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OFFICE OF **RAIL REGULATION**

15 March 2012

Rt. Hon Justine Greening MP
Secretary of State for Transport
Department for Transport
Great Minster House
33 Horseferry Road
London
SW1P 4DR

Dear Secretary of State,

ADVICE ON NETWORK RAIL'S COSTS AND OUTPUTS IN CONTROL PERIOD 5

I am pleased to enclose our advice to you on Network Rail's costs and outputs, which we have produced to inform your decisions on what you wish to see the railway deliver in England & Wales in return for public funds in Control Period 5 ('CP5' – 1 April 2014 to 31 March 2019). Your High Level Output Specification and Statement of Funds Available are key inputs into our 2013 periodic review (PR13) of Network Rail's access charges, regulatory outputs and the wider incentive framework for CP5.

Our commitment to improving value for money through PR13

We have demonstrated our commitment to improving the value for money that the railway provides to its customers and taxpayers over many years. As a result of our periodic reviews, Network Rail's is expected to have improved its efficiency by 40% in 2013-14 compared to 2003-04, while over the same period PPM is expected to have increased considerably, to 92.6%.

We have welcomed and support the findings and recommendations of Sir Roy McNulty's Rail Value for Money (RVfM) Study, which we jointly commissioned with your Department. The RVfM Study suggested that total industry costs should be £2.5bn to £3.5bn per year lower in 2018-19 than in 2008-09 (across Great Britain as a whole), as you highlight in your Command Paper. We estimate that around 70% of these savings can be delivered by Network Rail (i.e. savings of between £1.8bn and £2.2bn). We are pleased to see that in the Initial Industry Plan (IIP), Network Rail has effectively committed to achieving savings in line with the low end of the range of savings identified in the RVfM Study. Through PR13 we will be challenging Network Rail hard to deliver further savings in CP5, which we expect to be ambitious but achievable. To be clear, we expect these further savings to

come on top of those the company committed to delivering by its acceptance of our PR08 determination.

Our commitment to industry reform through PR13

We see PR13 as an important facilitator and driver of industry reform, through:

- a clear **focus on what matters** to passengers, freight customers and taxpayers – particularly improving value for money;
- a **more disaggregated approach** – increasing transparency, facilitating greater localism, and in due course allowing a more comparative approach to regulation;
- **alignment of incentives** – improving the interfaces between different players in the industry, facilitating alliances, efficiency benefit sharing at the route level and bespoke arrangements; and
- **greater contestability** – ensuring that there is more competition in the provision of infrastructure related services where appropriate, delivering further savings.

Around 30% of the savings identified in the RVfM Study (i.e. £0.7bn to £1.2bn per year) are to be realised by TOCs and ROSCOs. We welcome the Government's moves to drive out these efficiencies, for example by introducing greater flexibility in the new round of franchises. This, in particular, will be important to ensure that whilst Government sets overall franchise service levels, train operators have the ability to optimise delivery and achieve greater value for money from the system as a whole. We also welcome the leadership that the Rail Delivery Group is currently providing. If the RVfM savings are to be fully realised it is crucial that we all play our part in the coming years.

Key points from our advice

The key points within our advice are:

- We have assessed Network Rail's projected revenue requirement for running the railway in CP5 on the basis of continuing the current railway including committed enhancements but without any further enhancements and on the basis of the outputs assumed by the industry in its IIP.
- On the basis of our review and challenge of Network Rail's proposals, and assuming continuation of the existing financial structure for CP5 based on a continuation of the approach assumed in PR08 (whereby Network Rail introduces unsupported debt on a gradual basis), we expect Network Rail's overall revenue requirement for the purposes of your SoFA for the railway for CP5 without any further enhancements to be within the range **£23.2 to £29.1bn**. This compares to the company's proposal for **£28.0bn**. The top end of our range exceeds the costs that Network Rail have provided for the IIP principally because we have used a

different cost of capital assumption and made a different assumption about amortisation.

