OFFICE OF RAIL AND ROAD

CP5 Regulatory Accounting Guidelines for Network Rail Infrastructure Limited

Updated May 2016

Contents

1. Overview

Introduction

1.1 These regulatory accounting guidelines ('the Guidelines') are issued pursuant to Condition 11 of the Network Licence ('Condition 11') held by Network Rail Infrastructure Limited ('Network Rail'). Network Rail's 2015-16 regulatory financial statements and any subsequent regulatory financial statements in Control Period 5 ('CP5') will be prepared in accordance with these Guidelines unless an updated version of the Guidelines is issued.

1.2 A key objective of these Guidelines is to establish the basis of preparation and disclosure requirements of the regulatory financial statements that are consistent with the regulatory framework established by our 2013 periodic review ('PR13') determination[1]. Our PR13 determination established the regulatory framework under which Network Rail will operate for the five years between April 2014 and March 2019, including its revenue requirement, financial framework and incentive framework. These Guidelines, in particular, have been updated to reflect the changes in our regulatory approach from our 2008 periodic review ('PR08') determination.

1.3 Network Rail's main business is the operation, maintenance, renewal and enhancement of the majority of the rail infrastructure in Great Britain. It is wholly owned by Network Rail Limited, a company limited by guarantee. Network Rail is now classified as being part of the central government sector. To reflect that Network Rail now borrows directly from the UK Government and has a fixed, cash borrowing limit, we have updated the templates to improve disclosures required in Statement 4: Net debt and financial indicators.

1.4 Network Rail's regulatory accounts[2] are the primary source of information about the company's regulatory financial position and performance. Good quality financial information is important for effective regulation as it helps ensure that the interests of customers and funders are properly protected.

1.5 Network Rail is required by Conditions 3.4 and 11.13 of its network licence to provide us with the following information:

a) regulatory financial statements;

b) a statement on the adequacy of resources;

[1] This is available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-final-determination.pdf. Our regulatory approach is outlined in Chapters 2, 12 and 23 of our PR13 determination.

[2] In this document we use 'regulatory accounts' and 'regulatory financial statements' interchangeably.

c) reports prepared by its auditors on the regulatory financial statements and on the statement on the adequacy of resources as well as the report prepared by the Independent Reporter on the regulatory financial statements; and

d) a statement under Condition 3 on Network Rail's compliance with the limits on its financial indebtedness.

1.6 These documents are collectively referred to as the "regulatory accounts" in these Guidelines.

Purpose of regulatory accounts

1.7 Regulatory accounts facilitate:

a) monitoring of financial performance against the assumptions underlying our periodic review determinations;

b) assessment of financial position (RAB and debt); and

c) monitoring of capital investment.

They also inform future access charges reviews and other regulatory decisions that require financial information.

1.8 The regulatory accounts provide information in special-purpose financial statements. This information is more relevant for regulatory purposes than the information contained in statutory financial statements, as the statements are set out in a format consistent with our relevant policies and regulatory framework. By contrast, statutory financial statements are prepared in accordance with the requirements of the Companies Act 2006 and relevant financial reporting standards (UK Generally Accepted Accounting Principles or International Financial Reporting Standards).

1.9 In developing these Guidelines, we have consulted with Network Rail and sought to minimise the regulatory burden on Network Rail.

Components of this document

1.10 The rest of this document covers the following:

a) Chapter 2 describes the framework, content and delivery process of the regulatory financial statements and the statement of adequacy of resources, and how the regulatory financial statements and the statement of adequacy of resources will be audited and/or reviewed;

b) Chapter 3 sets out our policies relating to the reporting of financial performance;

c) Chapter 4 sets out our policies relating to the reporting of the Regulatory Asset Base (RAB);

d) Chapter 5 sets out our policies for other information required to be submitted in the regulatory financial statements; and

e) Annexes contain further information about the contents of the regulatory accounts and how they should be prepared. The Annexes include:

   (i) Annex A: Required statements and disclosures;

   (ii) Annex B: Guidelines for preparing the regulatory accounts;

   (iii) Annex C: Condition 3 and 11 of Network Rail's network licence;

   (iv) Annex D: Regulatory good practice;

   (v) Annex E: Worked examples of the Asset Management Excellence Model (AMEM) and Data quality adjustments to financial performance; and

   (vi) Annex F: ORBIS Milestones.

2. Components of the regulatory accounts

Introduction

2.1 This chapter describes the framework, content and delivery process of the regulatory financial statements, the requirements of the statement of adequacy of resources, and how the regulatory financial statements and the statement of adequacy of resources will be audited and/or reviewed.

Accounting period

2.2 Network Rail is required to produce the regulatory financial statements annually for the relevant 12 month period ending 31 March.

2.3 The statement of the adequacy of resources is required to also cover a period of 12 months looking forward from the date that the regulatory financial statements are signed.

Indexation

2.4 During CP5, the indexation adjustments to our PR13 baselines will be updated to reflect movements in the RPI CHAW index[3]. We will advise Network Rail each year of the RPI CHAW number to be used.

Quality of reporting systems and processes

2.5 In order for us to make an informed assessment about Network Rail's financial performance and financial position, we require confidence in the information that is being generated from its reporting systems and processes.

2.6 Therefore, Network Rail must adequately demonstrate to us that the reporting systems and processes that it uses to generate information that is included in its regulatory accounts, contains sound textual records and procedures and the investigations or analysis that support this information must be properly documented and recognised as fit for purpose. Network Rail must also demonstrate that it has used appropriate levels of internal verification and that an adequate number of fully trained individuals are responsible for and/or involved in the reporting systems and processes. In addition the numbers produced are expected as a minimum to be accurate to within ±5%. In some cases we expect the numbers to be more accurate than this, e.g. the amount of network grant received by Network Rail. This evidence on the reporting systems and processes must be provided to us before any outperformance can be recognised, unless otherwise agreed with us.

[3] The movement in the RPI CHAW index is calculated from November to November.

Regulatory financial statements

2.7 A key requirement of the regulatory financial statements is that Network Rail's financial position and performance are reported on a consistent basis over time and the baseline for comparison is our PR13 determination.

2.8 In general, the basis of preparation by Network Rail should also satisfy the following criteria:

a) accounting policies applied by Network Rail should be fair and reasonable and applied consistently and objectively;

b) the high-level principles and income and cost allocation rules as set out in Annex B of these Guidelines should be followed; and

c) the value of the Regulatory Asset Bases ('RABs') in the regulatory financial statements should be consistent with the basis adopted for our PR13 determination.

2.9 Condition 11.2 requires Network Rail to prepare regulatory financial statements in relation to itself[4] and in relation to Network Rail Infrastructure Finance PLC ('NRIF')[5] in accordance with Condition 11 and with these Guidelines[6].

2.10 In addition to the requirements of Condition 11[7], Network Rail's regulatory financial statements should comprise the items listed in Annex A and the spreadsheet: 'RAGs – template for CP5 regulatory financial statements'[8] for Network Rail and, if required by us, for

[4] The regulatory financial statements that Network Rail is required to produce as licence holder "in relation to itself" (in accordance with Condition 11 and these Guidelines) shall relate only to the company itself, Network Rail Infrastructure Finance, and its subsidiaries including:

Network Rail Development Limited, Network Rail Insurance Limited, Network Rail Consulting Limited, Network Rail Certification Body Limited, Vinegar Yard 1, Vinegar Yard 2, Network Rail (High Speed) Ltd and Network Rail Pension Trustees Limited. The regulatory financial statements shall not, without our agreement, be consolidated with any other related companies. Network Rail is required to inform us if there are changes in its corporate structure.

[5] Network Rail Infrastructure Finance PLC ('NRIF') is the special purpose vehicle that Network Rail has established to facilitate the licence holder's long-term debt issuance programme. Condition 11.14 requires Network Rail to procure an undertaking from NRIF to enable Network Rail's obligations under Condition 11.2 to be performed.

[6] Unless otherwise specified, we agree that the basis of consolidation for producing the regulatory financial statements should be consistent with the consolidation for Network Rail's statutory financial statements.

[7] For example, the statement of regulatory financial performance is required by Condition 11.4(c), to compare income and expenditure for the period with the assumptions underlying the most recent access charges review (the 'Determination Assumptions').

[8] The template RAGs – template for CP5 regulatory financial statements is available at: http://orr.gov.uk/publications/guidance/regulatory-accounts. These templates have been published at the start of CP5, but if during CP5, we become aware of better ways of presenting financial information, (for example following a review of how Network Rail reports on its unit costs) we would consider revising some of the templates.

NRIF[9]. Presentation of the required information may be adapted following our agreement, provided it is analysed, aggregated, presented and commented on in a form that readily conveys the same information.

2.11 The regulatory financial statements should include the following:

a) a directors' review which should analyse the company's financial performance in the year compared to our PR13 determination assumptions;

b) a statement of the directors' responsibilities; and

c) a statement of accounting policies.

2.12 The directors' review should include appropriate explanations of any material variances in income and expenditure from the previous year and from our annual and cumulative PR13 determination assumptions[10]. By material in this context we mean any variance that is ±10% than our PR13 determination or the previous year (as relevant) and greater than £5m. The director's review will also report on Network Rail's compliance with the de-minimis limits set out in its network licence and in our consents[11].

Statement of adequacy of resources

2.13 The purpose of the statement of adequacy of resources is to provide us and other interested parties with assurance about the future financial position of Network Rail.

2.14 The obligations contained in Condition 4.14 include the requirement that the licence holder shall at all times act in a manner calculated to ensure that it has available to itself sufficient resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents, and facilities to enable it to properly and efficiently carry on the permitted business and comply with its obligations under the Railways Act 1993 (as amended) and its network licence.

2.15 In addition, under Condition 11.5, Network Rail is required to make a statement, approved by a resolution of its Board of Directors, certifying the adequacy of its resources for a 12 month period commencing on the date of the statement.

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[9] Regardless of the requirement to produce the regulatory financial statements, the audited statutory financial statements for NRIF should be provided to us as soon as reasonably practicable and in any event not later than 1 July following the end of the relevant financial year, unless a later date has been approved by us.

[10] This explanation should be sufficiently detailed so that the reasons for the differences in income and costs compared to our PR13 assumptions are explained. For example if there is an increase in staff costs, it will be explained with reference to: the change in number of people employed, pay awards, the effect of leavers/joiners and the effect of promotions etc.

[11]This information does not need to be included within the directors' review if it is included elsewhere within the regulatory financial statements. The de-minimis limits are included in Condition 4 of Network Rail's network licence. This is available at: http://www.rail-reg.gov.uk/upload/pdf/netwrk_licence.pdf.

2.16 Table 2.1 below identifies the minimum forward looking financial indicators to be included in the statement.

Table 2.1: Financial indicators and definitions

Financial indicator	Definition
Adjusted interest cover ratio (AICR)	Funds from operations (FFO)[12] less capital expenditure to maintain the network in steady state divided by net interest[13]
FFO/Interest	FFO divided by net interest
Debt/RAB (gearing)	Net debt divided by RAB
FFO/Debt	FFO divided by net debt
RCF[14]/Debt	FFO less net interest divided by net debt

2.17 The financial indicators will be based on the forecasts included in the supporting information to Network Rail's latest update of its business plan for the control period as long as that plan was produced no more than four months before the date that the regulatory financial statements are published and there have been no changes to its forecasts that would materially affect the forward looking financial indicators[15].

