity volumes (as well as improvements in unit cost efficiency), consistent with your asset stewardship obligations.

(2) Omitted costs for seven day railway

Following publication of our determination we identified that we had inadvertently omitted £40m of renewals expenditure from the financial modelling for the determination. You also identified this. We confirm that we will add £40m including rolled-up financing costs to the RAB at the start of CP5.

(3) Logging up of capitalised overheads

In the run up to the finalisation and publication of our determination you told us that the unit costs in your infrastructure cost model (ICM) used as a basis for your strategic business plan excluded some capitalised overheads (e.g. costs relating to pensions). You provided us with an explanation and audit trail for these costs in respect of track and signalling renewals and we reflected these in our determination of your funding.

You also told us that overheads (in your view totalling around £100m for CP4) were also excluded from the unit costs in the ICM for other renewals asset categories. However, you did not provide us with an appropriate explanation and audit trail for these asset categories. If you can provide us with a satisfactory explanation and reconciliation of these costs, which we would expect to happen as part of the development of a robust unit cost monitoring framework for CP4 by the end of March 2009, we will add the costs, including rolled-up financing costs, to the RAB at the start of CP5. This emphasises the importance of working with us to ensure a robust unit cost monitoring framework for the next control period.

(4) Allowed return on third party enhancements

Our determination did not explicitly cover the issue of third party enhancements, which is generally dealt with under the investment framework. You have asked us for confirmation of the return that you should assume for the calculation of charges for these enhancements. I confirmed to you the level for the return on third party enhancements in CP4 in my letter of 17 December 2008. This will be 6.0% (pre-tax, real). We would not require you to set aside the potential future tax liability associated with third party enhancements and we would include the income from third party investments in single till income at future periodic reviews.

(5) Tax adjustment and financeability in CP5

As part of PR08 we identified a potential double-count of corporation tax payments given the change in the treatment of corporation tax (moving from a tax wedge in the cost of capital to specific corporation tax allowance). We concluded that the value of the double-count is £1.3bn. You have asked us to confirm whether we would provide a revenue uplift in CP5 if the tax adjustment creates any financeability issues at the next periodic review. We will undertake a financeability assessment as part of the next periodic review and take into account the treatment of tax in our assessment as to whether it would be unduly difficult for Network Rail to finance its activities.

(6) Future review of the tax double-count

We note your objections to the treatment of the tax double-count and your desire for us to revisit this at the next periodic review. As we explain in our determination, we consider that there is a solid justification for this policy and we see no need to alter it in the future.

(7) RPI indexation in Schedule 7

You have raised concerns about the appropriate values to index the access charges in schedule 7 of the track access agreements. As you know we sought views from the industry on the appropriate basis for the indexation in schedule 7 and elsewhere (schedule 4, schedule 8 and deeds of grant). We have written to you separately to confirm the values for rebasing our determination (expressed in 2006-07 prices) to 2009-10 prices for the purposes of schedule 7 etc.

An early piece of work we will undertake for the next periodic review will be the review of the indexation provisions in schedule 7 and elsewhere to ensure that these are fit for purpose and adequately protect Network Rail from general inflation risk consistent with our policy.

(8) British Transport Police costs

You consider that we made an error relating to the rebasing of costs for BTP that you submitted to us late in the PR08 process, that the funding for BTP is therefore too low (you estimate around £25m) and that we should correct for this.

We did misinterpret the information you provided to us, however the projected level of spend in 2008-09 does not directly translate into our determination – it is just one of the factors we have considered. We have reviewed our analysis and judgements and are content with our determination. The determination sets out the issues we considered.

As you know, our determination for opex, maintenance and renewals generally does not prescribe expenditure for any given issue and this is the case here. As you know the determination needs to be considered as a package and you are free to decide the specific levels of expenditure (consistent with the overall determination and your licence obligations) to deliver the required outputs.

I will also respond separately to Robin Gisby's letter on this issue.

(9) Logging up / down of further enabling investment

You asked us if you could log up to the RAB additional enabling investment during CP4 to deliver the efficiencies assumed in our determination. Our determination should provide sufficient funding to deliver the efficiencies in CP4 and we see no need to provide any further funding for additional investment to achieve these. However, we will consider logging up additional enabling investment to deliver further efficiencies in CP4 or efficiencies in CP5 and beyond. We will review these schemes on a case-by-case basis.