- Since we have not yet taken a decision on the appropriate approach to setting Network Rail's allowed return for CP5, we have also provided you with the range calculated on the basis of an alternative financing approach, which is **£21.9bn to £27.6bn** in CP5. This approach allows Network Rail only to recover its actual financing costs and the additional 'equity' return in the cost of capital assumed in the PR08 approach used to reduce the company's revenue requirement, rather than under the PR08 approach it is used to pay for some capital investment. In the alternative approach, in order to mitigate against increasing RAB and debt levels beyond CP5, we have assumed a higher level of amortisation in CP5.
- A key part of our assessment has focused on the opportunities for further efficiency improvement by Network Rail in CP5. We have assessed Network Rail's plans and consider that the amount of expenditure for running the railway in CP5 (on the basis of continuing the current railway and including committed enhancements) lies in the range **£23.9bn to £27.1bn** compared to **£26.6bn** assumed by Network Rail.
- Our assessment is based on the information available to us now and the work we have so far carried out in PR13. There is still a range of issues and uncertainties to be resolved before we publish our final determination on Network Rail's CP5 access charges and outputs, which is planned for October 2013. Our range reflects these uncertainties, which include the decisions on the outputs you require in CP5, Network Rail's financial arrangements, the company's performance over the remainder of CP4 and our assessment of the company's asset policies.

We recognise that any additional enhancement projects to be funded in CP5 will reflect your priorities and funds available. We have provided advice which will allow you to make your choice informed by our assessment of likely cost. We recognise that a number of schemes are already committed for CP5, either arising from decisions made in the 2008 periodic review or subsequently, including Thameslink and Crossrail.

We will continue to challenge Network Rail and the industry hard in our assessments of expenditure and revenue requirement in PR13, for example through our extensive use of benchmarking. We will also use PR13 to facilitate and incentivise better cross-industry working to achieve further efficiencies throughout CP5, for example through the implementation of the regional efficiency benefit sharing mechanism. We remain committed to making the fullest use of our tool kit to drive real improvements in safety and value now and in the long term.

Our position on key issues

In considering our advice, we ask that you note our position on a number of key issues.

1. **Outcomes and outputs**

   We recognise the success of the approach adopted in PR08, in which government specified at a high level the outputs you wanted from the railway in return for public funds, and relied on our work at a more detailed level to ensure efficiency delivery. Our advice recommends that we follow the same approach this time.

   Whatever high level outputs you choose to specify for Network Rail, we will monitor and hold the company to account for their delivery. We also have the ability to set and monitor delivery against more detailed milestones, and will do so where this is appropriate to provide further assurance. In addition, we expect to develop a suite of KPIs which we use to monitor the industry's performance in delivering the outcomes that passengers, freight customers and taxpayers care about.

2. **An industry-wide approach**

   In PR13 we will take an industry-wide approach, putting in place specific measures that will better align incentives between different players. PR13 is undoubtedly an important means by which we can drive improvements in value for money across the industry. But it will not be sufficient on its own. In producing our advice we have assumed that your department will continue to pursue a more flexible approach to franchise specification, and in particular will support the exposure of TOCs to changes in Network Rail's costs. This provides the basis for the alignment of incentives through our efficiency benefit sharing mechanism. It also provides the rationale for alliances, allowing Network Rail and TOCs to share costs and revenues, which we will facilitate through PR13.

3. **Excellence in health and safety**

   Whilst the UK rail industry is recognised as one of the safest in Europe, and we welcome Network Rail's contribution to achieving this in CP4, we believe that it could do more over the course of CP5 to deliver further improvements in health and safety.

   We do not recommend that the HLOS should set health and safety targets as the EU, in 2009, introduced Common Safety Targets and performance is now measured against these. To secure further improvement in health and safety we propose to set Network Rail specific health and safety targets in a number of areas which, if met, will demonstrate that Network Rail is managing its risks so far as is reasonably practicable and contribute to delivery of the EU's targets.

   We will take account of any other health and safety improvements you may wish to secure through additional funding in setting any targets.

4. Network Rail's financing

We have not yet concluded on the financing approach for Network Rail for CP5. We recognise this is an important issue for you, in particular given the potential impact on the revenue requirement for CP5 and we have therefore set out in our document two alternative approaches – the first a continuation of the approach we adopted in PR08, the second an approach based more on cash funding. We expect to set out our decision in our Framework for Setting Network Rail's Funding which we are publishing in April.

Review initiation notice

Along with our advice, I also enclose by way of service a notice of our access charges review in accordance with the provisions of Paragraph 1C of Schedule 4A to the Railways Act 1993. This notice formally begins the access charges review known as PR13.

I trust you will find our advice helpful in informing your choices. We will of course continue working closely with your officials throughout the process.

I am writing separately with a copy of this advice to Carl Sergeant, Minister for Local Government and Communities in the Welsh Government. Similarly, I am also writing to Scottish Ministers to providing them with our advice relating to Scotland.

Yours sincerely

Richard Price

RICHARD PRICE

CHIEF EXECUTIVE