2.18 If the supporting information to Network Rail's latest update of its business plan for the control period has been produced more than four months before the date that the regulatory financial statements are published or if there have been changes to its forecasts that would materially affect the forward looking financial indicators, then we will discuss with Network Rail what forecasts the financial indicators will be based on.

2.19 The auditors' report on the statement of adequacy of resources should be submitted along with the statement of adequacy of resources at the same time as the regulatory financial statements.

[12] FFO is defined as gross revenue requirement less support costs, less traction electricity, industry cost and rates, less maintenance, less Schedule 4 & 8 costs and less cash taxes paid.

[13] Net interest is the total interest cost including the Financial Indemnity Mechanism (FIM) fee, but excluding the principal accretion on index linked debt.

[14] Retained cash flow ('RCF') is defined as FFO less net interest.

[15] Network Rail will also be required to provide a statement by the auditors in its auditors' report confirming that in the auditors view there are no changes to Network Rail's forecasts that would have a material effect on the forward looking financial indicators.

Auditors' role

2.20 Network Rail is required to obtain from its auditors (under Condition 11.10 and 11.11) reports[16] on:

a) certain statements in the regulatory financial statements; and

b) Network Rail's statement on the adequacy of its resources.

2.21 The form of these reports has been/ will be established following discussion between us, Network Rail and the auditors, together with engagement letters that govern the responsibilities of the auditors and the duty of care owed to both Network Rail and us.

2.22 The format for the audit of the regulatory financial statements will be set out in a 'terms of engagement' letter. This engagement letter forms part of the contract of appointment with the auditors, which Network Rail is required to obtain under Condition 11.12.

2.23 Network Rail is required to procure a report by the auditors addressed to ORR stating whether, in the auditors' opinion, the regulatory financial statements present fairly the financial performance and financial position of Network Rail[17] and have been prepared in accordance with Condition 11 and these Guidelines.

2.24 The auditor should also identify, in this report, material circumstances or areas of judgement which appear to be relevant, having regard to these Guidelines and to the scope of work agreed with ORR. Annex A contains details of the statements that will be covered by the audit opinion.

2.25 The statements covered by the work of the auditors (but not necessarily covered specifically in the audit opinion) would generally include the following statements (separately for GB, England and Wales and Scotland) (referred to collectively as "Statement"):

- Statement 1: Summary regulatory financial performance;
- Statement 2a: RAB (regulatory financial position);
- Statement 2b: RAB – reconciliation of expenditure;
- Statement 3: Analysis of enhancement capital expenditure;
- Statement 4: Net debt and financial indicators;
- Statement 6a: Analysis of income;

[16] For the avoidance of doubt, the word report and opinion is used interchangeably when referring to the report issued by the auditors for the regulatory financial statements.

[17] And if required by the ORR, NRIF.

- Statement 6b: Analysis of other single till income;
- Statement 6c: Analysis of income by operator;
- Statement 7a: Analysis of network operations expenditure, support costs, traction electricity, industry costs and rates;
- Statement 7b: Analysis of network operations expenditure and support costs by activity;
- Statement 7c: Insurance reconciliation;
- Statement 7d: Network operations expenditure and support costs reconciliation from gross expenditure to net expenditure;
- Statement 8a: Summary analysis of maintenance expenditure;
- Statement 8b: Summary analysis of maintenance headcount by activity;
- Statement 8c: Analysis of maintenance expenditure by Maintenance Delivery Unit (MDU);
- Statement 8d: Analysis of maintenance headcount by Maintenance Delivery Unit (MDU);
- Statement 9a: Summary analysis of renewals expenditure;
- Statement 9b: Detailed analysis of renewals expenditure;
- Statement 10a: Other information - Schedule 4 and 8 income and costs;
- Statement 10b: Other information - Opex memorandum account;
- Statement 10c: Other information - Compliance with licence limits;
- Statement 10d: Other information- Income and costs from alliances;
- Statement 11: Analysis of Network Rail (High Speed) Ltd;
- Route Statements 1: Summary regulatory financial performance;
- Route Statements 2a: RAB (regulatory financial position);
- Route Statements 2b: RAB – reconciliation of expenditure;
- Route Statements 3: Analysis of enhancement capital expenditure;
- Route Statements 4: Net debt;

- Route Statements 6a: Analysis of income;
- Route Statements 7a: Analysis of network operations expenditure, support costs, traction electricity, industry costs and rates;
- Route Statements 8a: Summary analysis of maintenance expenditure;
- Route Statements 9a: Summary analysis of renewals expenditure;
- Route Statements 10a: Other information - Schedule 4 and 8 income and costs;
- Route Statements 10b: Other information - Opex memorandum account;
- Route Statements 10d: Other information- Income and costs from alliances;
- Annex A: Reconciliation of the RAB to statutory railway network fixed assets;
- Annex B: Reconciliation of operating and maintenance expenditure between regulatory financial statements and statutory accounts;
- Annex C: Reconciliation of regulatory income to statutory turnover;
- Annex D: Reconciliation of regulatory debt to statutory net debt; and
- Annex E: Reconciliation of regulatory capital expenditure to be added to the RAB to statutory capital expenditure.

2.26 For the avoidance of doubt, unless we state otherwise in Annex A, the above information will be published in Network Rail's regulatory financial statements and covered by the audit opinion.

2.27 Condition 11.11 requires that each statement made by Network Rail under Condition 11.5 (the statement of adequacy of resources) shall be accompanied by a report from the auditors stating whether or not they are aware of any inconsistencies between that statement and the regulatory financial statements or any information obtained by the auditors in the course of their audit work for Network Rail, and, if so, what these inconsistencies are. The auditors' statement should identify any material issues that could affect Network Rail's adequacy of resources. The form of this statement is prescribed in Condition 11 (which has been replicated in Annex C).

Auditors' role

2.28 Where appropriate, we will use Independent Reporters to review some of the information provided in Network Rail's regulatory financial statements. This will complement the work of the auditors. The statements covered by the work of the Independent Reporters would generally include:

- Statement 5a: Total financial performance;
- Statement 5b: Renewals variance analysis in total financial performance;
- Statement 5c: Enhancement variance analysis in total financial performance;
- Statement 5d: Route reconciliation for Scotland;
- Statement 12: Analysis of Network Rail's performance on the volume incentive;
- Statement 13: Maintenance volumes, unit costs and expenditure;
- Statement 14: Renewals volumes, unit costs and expenditure;
- Route Statements 5a: Total financial performance;
- Route Statements 5b: Renewals variance analysis in total financial performance;
- Route Statements 5c: Enhancement variance analysis in total financial performance;
- Route Statements 5d: REBS reconciliation;
- Route Statements 12: Network Rail's performance on the volume incentive;
- Route Statements 13: Maintenance volumes, unit costs and expenditure; and
- Route Statements 14: Renewals volumes, unit costs and expenditure.

Delivery and publication – process

2.29 Condition 11.13 requires that Network Rail delivers its regulatory accounts to us as soon as reasonably practical and in any event not later than 1 July following the end of the relevant financial year unless a later date has been approved by us.

2.30 This information should be submitted in hard and soft (electronic) copy, with the regulatory financial statements contained in a spreadsheet clearly showing the details of calculations undertaken by Network Rail.

2.31 If there is a difference between the regulatory accounts that have been submitted by Network Rail and the requirements of these Guidelines, we will consider whether or not to require modifications to be made to the information submitted. Subject to any modifications, Network Rail must then publish the information within one calendar month of delivery to us.

Other statements and notes to the regulatory financial statements

2.32 All details reasonably necessary to reconcile items included in the primary statements[18] and the statement that analyses net debt with any similar items in the statutory financial statements should be included in a note to the regulatory financial statements. In particular, the note should enable:

a) a comparison of the annual movement in the fixed assets reported on the balance sheet with the movement in the value of the RAB;

b) a comparison of the expenditure reported in the statutory financial statements to the expenditure reported in the regulatory financial statements;

c) a comparison of the income reported in the statutory financial statements to the income reported in the regulatory financial statements;

d) a comparison of the annual movement in net debt on the balance sheet with the movement in net debt in the regulatory financial statements; and

e) a comparison of capital expenditure in the accounts prepared under the Companies Act 2006 to capital expenditure added to the RAB in the regulatory financial statements.

2.33 The regulatory financial statements should also include any other statements and supporting notes that are required to fairly present the financial performance and financial position of the licence holder in accordance with Condition 11 and these Guidelines.

[18] The primary statements are described in Annex A.

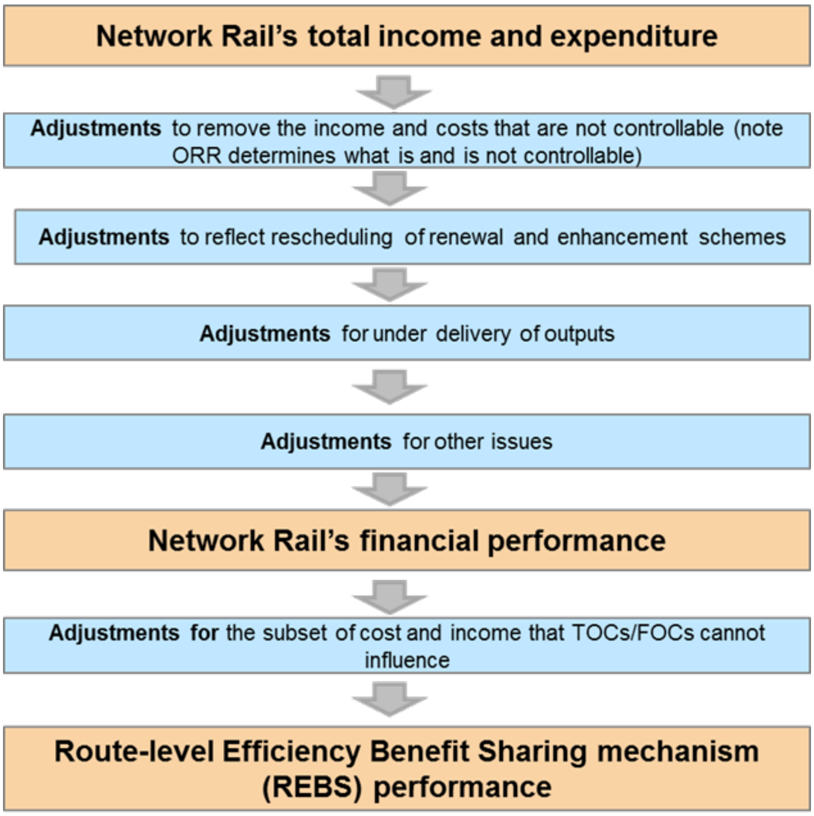
3. Financial performance

Introduction

3.1 This chapter explains how Network Rail's financial performance should be reported. It covers the objective, definition and scope of financial performance reporting, the baseline against which income and expenditure should be assessed and how variances should be reported. It then outlines the methods for adjusting financial performance if outputs have not been delivered as well as the method for assessing sustainability, and concludes with other matters that should be considered in reporting financial performance.

3.2 The process that Network Rail should follow to report its financial performance is summarised in Figure 3.1.

Figure 3.1: Process for calculating financial performance



Objective of financial performance reporting

3.3 Reporting of Network Rail's financial performance is intended to help Network Rail's customers, funders and other interested parties gain a better understanding of Network Rail's performance compared with the financial assumptions set out in our 2013 periodic review (which determined the funding that would be made available to Network Rail through access charges and government grants in CP5).