(10) Treatment of rollover from CP3 to CP4

You have sought clarification how any further rollover of activity/expenditure between the time of our determination and the end of CP3 will be treated. As you know the approach we generally adopted for our determination was to make an appropriate RAB/debt adjustment for outputs not delivered and then to reprogram work into CP4 as appropriate. We intend to generally continue to adopt this approach for activity/expenditure over the remainder of CP3. We will review the outturn position at the end of 2008-09.

(11) Treatment of reprofiling enhancement expenditure and investment

You have sought further clarification on how the reprofiling of enhancement expenditure and the inclusion of additional investment to deliver incremental benefits will be treated in relation to the annual £50m threshold for allowing enhancement overspend to be logged up to the RAB (for schemes in England & Wales). We confirm that you can reprofile enhancement spend through the CP4 change control process without the reprofiled expenditure being captured under the policy whereby you bear the first £50m of any overspend; and that any additional investments that you make to deliver incremental benefits (such as future efficiency savings) will be excluded from the policy whereby you bear the first £50m of overspend on enhancement schemes. For these schemes we intend to review any overspend (for potential logging up to the RAB) on the same basis as renewals or the enhancement schemes in Scotland (i.e. using an ex post efficiency assessment).

(12) Reporting of "mixed" renewals and enhancement schemes

You have asked us to consider categorising (in your delivery plan) a number of investment schemes that comprise both renewals and enhancement elements into either renewals or enhancements. We understand and we recognise that there is benefit in principle in categorising any major projects as either enhancements or renewals. However, we would like to see first the overall structure for the delivery plan and then discuss the appropriate approach with you.

(13) Reporting of operating and maintenance costs

You have told us that you want to alter the allocation of some items of opex and maintenance in your delivery plan. We accept in principle the case for doing this given the way you now manage your business. You have provided us with a paper setting out your proposed approach which we need to consider. Any changes will need to be reflected in the regulatory accounts (through the regulatory accounting guidelines).

(14) Use of the safety and environment fund

You asked us about the level of discretion you have for changing the schemes that are delivered through the S&E fund carried over from CP3 (£110m). We confirm you have discretion to change which schemes are delivered by the fund, provided the changes are consistent with the purpose of the fund. We also expect you to report periodically on any changes, the reasons for change and the benefit of the changes.

(15) The base revenue forecast for volume incentive

You asked us to provide you with the detailed base assumptions for revenue (and traffic) for the volume incentive so that you are able to make projections and calculations of the volume incentive in CP4. We are providing this information to you separately.

(16) Open access operator delay

You have asked us to confirm whether open access operator delay is included or excluded in the targets set out in table 4.3 of our determination. We can confirm that open access operator delay is included. This table was included in our draft determinations and we referred to it as including passenger train delay minutes and you had not commented on this in your response to the draft determinations.

(17) Confirmation that hypo gains target will also be adjusted if we do not deliver Euston and Victoria in CP4

You asked us to confirm how we would treat our assumption for hypothecated gains if the Euston and Victoria development projects are not delivered in CP4. The hypothecated gains associated with these two schemes, if they proceed in CP4, is projected to be £146m. We confirm that we will reduce our total hypothecated gains assumption of £255m if the Euston and Victoria schemes do not proceed, which is consistent with the treatment of cash income for these two schemes, where we will make an ex post reduction (and compensating reduction in assumed property income in CP5) if the schemes do not proceed. If you can provide firm evidence of deferral of the schemes out of CP4 then we will revise down the level of hypothecated gains which, if exceeded, we will consider further gains for addition to the RAB on a case-by-case basis.

(18) Capacity charges

We have recognised that there may be a comparatively small error in the assumptions in our determination of capacity charge income in CP4. We inadvertently assumed that the income would be higher than is likely to be the case, given that a 25% reduction on weekend rates will be implemented. Due to the way that the assumed variable charge income (including capacity charges) is then netted off the overall revenue requirement to determine the level of the fixed charges/grants, this means that the level of the fixed charges/grants is too low. Your initial estimate, which we will need to confirm, is that this could amount up to £50m in total over CP4. We confirm that in principle we will make an adjustment for the final confirmed amount for this, including rolled-up financing costs, to your income levels in the next control period.

Please do not hesitate to contact me if you would like to discuss any of these issues further. I am placing a copy of this letter on our website and copying it to Bob Linnard (DfT), Jonathan Pugh (Transport Scotland), Alec McTavish (ATOC) and Graham Smith/Lindsay Durham (for RFOA).

Yours sincerely

J. R. Thomas

John Thomas