3.4 Our 2013 periodic review also set out the outputs that Network Rail must deliver during CP5. These outputs included punctuality and reliability requirements for passenger and freight trains, maintaining and renewing the network to ensure network capacity and availability is sustained in the short, medium and long term, and successfully completing required enhancement projects.

3.5 In determining the funding that Network Rail requires to deliver these outputs, we made a detailed assessment of the efficient level of expenditure which it would need to incur in CP5. Our PR13 determination included projections of the maintenance and renewals volumes needed to deliver Network Rail's performance targets and maintain its assets in a safe and sustainable condition. Our PR13 determination also included assumptions for the associated maintenance and renewals costs, expenditure to fund the enhancement projects, as well as support costs and financing costs, and provisions for dealing with risk. The detailed information underlying these assumptions was also set out in our PR13 determination.

3.6 As set out in our PR13 determination, Network Rail bears income and expenditure risk (subject to certain provisions that deal with some aspects of risk such as inflation). Network Rail is entitled to retain the benefit of outperformance (where income is higher and/or expenditure is lower in aggregate than assumed in our PR13 determination), after adjusting for under delivery of required outputs over CP5. Likewise, Network Rail bears the consequences of underperformance (where income is lower and/or expenditure is higher in aggregate than assumed in our PR13 determination)[19].

Objective of financial performance reporting

3.7 In CP5 we have introduced a new measure of Network Rail's financial performance, called total financial performance, which replaced the Financial Value Added measure and the Real Economic Efficiency measure that were used in CP4[20].

3.8 The CP5 measure of Network Rail's financial performance will compare Network Rail's income and expenditure to the financial assumptions in our PR13 determination. This will generate either an aggregate underspend, i.e. Network Rail has spent less than we assumed was necessary to deliver its required outputs, or an aggregate overspend, i.e. Network Rail has spent more than we assumed was necessary to deliver its required outputs.

3.9 In determining its financial performance, Network Rail will also need to assess whether it is has delivered the outputs specified in our PR13 determination. We define this as the 'robustness' test. Network Rail also needs to assess whether it has done enough maintenance and renewal work to counter the wear, degradation and ageing of its assets over time, so that the condition and performance of the network infrastructure is sufficient to

[19] Technically, Network Rail could also spend exactly the same as the determination but this is unlikely.

[20] The reasons why these measures are being replaced is explained in paragraphs 23.37 to 23.41 in our PR13 determination.

enable the PR13 output targets to be achieved for the forecast level and mix of use, and will continue to do so in the medium and long term. We define this as the ‘sustainability’ test.

3.10 The aggregate underspend or overspend will then need to be adjusted downwards if Network Rail has not fully delivered the output requirements of our PR13 determination, for example in relation to train punctuality and reliability.

3.11 The burden of proof is on Network Rail to show that any claimed financial outperformance is consistent with these requirements.

3.12 The measure of financial performance is a mixture of cash and accruals based accounting[21] as set out in our PR13 determination. Therefore the CP5 actuals are to be reported on the same basis as our PR13 determination.

3.13 Financial performance should be calculated as follows:

a) categories of income and expenditure that are not controllable by Network Rail should be excluded in the ‘variance not included in total financial performance’ column. The categories excluded are set out in Table 3.1 below;

b) for all other categories of income and expenditure, variances between Network Rail’s actual income and expenditure should be compared to our PR13 assumptions. These variances may be subject to adjustment in respect of the civils adjustment mechanism[22] and changes in enhancement expenditure as a result of:

(1) the November 2015 report from Sir Peter Hendy to the Secretary of State on the replanning of Network Rail’s Investment Programme (see paragraphs 3.16 to 3.17); and

(2) any subsequent adjustments to project baseline cost levels (see paragraphs 3.18 to 3.19);

c) the reasons for variances between actual income and expenditure and our PR13 financial assumptions (as adjusted) should be explained;

d) underspend should only be reported as financial outperformance where there is an adequate supporting explanation to demonstrate that the underspend is not simply due to the avoidance of work; and

[21] The cash method of accounting records revenue when cash is received, and expenses when they are paid in cash. In contrast the accrual method records income items when they are earned and records expenditure items when expenses are incurred regardless of the flow of cash.

[22] The civils adjustment mechanism is outlined in paragraphs 8.454 to 8.458 of our PR13 determination.

e) if Network Rail has not fully delivered our PR13 output requirements, financial performance should be adjusted downwards in accordance with the requirements set out in the 'Impact of not achieving outputs' section below.

3.14 Any adjustments to reported financial performance for under delivery of required outputs will not have a direct financial impact on Network Rail as these adjustments do not in themselves affect the funding available to Network Rail in CP5. However, Network Rail's financial performance does have links to the route-level efficiency benefit sharing mechanism (REBS), the value of Network Rail's regulatory asset base, the restrictions on its financial indebtedness in its licence and is also linked to Network Rail's Remuneration Committee's decisions about management bonuses.

Baseline costs for enhancement projects

3.15 In our PR13 determination we set out baseline cost levels for some enhancements on a provisional basis because of uncertainty about some project costs. We said we would give Network Rail more time to develop these projects and that we expected to conclude the funding baselines for most projects by March 2015 and determine adjustments to our provisional figures under the enhancement cost adjustment mechanism ('ECAM').

3.16 However, during 2015 the Secretary of State commissioned Sir Peter Hendy to conduct a comprehensive review of the CP5 enhancements programme for Network Rail, addressing affordability and timeliness aspects. Sir Peter made his report ('the Hendy report') to the Secretary of State in November 2015 and, subject to a short period of consultation with stakeholders, the Secretary of State accepted it. The report set out an enhancements delivery plan ('EDP') [23] that had the latest view of project delivery based on the high level output specification ('HLOS') we referred to in arriving at our PR13 determination. It also specified a not to be exceeded overall funding baseline that was greater than we had assumed for PR13.

3.17 Subject to paragraph 3.18, we have adopted the overall funding baseline from the Hendy report as an updated portfolio (total) cost baseline for CP5 enhancement projects[23]. We also consider the individual project costs set out in the Hendy report to constitute revised project baseline costs for the projects concerned.

3.18 Projects that had not had Governance for Railway Investment Projects Stage 3 milestones set at the time the Hendy report was made ('the GRIP 3 projects') will be excluded from the financial performance scheme. However, they may be brought into scope by any future review and adjustment process.

[23] Enhancement projects in Scotland that are funded by Transport Scotland and managed through the ScotRail Alliance are being progressed and reviewed separately.

3.19 If updated baseline cost levels (including for the GRIP 3 projects) were to be agreed, we would treat them as revised project baseline costs for the projects concerned.

Scope

3.20 Financial performance reporting should include all categories of income and expenditure that we deemed were controllable by Network Rail in our PR13 determination. These categories are shown in Table 3.1. There are two categories of expenditure which are deemed to be controllable but we have decided for CP5 that these categories would not count towards financial performance. These categories are civils renewal volumes[24] and spend to save schemes[25].

3.21 Network Rail will not be able to claim outperformance from the under delivery of civils volumes but an overspend is underperformance as set out in our PR13 determination. However, investing in more spend to save schemes than we assumed in our PR13 determination that generate future value, will not be underperformance as this could provide a perverse incentive on Network Rail, i.e. it may not be incentivised to do these schemes.

3.22 In addition, we noted in our PR13 determination that an important issue in relation to incentives is how variances in reactive maintenance are treated in our assessment of Network Rail's financial performance. We also noted the introduction of the civils renewals mechanism has already complicated this issue because we will need to have a different treatment of civils renewals volumes compared to civils unit costs. We said in our PR13 determination we would resolve how reactive maintenance should be treated in our assessment of Network Rail's financial performance in these Guidelines. However, as Network Rail is not yet aware of the potential amount of reactive maintenance over CP5, we will evaluate the treatment of reactive maintenance in financial performance after the 2015-16 financial year, once financial information on reactive maintenance has become available. The treatment of reactive maintenance will also be considered in light of the outcomes of the civils adjustment mechanism.

3.23 Table 3.1 below describes the inclusions and exclusions of total financial performance.

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[24] In our PR13 determination we require Network Rail to deliver the volumes of civils renewals as proposed in the Strategic Business Plan ('SBP'). Costs associated with delivering volumes at or above SBP levels will be included in the financial performance assessment for renewals and treated as a renewals overspend in the RAB roll forward mechanism. If volumes are below SBP levels then Network Rail will adjust so that there is not benefit from the lower volume delivery. The remaining overspend or underspend (attributable to unit cost variances) will be included in the financial performance assessment for renewals and the RAB roll forward mechanism.

[25] The types of schemes that can be included in the spend to save framework are: (a) information management schemes; (b) plant and machinery (including wheeled plant). This is for individual projects with a total cost in excess of £5m (2012-13 prices); (c) income generating schemes that provide additional property income; and (d) other cost saving or income generating schemes. This is for individual projects with a total cost in excess of £5m (2012-13 prices), subject to meeting the criteria in paragraphs 4.47.

Table 3.1: Inclusions and exclusions in total financial performance

Financial performance includes	Financial performance does not include
Income	
Variable charges	Grant income
Other Single Till Income (OSTI) (excluding non PR13 facility charges (whether included in our PR13 determination or not) and property income in relation to spend to save schemes)	Fixed charges income
	Property income in relation to spend to save schemes
	Traction electricity income received from train operations
	Non PR13 enhancements income (facility charge incomes relating to enhancement schemes not included in PR13, e.g. stations, depots, commercial property)
Expenditure	
Operations expenditure	Traction electricity costs paid on behalf train operators
Support costs	Licence and safety fees
Maintenance expenditure	Cumulo rates[26]
Renewals expenditure	Underspend on enhancement schemes with ring-fenced capped funding, e.g. Access for All
PR13 enhancement expenditure including projects with specific protocols	Non PR13 enhancement capital expenditure

[26] Cumulo rates will be excluded from the reporting of financial performance in CP5 only if we determine that Network Rail has negotiated these costs efficiently, e.g. it has raised the right issues, otherwise they will be included.

Overspend on enhancement schemes with a ring-fenced capped funding	
Schedule 4 & Schedule 8	
Traction electricity (only controllable traction electricity is included – i.e. transmission losses and Network Rail's own electricity costs)	
British Transport Police ('BTP') costs	
Rail Safety and Standards Board ('RSSB') costs	
Reporters' fees	
Other	
Taxation[27]	Finance costs
Volume incentive	REBS payments
Opex memorandum account adjustments in relation issues to that are not included in the 'Financial performance does not include' column	Rebates
Financial penalties as a result of licence enforcement action	

3.24 All the elements of Network Rail's income and expenditure included in Network Rail's financial performance are recognised for reporting outperformance or underperformance purposes at 100% of the final variance except for renewals, enhancements and also reporters' fees, which are recognised at 25% (i.e. efficient underspend of £100 x 25% = £25 of outperformance). The recognition at 25% for renewals and enhancements is because it aligns with Network Rail's financial reward/penalty for renewals and enhancements expenditure through the RAB roll forward mechanism. Reporters' fees are included at 25%

[27] As set out in paragraph 23.74 of our PR13 determination, we will assess potential windfall gains on issues like VAT rebates, on a case by case basis, as Network Rail said that some of these issues are so uncertain that it cannot provide a reasonable estimate of the potential gain at the time of our determination, so it assumed no gains from these issues in its SBP and we assumed no gains in our determination. This means that we will not simply assume that a VAT rebate that Network Rail has received in CP5 should be treated as outperformance..

as set out in our determination to recognise that overspend or underspend may not be fully within Network Rail's control because we may require Network Rail to engage Independent Reporters to undertake a piece of work.

3.25 However, if there is deemed to be a manifestly inefficient overspend[28] on renewals or enhancements, the treatment in the financial performance calculation will be that 100% of the manifestly inefficient overspend is deducted from financial performance, which is consistent with the RAB roll forward mechanism.

Treatment of material one-off changes to Network Rail's income and expenditure

3.26 As noted above, our general approach is that if a category of income or expenditure is deemed controllable by Network Rail then it should be included in the reporting of Network Rail's financial performance. Therefore, to the extent that we consider them controllable by Network Rail, unforeseen material one-off changes (both positive and negative) should be included in the reporting of financial performance.

3.27 However, we do not want to incentivise Network Rail to make decisions which result in inefficient expenditure. Therefore there is one exception to the rule on controllable material one-off changes. Providing Network Rail has shown that a change in a buy or lease decision is for good economic reasons, we will hold Network Rail neutral to the financial consequences of the change (for example, to buy rather than lease an asset) to avoid creating a perverse incentive for the company. Our above approach to a buy or lease decision also applies to the way the RAB is rolled forward as explained in Chapter 4.

Baseline and indexation

3.28 The baseline for measuring Network Rail's financial performance is the financial assumptions in our PR13 determination, adjusted for inflation. Financial performance should be reported on a real rather than nominal basis. Appropriate indexation should be applied to all figures carried forward from previous years to ensure that all figures are presented in a consistent price base. Indexation adjustments should be calculated as outlined in paragraph 2.4.

Identification and explanation of the causes of any underspend or overspend

3.29 For the recognition of financial performance, it is not sufficient for Network Rail to simply quantify any underspend and represent this as outperformance as this underspend could

[28] Manifestly inefficient is defined as overspend that is not either: (a) within the scope of Condition 4.1 of the licence (b) within the scope of the HLOS requirements (if relevant); (c) meeting a customer reasonable requirement; or (d) adding economic value to the railway.

have resulted from the company simply avoiding work that it should have undertaken. Therefore, Network Rail also needs to be able to provide an adequate explanation of any underspend and how it has been achieved. In the absence of such an explanation, underspend should not be assumed to represent financial outperformance.

3.30 In addition to quantifying the variances between actual income and expenditure and the assumptions in our PR13 determination, Network Rail also needs to identify the reasons for these variances, in particular, the extent to which any variances may be the result of financial outperformance or underperformance. This is important because the explanation of variances helps us understand how Network Rail is managing its business compared to the assumptions in our PR13 determination.

3.31 Variances should be explained in aggregate for Great Britain, in aggregate for England & Wales, in aggregate for Scotland and for each of Network Rail's operating routes[29].

3.32 Variances in maintenance and renewal categories, where appropriate, should be separately analysed between the effect of unit cost and volume variances. Volume variances are required to be further explained as outlined in paragraphs 3.71 to 3.84. The enhancement variances should be separately analysed for changes to project cost levels from the Hendy report and any other adjustments (see paragraphs 3.16 to 3.19), change control (which may include scope changes), and for work that might have been delivered earlier or later than assumed in our PR13 determination.

Adjustments for under delivery of required outputs

3.33 Our PR13 determination set out a number of output requirements that Network Rail must deliver in CP5. If Network Rail does not deliver these outputs it will not have fully delivered the output requirements that it was funded to deliver in CP5 and any such under delivery needs to be reflected in the reporting of Network Rail's financial performance.

3.34 We have worked with Network Rail to establish the methods by which financial performance should be adjusted for under delivery of the different regulatory outputs for CP5. Our approach was developed based on the following principles:

a) **Understandable:** Network Rail and other stakeholders need to be able to understand the consequences of underperformance in order to drive the right behaviours. Therefore, the approach needs to be transparent and as simple and unambiguous as possible;

[29] Explanations for individual operating routes in England & Wales can be provided by exception, i.e. explanations are only required where the reasons are different to those for England & Wales overall.

b) **Objective:** Calculations should be performed on an objective basis and should not be intended to unduly benefit or penalise the regulated company or any other person or organisation;

c) **Consistent:** The approach should align with the approach underpinning other aspects of regulatory reporting and our PR13 determination; and

d) **Proportionate:** The size of any adjustment to financial performance should be proportionate to the cause and consequences of any under delivery of a regulatory output. Any adjustment should take into account any financial consequences already incurred by Network Rail such as Schedule 8 payments and fines.

3.35 There are two high level approaches to adjusting financial performance for under delivery of required outputs, either (a) adjust for the estimated cost that Network Rail has avoided in under delivering what it was required to, or (b) assess the impact on Network Rail's customers of this under delivery. Both approaches have advantages and disadvantages as outlined in Table 3.2 below:

Table 3.2: Advantages and disadvantages of approaches to adjusting financial performance

(a) Estimate of the costs avoided in under delivering required outputs	
Advantages	**Disadvantages**
Consistent with the way that financial performance is measured (which is a comparison of actual costs incurred to the costs assumed to deliver our PR13 determination requirements in full)	There is not yet a good understanding of the relationship between the cost of Network Rail's activities and the impact those activities have on the performance of the network, e.g. if Network Rail spends £100m on a renewal, it is not clear what impact that renewal would have on the performance of the network

(b) Estimate of the value lost to users of under delivering required outputs	
Advantages	**Disadvantages**
Links to how Network Rail and industry makes business decisions based on the impact to users	Not consistent with the way that the rest of financial performance is measured

3.36 Using a combination of the two approaches has the potential to reduce the double count issue when adjusting for under delivery of different outputs. However, the double count issue would need to be considered every time adjustments to financial performance are calculated.

3.37 Although we have worked with Network Rail to establish the methods by which financial performance should be adjusted, we will need to assess them in the round when the financial adjustment values are calculated and also when considering the extent of under delivery of outputs (i.e. where we consider the adjustments are not appropriate). The methods for adjusting financial performance are not absolutely definitive and we may alter the methods as we recognise that the issues may change over time.

Train performance

3.38 In our PR13 determination we set out the following outputs in relation to train performance:

a) Public Performance Measure[30]:

[30] Public performance measure ('PPM') is the proportion of trains that arrive at their final destination on time. A train is defined as on time if it arrives within five minutes of the planned destination arrival time for London & South East and regional services; or ten minutes for long distance services.

(i) England & Wales annual of 91.9%, 92.1%, 92.3%, 92.4% respectively with a CP5 exit of 92.5%;

(ii) Scotland annual 92.0% and CP5 exit of 92.5%;

(iii) Franchised Train Operating Companies (‘TOCs’) in England & Wales rolling annual output Joint Performance Improvement Plan (‘JPIP’), no TOC to exit CP5 below 90% except Virgin East Coast and Virgin West Coast who must not exit CP5 with PPM below 88% or Cancellations and Significant Lateness (CaSL) above 4.2% and 2.9% respectively; and

(iv) 88% minimum for First Great Western high speed services at the end of CP5.

b) Cancellations and Significant Lateness[31]:

(i) England & Wales annual and CP5 exit of 2.2%; and

(ii) rolling annual output JPIP.

c) Freight Delivery Metric[32]:

(1) National annual 92.5%.

3.39 Network Rail will adjust its financial performance for any under delivery of the national train performance outputs. These are the annual England & Wales PPM, annual Scotland PPM, annual England & Wales CaSL and the annual Freight delivery metric. This is because the individual TOC targets, the JPIPs, are included in the national outputs and there is no specific adjustment for under delivering the JPIP outputs, but we may take enforcement action.

3.40 Network Rail’s train punctuality and performance measures in CP4 were below the requirements set out in our PR08 determination, as explained in our CP4 annual efficiency and finance assessments[33]. Working together with Network Rail we used the information set out in Network Rail’s CP4 performance Delivery Plan to estimate the additional cost that Network Rail may have reasonably needed to incur to fully deliver its train performance requirements. This amount was then applied as a downward adjustment to Network Rail’s financial performance in CP4. This adjustment was seen in CP4 as a proxy of a cost-avoided approach. However, a value based approach has been considered for CP5 because of the

[31] CaSL (Cancellations and Significant Lateness) is a combined measure of punctuality and reliability. It is a percentage measure of scheduled passenger trains which are either: cancelled (including those cancelled en route); miss one or more scheduled stops; or arrive at their scheduled destination 30 or more minutes late.

[32] Freight Delivery Metric (FDM) measures the percentage of freight trains arriving at their destination within 15 minutes of scheduled time. It only covers delay caused by Network Rail.

[33] Our 2012-13 Annual efficiency and finance assessment is available at: http://orr.gov.uk/__data/assets/pdf_file/0015/3165/nr-annual-asessment-2012-13.pdf.

advantages outlined in Table 3.2 above, the direct impact this output has on the users of the railway and the reduction in the potential double count if combined with a sustainability adjustment.

3.41 By value based approach we mean the value of lost time to passengers or freight users. For PPM and CaSL the method of calculation for adjusting financial performance for under delivery of this output will be based on the difference between the actual PPM and CaSL and the assumptions set out in our PR13 determination which will then be multiplied by[34]:

a) for England & Wales PPM: £30m per 1% shortfall;

b) for Scotland PPM: £2.5m per 1% shortfall;

c) for England & Wales CaSL: £3m per 0.1% shortfall; and

d) freight delivery metric (FDM): £1m per 1% shortfall.

3.42 Schedule 8 costs are not netted off from the adjustment. This reflects an assumption that TOCs generally do not change the services they run or fares in response to performance, and therefore the main costs of poor performance is as follows:

a) value of time to the passengers who continue to use the service (the majority of passengers);

b) dis-benefit to passengers who switch modes (more than zero but less than value of time arising from poor train performance – a standard assumption would be that it is half the value of time); and

c) revenue loss to TOCs due to a small number of passengers switching modes.

[34] These values were determined as follows: (average lateness minutes in a given year) * (number of passengers in the same given year) * (the value assigned by category (business, commuter, leisure) by WebTAG for passenger value of time) * (the lateness multiplier for each of those categories). This was then split between PPM and CaSL and the value was then reduced to reflect uncertainty and subjectivity in the calculation, the degree of control that Network Rail has over the measure and to be broadly similar to the volume incentive, which provides the right financial incentive for Network Rail to manage the potential additional traffic that operators wish to run.

WebTAG (Web Transport Analysis Guidance) provides information on the role of transport modelling and appraisal, and how the transport appraisal process supports the development of investment decisions to support a business case.

The value for the FDM adjustment was determined from analysis in the ORR freight user value of time study which estimated the total economic impact of delays to freight services and then netting off the Schedule 8 Network Rail payment rate, which represents the part of the total economic impact of freight service delays that is incurred by Freight Operating Companies (‘FOCs’). This approach is different to the PPM and CaSL adjustment because, unlike TOCs, the freight sector can offset a fall in revenue by making corresponding reductions in costs and are also more likely to respond to a fall in performance by reducing fares or being able to adapt services, which would help mitigate the impact on customers. The value was then reduced to be largely consistent with the approach taken in relation to PPM and CaSL.

The first two costs (a) and (b) are reflected in the value of time adjustment that we are using to calculate the adjustment to financial performance, and the final cost is reflected in the Schedule 8 payment Network Rail makes.

3.43 Any adjustment in respect of PPM and/or CaSL will be allocated to routes using a two-stage calculation. First, the adjustment will be allocated between train operators, based on actual PPM and CaSL for each operator compared to the assumptions in the CP5 Delivery Plan. Second, for train operators that run over more than one route, the adjustment will be allocated between routes using the same methodology as that used for these TOCs to allocate Schedule 8 payments between routes. The resulting adjustments will then be summed by route, to give an overall adjustment for each route.

3.44 Any adjustment in respect of freight performance will be allocated to routes in proportion to the allocation of freight Schedule 8 payments between routes.

Network availability

3.45 In our PR13 determination we set out the following outputs in relation to network availability:

a) Possession disruption index – passenger[35] (PDI-P);

(i) national CP5 exit of 0.58; and

b) Possession disruption index – freight (PDI-F);

(ii) national CP5 exit of 0.73.

3.46 Similar to train performance, we are using a value based approach to adjusting financial performance for under delivery of the PR13 network availability requirements[36]:

a) for PDI-P the method of calculation for adjusting financial performance for under delivery will be based on the difference between the actual CP5 exit PDI-P and the

[35] The possession disruption index – passenger (PDI-P) and possession disruption index – freight (PDI-F) measure the level of disruption caused by planned engineering possessions over a period of time.

[36] These PDI-P value was determined as follows: (the additional journey time in a given year as a result of possessions) * (the number of passenger journeys in that year) * (the value assigned by category (business, commuter, leisure) by WebTAG for passenger value of time) * (the types of journeys being made on affected services (business, commuter, leisure)) * (the lateness multiplier for each of these categories) * (discount reflecting the amount of notification given for the possessions, and how this affects the passenger value of time). The value was then reduced to be consistent with the approach taken when adjusting for train performance (as not doing so would have a detrimental effect on the balance of Network Rail's incentives, causing it to favour unplanned over planned disruption).

The value for the PDI-F adjustment was determined from the value of the PDI-P adjustment but taking account of the expected value of freight Schedule 4 payments as a proportion of passenger Schedule 4 payments over CP5. This gives an indication of the relative value of freight and passengers of the planned disruption that is expected to take place in CP5; and the absolute value of PDI-F in 2011-12 relative to PDI-P (0.85 vs. 0.54) to reflect the fact that PDI-F of 0.1 above target represents a lower percentage of total PDI-F than PDI-P.

assumption set out in our PR13 determination which will then be multiplied by £15m per 0.1 shortfall; and

b) for PDI-F the method of calculation for adjusting financial performance for under delivery will be based on the difference between the actual CP5 exit PDI-F and the assumption set out in our PR13 determination which will then be multiplied by £1m per 0.1 shortfall.

3.47 In relation to allocating the adjustment to the routes, Network Rail are making some changes to the way it produces and reports PDI-P and PDI-F that will enable it to report values by operating route in CP5. Network Rail will therefore be able to make a direct comparison to the output without the need for assumptions on allocation.

Network capability

3.48 In our PR13 determination we set out the following output in relation to network capability:

> the baseline capability of the network will be that in place as at 1 April 2014 in terms of track mileage & layout, line speed, gauge, route availability, and electrification type which provides the minimum level of capability so that Network Rail cannot reduce capability without going through industry processes (including the network change process).

3.49 There are a number of scenarios that may arise in considering this output:

a) capability better or no worse than the baseline at the start of CP5, i.e. output met. The railway is currently facing a growing demand and the funding and outputs for CP5 reflect this continued growth. Therefore in the current circumstances the capability of the network is generally improving rather than being in a situation of reducing network capability;

b) capability is reduced (e.g. for small sections of the network) but this has been through network change. In this situation compensation to train operators is often agreed as part of the network change but there will not have been an under delivery of the regulated output. However, it is conceivable that in an extreme case the capability of the network is significantly changed (with train operator agreement through network change) such that we consider there should be an adjustment to total financial performance to reflect the fact that the network would no longer match the level of capability that had been funded. This would be dealt with on a bespoke basis; and

c) actual capability is less than published capability[37]. In this situation, Network Rail will either: (1) request a network change (as in scenario (b) above) to amend published capability downwards to match actual capability; or (2) make infrastructure

[37] By published capability, we mean the capability meets the requirements in paragraph 3.48.

improvements to bring actual capability up to the level of the published capability. If we do not agree with the network change request or the actual capability is not improved so that the regulated output is met, we will consider whether we should make an adjustment to Network Rail's financial performance. However, given this is a relatively straightforward issue we have not included in the RAGs a method of calculating an adjustment for under delivery of this output.

3.50 We also retain the right to take regulatory enforcement action for any concerns related to network capability in CP5.

Enhancement milestones

3.51 In our PR13 determination we said that we would monitor the achievement of enhancement project milestones as set out in EDPs as updated, where applicable, during the control period.

3.52 Adjustments to financial performance should be made of between 2% and 5% of the project value if there is an impact on railway users as follows:

a) if a final milestone has been missed (usually this is the regulated output – intermediate outputs are used as monitoring milestones by us) and this missed milestone has an impact on train services or station facilities (e.g. it is not possible to run new or amended train services), the value of the adjustment would be based on a percentage, scaled to the impact on users, of the project cost attributed to that milestone (e.g. if there is more than one milestone per project, the project cost would be divided by the relative portion of the total project cost assumption attributable to that milestone);

b) if a development milestone has been missed, the value of the adjustment would be based on a percentage, scaled to the potential impact on users, of the project cost attributed to that milestone;

c) adjustments will be on a project by project basis and there is no net-off of early and late delivery between projects or within projects;

d) if an output is missed and the output is change controlled (regardless of whether there is assessed to be a financial adjustment or not) and the output is missed again, we will consider whether we should also adjust for the second missed output. This will continue until the output is delivered[38]; and

e) if a final milestone is not delivered at all and is not planned to be delivered (and has not been change controlled), we will adjust for 100% cost of the project associated with the

[38] For example, if platform lengthening was to be delivered in December but it was not delivered which results in an adjustment, the change control occurs after the December missed milestone so that delivery is now scheduled for May the following year. If that May milestone is not delivered, another adjustment may be made.

milestone, in addition to ensuring that Network Rail do not benefit from our PR13 determination assumption by adjusting financial performance (and the RAB) for the money not spent.

3.53 In relation to allocating the financial adjustment to routes, as milestones will be project specific, adjustments will generally be route specific. If there is a large enhancement scheme that covers more than one route then the adjustment would be in proportion to the scheme expenditure in each route.

Asset management

3.54 In our PR13 determination we set out the following outputs in relation to asset management:

a) asset management excellence model (AMEM) capability for each core group at National level (72%);

b) asset data quality for each asset type at National level (A2); and

c) milestones for Offering Rail Better Information Services (ORBIS).

3.55 Route allocation of any financial adjustment for asset management outputs will be done in proportion to the relative size of each route. The total Great Britain adjustment will be divided using the proportion of train miles attributable to that route.

Asset Management Excellence Model (AMEM)

3.56 The AMEM output should be achieved by the time of submission of Network Rail's PR18 Strategic Business Plan (SBP), now expected to be in October 2017, to support the production of that SBP. If the output target of 72% is not achieved in each of the six AMEM categories, the approach for adjusting financial performance for the under delivery of this output is:

a) a maximum downward adjustment of £20m;

b) the adjustment will be calculated based on a weighted calculation of the shortfall for each of the six AMEM categories at PR18 SBP (as explained in greater detail in Annex E);

c) there is inherent uncertainty associated with the AMEM scoring system, so there will be no adjustment to financial performance if the AMEM outturn scores are in the range of 70-72% and Network Rail demonstrates that all reasonable steps have been taken to achieve the AMEM output;

d) there is no allowance for outperformance, i.e. if a score above 72% is achieved in any AMEM category, then no positive adjustment is made.

Data Quality

3.57 The data quality output is a requirement to achieve a confidence grading of A2 in all asset sub-categories. This would mean that there is a robust system and that data is accurate to within 5%. The approach for adjusting financial performance for the under delivery of this output is:

a) a maximum downward adjustment of £20m.

b) if Network Rail has not delivered these outputs, financial performance will be adjusted in proportion to a weighted measure of the under delivery, based on how much progress has been made between CP4 exit and April 2017 in each of the asset sub-categories (this is explained in greater detail in Annex E); and

c) there is no allowance for outperformance of outputs, i.e. if a score above A2 is achieved, then no positive adjustment is made.

Offering Rail Better Information Services (ORBIS)

3.58 The approach for adjusting financial performance for the under delivery of this output is as set out above for enhancement milestones. For the purposes of calculating an output adjustment relating to ORBIS, one ninth of the total CP5 ORBIS programme cost according to our PR13 determination[39] is attributed to each of the nine ORBIS milestones. The ORBIS milestones are set out in Annex F.

Level crossing programme

3.59 In our PR13 determination we set out the following output in relation to health and safety:

> a plan of projects for CP5, to achieve the maximum possible reduction in the risk of accidents at level crossings using the £99m ring-fenced fund.

3.60 Network Rail will adjust financial performance by following an approach that is similar to enhancements, i.e. an adjustment of between 2% and 5% of project value depending on the impact on railway users. However, Network Rail will be able to net off early delivery against late delivery as there would be no change in the overall risk reduction.

3.61 The allocation to routes will be similar to enhancements. As milestones will generally be location specific, adjustments will generally be route specific.

Sustainability

3.62 In this section we cover four elements of assessing sustainability: (1) how is sustainability defined; (2) what Network Rail needs to do to demonstrate that it is delivering work

[39] £173m in 2012-13 prices and subject to indexation adjustment

sustainably; (3) the treatment of under delivery of work; and (4) our treatment of variances in the amount of work done where Network Rail is delivering sustainably.

Definition of sustainability

3.63 Sustainability in this context means whether Network Rail can demonstrate that it is doing enough maintenance and renewal work to counter the wear, degradation and ageing of the assets over time, so that the condition and performance of the network infrastructure is sufficient to enable the PR13 output targets to be achieved for the forecast level and mix of use, and will continue to do so in the medium and long term. We define this as the 'sustainability' test.

3.64 Sustainability applies at asset group level and at route level, because future performance depends on all asset groups, and should be ensured on all routes. The asset groups are:

a) track, including off-track and track drainage;

b) signalling, including level crossings;

c) electrification, including fixed plant;

d) operational property;

e) structures;

f) earthworks, including associated drainage; and

g) telecoms.

Demonstrating Sustainability

3.65 As part of our assessment of financial performance, we need to assess sustainability each year. Asset condition measures, such as the Station Stewardship Measure ('SSM'), asset remaining life, and trends in asset failure rates provide some evidence of whether sustainability is being achieved, but they are generally high-level, slow-moving and lagging measures[40].

3.66 Therefore, we also require reasonable evidence that future sustainability will be achieved. For this, Network Rail needs to demonstrate that: (1) its asset policies[41] when applied, can

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[40] As an absolute, sustainability can only be determined in hindsight.

[41] As required by its licence, Network Rail is to develop the policies and criteria it will apply in respect of the maintenance, renewal, replacement, improvement, enhancement and development of the relevant assets, which shall demonstrate how it will comply with the general duty. The general duty states that: "Network Rail should achieve the purpose of the operation and maintenance of the network; the renewal and replacement of the network; and the improvement, enhancement and development of the network, in each case in accordance with best practice and in a timely, efficient and economical manner so as to satisfy the reasonable requirements of persons providing services relating to railways and funders, including potential providers or potential funders, in respect of the quality and

be reasonably expected to achieve sustainability; and (2) that it has in place a management process and governance arrangements which ensure that the policies are applied appropriately.

3.67 Network Rail's asset policies should define the various interventions required over the lifecycle of every type of network asset to achieve sustainability at the least whole-life cost commensurate with the level of performance required.

3.68 The asset policies are applied by the routes, including both short-term (planned preventative maintenance) and long-term (renewals) intervention cycles. Applying the asset policies involves:

a) maintaining reliable and accurate information about each asset, including its type, criticality (or other characterisation of the effect of the asset on performance), and condition;

b) creating a bottom-up, asset-specific workbank, including renewals and planned preventative maintenance. This will involve defining what future interventions are required and when they should be made, as indicated in the asset policy for an asset of a particular type, criticality and condition. This process may involve some degree of professional judgement, but the policy should provide a robust framework that minimises subjectivity; and

c) delivering the interventions specified in the workbank, as planned and to the standard required. Asset condition sometimes deteriorates more quickly than expected, resulting in unplanned, reactive maintenance.

3.69 We expect Network Rail to assure itself that its governance arrangements are effective in practice, for example by audit of the end-to-end process applied to a sample of assets across all asset groups, verifying: the condition information for the sample assets (whether by physical inspection or remote condition monitoring); that the workbank created for the sample assets is in accordance with the asset policies with regards to timing and type of intervention; and that all work in the workbank for the sample assets has been delivered as planned to the standard required. We will accept the outputs of Network Rail's internal assurance process as evidence of sustainability, providing its assurance and governance arrangements are robust. We will also conduct some independent verification activities from time to time to validate Network Rail's internal assurance process, which may include commissioning audits, reviews and the use of independent reporters.

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capability of the network; and the facilitation of railway service performance in respect of services for the carriage of passengers and goods by railway operating on the network. Network Rail should do this to the greatest extent reasonably practicable having regard to all relevant circumstances including the ability of the licence holder to finance its licensed activities".

3.70 This approach to demonstrating sustainability applies both to work defined in the relevant accepted Delivery Plan by volume, and to work not defined by volume. For areas of work that are not defined by volume, or in the case of reactive maintenance for which the volumes in the accepted Delivery Plan are forecasts rather than plans, Network Rail will need to demonstrate that its internal governance processes have ensured that sufficient work has been done to claim any underspend as outperformance. We will consider all the evidence on sustainability as a whole in determining whether it has been achieved.

3.71 It is possible that the evidence for a particular asset group is conflicting. For example, if volume has been delivered as planned, but asset failure rates suggest declining condition, we would expect Network Rail to assess whether the asset policy underestimates the volume or type of intervention required for sustainability. Conversely, if less than the planned volume has been delivered but condition indicators are as forecast, we would expect Network Rail to assess whether the policy overestimates the volume or type of intervention required for sustainability, taking into account the lagging and slow-moving nature of the condition indicators.

3.72 Network Rail should improve its understanding of the condition of the assets and their behaviour over time, including the effectiveness of the various intervention options, and should refine their asset policies accordingly, consistent with best practice asset management. The policies should also be kept up to date with wider industry learning, for example about asset degradation, and new technology that creates more cost-effective intervention options. For some assets the policy might need to be revised if the required level of performance is increased, such that the stable level of asset condition also has to rise.

3.73 Providing we accept that Network Rail has demonstrated that the revised asset policy is better than the previous policy, the evidence required to demonstrate sustainability will be in relation to the revised policy from that point on.

Treatment of under delivery of work

3.74 If Network Rail has not demonstrated that it has maintained the sustainability of the network appropriately (i.e. it has not met the sustainability test), a cost based approach to adjusting financial performance will be used. The calculation of the adjustment is based on the cost of work not done. For maintenance this is 100% of the cost of the work not done, but for renewals it is 25% of the cost of the work not done, consistent with our RAB roll forward policy. This is highlighted in Table 3.3 below where it shows the default positions in the situation where Network Rail has done less work than the accepted Delivery Plan.

3.75 As set out above, we have worked with Network Rail to establish the methods by which financial performance should be adjusted, we will need to assess the methods in the round when the financial adjustments are calculated and also when considering the extent of under delivery of outputs. The methods for adjusting financial performance are not absolutely definitive and we may alter the methods as we recognise that the issues may change over time. In deciding whether Network Rail is maintaining the network sustainably we will consider a number of factors as set out in the 'demonstrating sustainability' section above. One of the key factors is Network Rail's delivery of the work that it needs to do.

3.76 Given this important connection between sustainability and the amount of work done, we have set out below in Table 3.3 our default position for changes in the amount of work done where Network Rail does less work than the Delivery Plan. This is because if Network Rail completes more work than is required by the accepted Delivery Plan, the additional work is assumed to be overspend (unless Network Rail can demonstrate it is, for example, an acceleration). This recognises that the burden of proof is on Network Rail to show that a change in the amount of work done from our determination and the accepted Delivery Plan is sustainable.

Table 3.3: Categorisation of under delivery of work compared to the accepted Delivery Plan

Can it be delivered within the control period?	What would it be classed as?	What is the impact on financial performance?	Explanation
Yes	Deferral	Neutral	This category covers the situation where there is delay in the delivery of work that is not due to an efficiency initiative but sustainability of the network is not affected.
No	Deferral and unsustainable delivery	-25% for renewals -100% for maintenance	This is our default position unless Network Rail has demonstrated that a deferral into a following control period is sustainable.
No	Deferral	Neutral	Network Rail has demonstrated that a deferral into a following control period is sustainable.

Treatment of variances in the amount of work done where Network Rail is delivering sustainably

3.77 In this section we identify the main generic reasons for differences in the amount of work done when Network Rail is delivering the PR13 outputs sustainably and how we will treat those variances.

Maintenance and Renewals

3.78 Our PR13 determination included assumptions about the amount of maintenance, renewals and enhancements work that Network Rail will undertake in each year of CP5. As explained in our PR13 determination, these assumptions were largely based on the levels of work set out in Network Rail's own Strategic Business Plan ('SBP') for CP5.

3.79 However, the volume of maintenance and renewal work required to satisfy our robustness and sustainability tests may change as knowledge of the assets and their behaviour matures or there are changes in traffic or other external factors. At any point in time the reference point for the volume of work required is Network Rail's latest Delivery Plan, providing we have accepted that the asset policies are appropriate under Condition 1.19, and that the Delivery Plan is consistent with the asset policies.

3.80 If an asset policy has not been accepted as appropriate, or is no longer considered appropriate, or if the work for a particular asset group set out in the Delivery Plan is not accepted as consistent with the relevant asset policy, that asset group will be excluded from consideration of financial outperformance until the situation has been remedied.

3.81 To assist in clearly understanding the difference between the actual amount of work delivered compared to our determination, the assessment of variances will be made in two stages (based on explanations provided by Network Rail). The first stage of the assessment will be the changes in the volume of work between our determination and the accepted[42] Delivery Plan. The second stage of the assessment will be the changes in the volume of work between the accepted Delivery Plan and the actual amount of work done. Depending on the reasons for the variances, they will be considered as either outperformance or underperformance or deferral or acceleration.

3.82 Table 3.4 below identifies the main generic reasons for differences in the amount of work done when Network Rail is delivering the PR13 outputs sustainably and how we will treat those variances (this table is not intended to be exhaustive, e.g. there are other reasons for the differences that we have not included in the table). This table is designed to illustrate some of the issues involved in our assessment of financial performance by showing our treatment of variances in work done for some simple scenarios. For example, Network Rail could change an asset policy but still deliver the same amount of work, whereas in the table below we have shown that a change in asset policy results in an efficient underspend or efficient overspend.

[42] By accepted we mean we accept that the Delivery Plan complies with Conditions 1.4 and 1.6.

Table 3.4: Categorisation of variances in volumes of work – when Network Rail has maintained sustainability at an appropriate level

Compared to the determination or Delivery Plan as appropriate - is it?	What has caused the difference?	What would it be classed as?	The impact on financial performance[43] between the accepted Delivery Plan compared to our PR13 determination?	The impact on financial performance[44] between the outturn compared to the accepted Delivery Plan?
more than	acceleration (not in delivery plan)	neutral	N/A	0%
	revised asset policy	efficient overspend	-25% for renewals -100% for maintenance	-25% for renewals -100% for maintenance
	revised asset information			
	delivery inefficiency			
	change in usage			
	efficient re-programming	neutral	0%	0%
equal to	+/- minor re-phasing	neutral	0%	0%
less than	efficient re-programming	neutral	0%	0%
	change in usage	efficient underspend	25% for renewals 100% for maintenance	25% for renewals 100% for maintenance
	delivery efficiency			
	revised asset information			
	revised asset policy			
	slippage within control period* (included in deferral/acceleration column in total financial performance)	neutral	N/A	0%

Note 1 - Network Rail would need to show that it can recover the slippage within the control period, otherwise it would not be considered sustainable delivery and the adjustment shown in Table 3.3 in the second line would be applied.

Note 2 - To illustrate how variances in work done may be treated, refer to the following example.

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[43] Of the difference in the amount of work required.

[44] Of the difference in the amount of work actually delivered.

Example:

We assumed in the determination that Network Rail would deliver £100m of renewals. Then in the Delivery Plan it planned to deliver £200m worth of renewal volumes due to a revised asset policy. The negative impact on financial performance would be £25m (25% of the £100m difference) if Network Rail delivered the Delivery Plan. However, Network Rail actually end up spending £160m, £40m less than the Delivery Plan, which it explained was due to a delivery efficiency. In this case it would retain £10m of that delivery efficiency (25% of the £40m difference). Overall it has spent £160m which is an overspend of £60m compared to the determination assumption and the overall impact on financial performance is £15m (£25m less £10m). As highlighted by this example, there are many combinations of the last two columns in this table and it should not be assumed that you combine the two columns on the same row in determining the impact on financial performance. This is because the differences could be attributed to two different reasons when comparing volume of work: (1) between our determination and the accepted Delivery Plan; and (2) between the accepted Delivery Plan and the actual amount of work done.

3.83 Better asset information or a change in asset policy might result in more or less work being required. For example if asset condition is found to be worse than previously thought, due to improvements in capturing asset information, or degradation being less than expected, the workbank should be adjusted to achieve least whole life cost. This might be captured in the accepted Delivery Plan, or identified later.

3.84 Delivery efficiency might arise through an improved method of working, or better targeting of the intervention to the specific situation on site through value engineering. The delivery efficiency might have been captured in the accepted Delivery Plan, or been identified later as the work is progressed. Delivery inefficiency, if identified as the reason for the variance, would generally arise during the course of delivering the work.

3.85 A change in usage on a part of the network might lead to more or less work being required. For example, if there is an increase or decrease in freight traffic. This might be captured in the accepted Delivery Plan, or identified later.

3.86 Efficient reprogramming is where Network Rail identifies an opportunity to reschedule renewals around other capital works, so the work can be delivered more efficiently as a whole. For example, by coordinating possessions to minimise network disruption. This might result in work being brought forward or put back. In the situation where work is put back (whether within or between control periods), we will hold Network Rail neutral providing it can demonstrate that delaying the work is sustainable. Similarly where work is brought forward (whether within or between control periods), providing Network Rail can demonstrate that it is efficient, we will hold Network Rail neutral.

3.87 To further illustrate the assessment of volume variances, Table 3.5 outlines four simple example cumulative scenarios which could result in volume variances.

Table 3.5: Example of scenarios which may be attributable to a cumulative volume variance

	Volume assumed in our PR13 determination	Volume assumed in accepted Delivery Plan	Volume actually delivered	Variance comparing accepted Delivery Plan to our PR13 determination	Variance comparing actual volume delivered to the accepted Delivery Plan
Scenario 1	100 units	110 units	95 units	10 units more	15 units less
Scenario 2	100 units	90 units	80 units	10 units less	10 units less
Scenario 3	100 units	95 units	110 units	5 units less	15 units more
Scenario 4	100 units	105 units	100 units	5 units more	5 units less

3.88 In relation to recognising financial performance, if a unit cost of £1m per unit is assumed, our default assumptions on outperformance, underperformance, acceleration or deferral is outlined in Table 3.6.

Table 3.6: Example cumulative total financial performance statement for variances in cumulative volumes

£m	Actual	PR13 assum-ption	Variance to PR13	Due to:	Accelera-tion/ (deferral)	Other adjust-ments	Final Variance	Financial out / (under) perform-ance
Scenario 1	95	100	5		-15	-	-10	-2.5
Scenario 2	80	100	20		-10	-	10	2.5
Scenario 3	110	100	-10		-	-	-10	-2.5
Scenario 4	100	100	-		-5	-	-5	-1.25

a) Scenario 1 would be assumed to be £15m of deferral and £10m of underperformance unless Network Rail can demonstrate that this is not the case[45];

b) Scenario 2 would be assumed to be £10m of deferral and £10m of outperformance unless Network Rail can demonstrate that this not the case;

[45] As this is just an illustrative default example, we have made some simple assumptions that the variances are due to deferral and underperformance but as we set out above there are other potential reasons for the variance. For example, Network Rail could provide an appropriate explanation for the £10m variance, showing that it was not underperformance, in which case we would change our treatment.

c) Scenario 3 would be assumed to be £0m of acceleration and £10m of underperformance unless Network Rail can demonstrate it is an acceleration of work; and

d) Scenario 4 would be assumed to be £5m of deferral and £5m of underperformance unless Network Rail can demonstrate this is not the case.

Effect of changes in work done on Schedule 4

3.89 For deferred renewals, the amount of the Schedule 4 variance will need to be amended because the annual level of access charge supplement (ACS) Network Rail receives, which funds the amount of Schedule 4 compensation expected to be paid in any one year, is based on the level of maintenance and renewals activity forecast for that year at each periodic review. As there is no mechanism to adjust the ACS between periodic reviews to reflect actual renewals activity levels, without an amendment to the variance, the appropriate variance on Schedule 4 would not be included in financial performance. If there has been an acceleration of renewals, the variance will also need to be amended to reflect the actual renewal activity levels being more than planned.

3.90 For enhancements schemes, Schedule 4 costs are funded separately to the ACS as they are included in the total capital cost of the enhancement scheme. Where an enhancement scheme is deferred (accelerated) an amendment will need to be made to the enhancement variance to reflect that Network Rail will not have paid the expected level of Schedule 4 compensation associated with the scheme.

Other considerations in treatment of financial performance

Treatment of input price changes

3.91 Changes to Network Rail's input prices[46] can have a significant effect on Network Rail's total financial performance. As we consider these effects to be controllable by Network Rail, for CP5, there will be no adjustments to financial performance for the effect of input price inflation[47].

Treatment of change control on enhancement projects

3.92 During the planning stage of an enhancement project, if a material unforeseen cost increase arises that is attributable to Network Rail that directly results in a funder change controlling the scope of the project, an adjustment to total financial performance should be made to reflect the inefficiency in planning. In this scenario financial performance may be adjusted at

[46] Input price inflation is the change in the prices of Network Rail's inputs (the goods and services it consumes). Input price inflation can be measured in absolute terms or relative to movements in more general price indices, such as RPI or CPI.

[47] Our PR13 determination assumed input price inflation of 0%.

25% of the difference between the original forecast and the new forecast, so that Network Rail does not unduly benefit from change control.

Route-level efficiency benefit sharing mechanism (REBS)

3.93 The methodology used to calculate REBS payments is consistent with the approach used to calculate financial performance. Our REBS guidance sets out further detail of how our output adjustments are applied to the calculation of REBS performance[48].

[48] ORR, Guide to the route level efficiency benefit sharing (REBS) mechanism in control period 5 (CP5), 31 March 2016.

4. Regulatory Asset Base (RAB)

Introduction

4.1 This chapter sets out our policies relating to the reporting of the Regulatory Asset Base (‘RAB’). It outlines the background, general policy and process issues, and then discusses the specific policies relating to renewals, PR13 enhancements, non-PR13 enhancements, amortisation and adjustments for under delivery of outputs. It concludes with how the RAB is presented in the regulatory financial statements and the adjustments made to ensure that capitalised financing is appropriately taken into consideration.

4.2 The RAB roll forward policy is a key element of our regulatory framework and is described in detail in this chapter. Within the RAB roll forward policy there are rules associated with the treatment of overspend or underspend compared to our PR13 determination assumption. These overspend or underspend rules are uniform in relation to renewals (except for the treatment of spend to save schemes) but in relation to enhancements there are some exceptions. The exceptions are: (1) the treatment of enhancement overspend in Scotland; (2) the treatment of ring-fenced capped funds; (3) other funding allowances; and (4) enhancements subject to bespoke target price arrangements. This is outlined in further detail below.

Background

4.3 A key purpose of the regulatory financial statements is to monitor and roll forward the RAB. This section of the document provides further explanation of how the RAB will be rolled forward.

4.4 In CP5, the RAB is calculated as:

the opening RAB (which is the number after adjusting the value of the CP5 opening RAB per our PR13 determination for agreed changes as set out in our letter[49] that determines the final value of the CP5 opening RAB);

a) plus an inflation adjustment (uplifting the CP5 opening RAB into the price base of the relevant year);

b) plus renewals and enhancements expenditure that is allowable for RAB addition (after adjusting for the effect of the RAB roll forward policy as described below);

c) less our PR13 determination amortisation assumptions; and

d) less adjustments for under delivery of outputs.

[49] Our letter will be published in autumn 2014, once we have completed our assessment on the CP4 closing RAB.

This methodology is similar to that adopted in our PR08 determination, except there is no deduction for ring-fence fund funding[50] as we have changed the policy for this issue in our PR13 determination.

4.5 Our PR13 determination established assumptions for renewal and enhancement expenditure in CP5 that would enable Network Rail to deliver the required outputs in CP5 and to sustain the long term condition of the network[51]. The baseline cost levels for enhancement projects have since been updated as a result of the Hendy report[52] and may be subject to other adjustments (see paragraphs 3.16 to 3.19).

4.6 The main features of our RAB roll forward policy are:

a) to provide an appropriate balance of incentives and protections for Network Rail by only adding actual efficient capital expenditure to the RAB in CP5;

b) the incentives the company faces are equalised across the five years of the control period, for example, Network Rail faces the same incentive to outperform in the last year of CP5 as it does in the first year of CP5 and will bear the same cost of efficient overspend in year five of CP5 as it does in the first year of CP5[53];

c) we set the incentive rate at 25%, which is approximately five years of the allowed return (4.31%). This is also called the '25% pain/gain sharing mechanism'[54];

d) if an efficient overspend is added to the RAB, Network Rail will bear 25% of the overspend (therefore only 75% of the overspend above our PR13 determination assumption is added to the RAB[55]). If the overspend is not eligible for a RAB addition because it is manifestly

[50] For the avoidance of doubt, as set out in our PR13 determination, 'ring-fence fund funding' is different to the 'ring-fence funds' outlined in paragraph 12.307 of our PR13 determination. Ring-fence funds are included in the CP5 RAB.

[51] Generally, in this section of the Guidelines when we refer to an under delivery of outputs we also mean Network Rail not meeting the sustainability test.

[52] Enhancement projects in Scotland that are funded by Transport Scotland and managed through the ScotRail Alliance are being progressed and reviewed separately.

[53] Except for spend to save expenditure which has different incentive rates across the control period as outlined in paragraph 4.50.

[54]The RAB adjustment is calculated as the amount of underspend or overspend plus associated capitalised financing from the year in which the underspend or overspend occurred based on a weighted average cost of capital (WACC) approach, less 25% of the underspend or overspend (with no capitalised financing accruing on the 25% adjustment). For example, if Network Rail underspent efficiently on its renewals programme in the first year of CP5 by £100m then the RAB would be reduced at the start of CP6 by £98m. This is the amount of the underspend of £100m plus the associated capitalised financing benefit to the end of CP5 of £23m, less 25% of the underspend of £25m. If the underspend of £100m occurred in year three of CP5 then the RAB reduction would be £87m, which is the £100m underspend plus capitalised financing of £12m (for the benefit to the end of CP5) less £25m.

[55] For clarity, it is our PR13 determination assumption that is added to the RAB, with adjustments made to that number for overspend or underspend.

inefficient (as it meets the criteria in paragraphs 4.18), Network Rail will bear 100% of the overspend;

e) Network Rail will retain 25% of an efficient underspend (therefore only 75% of the underspend below our PR13 determination assumption[56] is deducted from the RAB);

f) Network Rail will not be penalised for or benefit from rescheduling its capital expenditure programme (deferring work or bringing work forward) within CP5 where outputs are met. By not penalising or rewarding Network Rail we mean that the expenditure variance will not be treated as an efficiency or inefficiency (subject to Network Rail showing that the required outputs in CP5 have been delivered). This means that the RAB will be adjusted for the financial effect of rescheduling activity, so that Network Rail does not retain/bear the financing benefit/cost of the rescheduling. For the avoidance of doubt, these rescheduling adjustments will not be subject to the 25% pain/gain sharing mechanism;

    (i) For example if there is a deferral of work from year one to year two of CP5, in our PR13 determination Network Rail will be deemed to have received an allowed return on that work for year one[57]. In order to make the effect of rescheduling within CP5 neutral[58], the amount of allowed return that Network Rail would have received under a full weighted average cost of capital approach for that work for the period until the work is done in year two will be deducted from the RAB; and

    (ii) the RAB will be reduced for under delivery of outputs[59] regardless of whether there is an underspend or overspend. Adjustments for capitalised financing will also be made on the logged down amount.

General policy issues

4.7 Before we set out the specific issues that apply to renewals and enhancements, the following general policy issues apply to both renewals and enhancements:

a) renewals and enhancements will be rolled forward separately for England & Wales and Scotland and on an indicative basis for the routes;

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[56] Or for enhancements the cost level set out in the Hendy report and any other adjustments. Enhancement projects in Scotland that are funded by Transport Scotland and managed through the ScotRail Alliance are being progressed and reviewed separately.

[57] Due to the adjusted Weighted Average Cost of Capital ('WACC') approach in CP5, the actual return Network Rail will recover is lower. The adjusted WACC approach is, as far as possible, to be solely used for calculating Network Rail's revenue requirement as we think that it is better that financial decisions should be made with reference to Network Rail's cost of capital, which reflects the risks it faces. Therefore, for RAB capitalised financing adjustments, we have decided to use Network Rail's cost of capital to calculate the adjustment.

[58] Before detailed consideration of the effects of the adjusted WACC approach.

[59] Adjustments for under delivery of outputs include the sustainability test as outlined in 4.67 to 4.68).

b) RAB adjustments for the under delivery of outputs will generally be calculated with reference to the principles and methods outlined in the financial performance section in Chapter 3, except as outlined in paragraphs 4.67 to 4.68;

c) RAB adjustments for deferrals within CP5, underspend and efficient overspend, will be calculated with reference to our PR13 determination. This includes a requirement for Network Rail to explain how a reduction in work is efficient and meets the sustainability test. It should be demonstrated as outlined in paragraphs 3.24 to 3.27;

d) the assessment of the RAB is a cumulative assessment for CP5, i.e. an overspend in year one would be offset by underspend in year two. This means that it will only be possible to finalise the value of the RAB once CP5 is completed. All annual calculations of the RAB during CP5 in the regulatory financial statements will therefore be provisional; and

e) agreed deferrals of expenditure from CP4 to CP5 (e.g. Cardiff Queen street) will be treated under the CP5 RAB roll forward policy rather than the CP4 RAB roll forward policy, unless agreed otherwise.

General process issues

4.8 The following general process issues apply to both renewals and enhancements:

a) Network Rail will include in its regulatory financial statements its estimate of the RAB annually and we will assess its estimate and report on it in our annual efficiency and finance assessment of Network Rail. However, the estimates will be provisional until an overall ex-post assessment at the beginning of the next control period has been completed. Therefore the closing CP5 RAB will remain provisional until the end of CP5, and will only be finalised after the end of CP5;

b) capital expenditure should be recorded and added to the RAB in three broad categories: renewals, enhancements funded by our PR13 determination (as updated by the Hendy report and any other adjustments (see paragraphs 3.16 to 3.19), and enhancements not funded by our PR13 determination but approved by us ('non-PR13 enhancements'); and

c) in order for expenditure greater than the determination to be considered for a RAB addition under the RAB roll forward policy, Network Rail will need to provide comprehensive supporting documentation that clearly identifies all the relevant issues and shows that the proposed capital expenditure to be added to the RAB as set out in paragraphs 4.7(c), 4.17 and 4.26 but also does not meet one of the exceptions under paragraphs 4.18 and 4.31 to 4.35 or is not able to demonstrate that the expenditure is efficient in Scotland in accordance with paragraph 4.29. The burden of proof is on Network Rail to show that a RAB addition is justified. Network Rail needs to submit this information to us one month after the end of Network Rail's financial year at the latest. Network Rail will not be able to resubmit inappropriate submissions, unless otherwise agreed by us. If Network Rail is not able to show that our PR13 determination criteria have been met and/or provide the appropriate documentation in time, or if the submission is inadequate, the expenditure may not be added to the RAB.

Renewals

General

4.9 The policy and process for adding renewals to the RAB is the same in England & Wales as for Scotland.

4.10 As set out in our PR13 determination, unlike in CP4, in CP5 our renewals assumptions will not be adjusted for movements in the infrastructure output price index (IOPI).

Process for calculating a renewals underspend or overspend

4.11 The process for determining whether Network Rail is underspending or overspending our renewals assumption is firstly to calculate the baseline determination by uplifting the renewals assumption in our PR13 determination to the price base in the relevant year as described in paragraph 2.4. The inflated baseline number will then be adjusted for:

a) the agreed changes to the baseline as discussed in paragraph 4.71; and

b) any deferral or acceleration of expenditure.

4.12 The adjusted renewal determination assumption is then deducted from actual expenditure to determine whether there is an underspend or overspend (after removing any capitalised financing adjustments).

4.13 If there is an underspend it will be deemed efficient as long as Network Rail meets the robustness and sustainability tests as described in paragraph 3.9 as well as meeting the requirements of explaining the variances in paragraphs 3.24 to 3.27.

4.14 If there is an overspend Network Rail will need to demonstrate that the overspend does not meet the manifestly inefficient criteria set out in paragraph 4.18[60].

Renewals underspend

4.15 Network Rail will retain 25% of an efficient underspend. If an underspend is due to a deferral of work that will be caught up during the control period without adversely affecting the performance or sustainability of the network or Network Rail can demonstrate that a deferral into a following control period is sustainable, Network Rail will not benefit from the

[60] That is, the burden of proof is on Network Rail.

underspend as it will be held neutral. Where an underspend is inefficient, i.e. it has not met the robustness or sustainability tests (as described in paragraph 3.9) or the requirements of paragraphs 3.24 to 3.27 in explaining the variances, Network Rail will not benefit from the underspend because the RAB will be reduced by 100% for the expenditure included in our PR13 determination assumption (instead of the 75% reduction if the underspend were deemed efficient) [61].

4.16 Under delivery of outputs may also result in us making a further adjustment to the RAB in accordance with paragraphs 3.51 to 3.52 on asset management, paragraphs 3.45 to 3.47 on network capability and paragraph 3.68 on sustainability and taking enforcement action in accordance with our policies.

Renewals overspend

4.17 In CP5 a renewals overspend in England & Wales and Scotland will be added to the RAB and Network Rail will bear 25% of the overspend (i.e. 75% of the overspend will be added to the RAB, after adjusting for capitalised financing), unless the overspend is manifestly inefficient and then the spend will not be able to be added to the RAB (and Network Rail will bear 100% of the overspend).

4.18 Manifestly inefficient is defined as overspend that is not either:

a) within the scope of Condition 4.1 of the licence;

b) within the scope of the HLOS requirements (if relevant);

c) meeting a customer reasonable requirement; or

d) adding economic value to the railway.

4.19 We would expect a key element of Network Rail’s justification that the expenditure is not manifestly inefficient would be evidence that internal project management and investment authorisation controls had been properly applied.

PR13 enhancements

General

4.20 Some of our policies for adding enhancement expenditure to the RAB are different for England & Wales and Scotland in accordance with our PR13 determination. In addition, as highlighted previously and outlined in more detail below, there are exceptions to the overspend or underspend rules for enhancements including the treatment of enhancement overspend in Scotland as well as the treatment of ring-fenced capped funds, other funding

[61] As well as any financing benefit received by Network Rail.

allowances and enhancements subject to bespoke target price arrangements in both England & Wales and Scotland.

Process for calculating an enhancement underspend or overspend – in relation to the delivery of PR13 outputs

4.21 The process for determining whether Network Rail is underspending or overspending our PR13 determination assumption is firstly to calculate the baseline determination by uplifting the enhancement assumption in our PR13 determination assumption to the price base in the relevant year as described in paragraph 2.4. The inflated baseline number will then be adjusted for:

a) the updates from the Hendy report and any other adjustments (see paragraphs 3.16 to 3.19);

b) the agreed changes to it as discussed in paragraph 4.73[62]; and

c) for any deferral or acceleration of expenditure.

4.22 The adjusted enhancement determination assumption is then deducted from actual expenditure to determine whether there is an underspend or overspend.

PR13 enhancement underspend

4.23 If there is an underspend, it will be deemed efficient as long as the enhancement regulated outputs per our PR13 determination (as updated by the Hendy report and any other adjustments – see paragraphs 3.16 to 3.19) are delivered and the requirements of paragraphs 3.24 to 3.27 in explaining the variances are met. In simple terms, 75% of the underspend (below the adjusted enhancement determination assumption) will be deducted from the RAB, thus allowing Network Rail to retain 25%, after adjusting for capitalised financing.

Regulatory milestones

4.24 If any regulated milestones have been missed, an adjustment to the RAB will be made for under delivery of outputs in accordance with paragraphs 3.51 to 3.53 for enhancement milestones and 3.59 to 3.61 for level crossings. This is regardless of any aggregate overspend or underspend.

4.25 If no regulated milestones have been missed, no further adjustments will be made.

[62] The change control process is referred to in paragraphs 3.244 to 3.248 of our PR13 determination.

PR13 enhancement overspend

4.26 If there is an overspend Network Rail bears 25% of the overspend and will only be allowed to add 75% of the overspend to the RAB after adjusting for capitalised financing, unless it is manifestly inefficient where the overspend is not allowed to be added to the RAB.

4.27 This process for the treatment of PR13 enhancement overspend is the same for England & Wales and Scotland except that there is not a manifestly inefficient test in Scotland; instead there is an ex-post efficiency assessment as set out in our PR13 determination.

4.28 In England & Wales, Network Rail would have to justify the overspend does not meet the criteria of being manifestly inefficient as outlined in paragraph 4.18. This means that Network Rail will need to review the enhancement spend in England & Wales (excluding spend on bespoke target price arrangements, ring-fenced funds and other funding allowances) and identify in a letter to us any manifestly inefficient spend. This needs to be done annually for each year of CP5, even where there is not an aggregate overspend as an aggregate overspend may occur in the later years of CP5.

4.29 In Scotland, Network Rail is required to demonstrate that an increased spend above our PR13 determination assumption (as updated by the Hendy report and any other adjustments – see paragraph 3.16 to 3.19) is efficient, and it will do this by providing the necessary documentation to enable us to perform an ex-post efficiency assessment. For example, Network Rail's documentation may identify one or more of the following as reasons for the increased spend:

a) improvements in enhancement projects that demonstrate optimisation of whole life costs;

b) systemic issues that could not reasonably have been foreseen at the time of our PR13 determination;

c) work brought forward in order to minimise total cost; and/or

d) external factors that could not have reasonably been taken into account at our PR13 determination.

Portfolio treatment

4.30 Excluding the projects outlined below, we determine the overall portfolio efficient cost and Network Rail is free to budget for individual schemes as it sees fit and the underspend or overspend rules will apply to the aggregate costs, per our PR13 determination.

4.31 The projects excluded from the portfolio treatment are as follows:

a) England & Wales – Ring-fenced capped funds:

(i) Strategic Rail Freight Network fund (including the CP4 rollover of the SFN);

(ii) East Coast Connectivity fund;

(iii) Passenger Journey Improvement fund;

(iv) Station Improvement fund (including the CP4 rollover for NSIP and Access for All);

(v) Development fund;

(vi) Level Crossing Safety fund; and

(vii) Funding allowance for research & development.

b) England & Wales – Other funding allowances:

(i) Funding allowance for depots and stabling; and

(ii) Funding allowance for ETCS cab fitment.

c) England & Wales – Enhancements subject to bespoke target price arrangements:

(i) Crossrail; and

(ii) Thameslink.

e) Scotland – Ring-fenced capped funds:

(i) Scottish Stations fund;

(ii) Scottish Strategic Rail Freight Investment fund;

(iii) Scottish Network Improvement fund;

(iv) Future Network Development fund;

f) Level Crossings fund; and

(i) Funding allowance for research & development.

g) Scotland – Other funding allowances:

(i) Funding allowance for ETCS cab fitment.

h) Scotland – Enhancements subject to bespoke target price arrangements:

(i) Borders; and

(ii) EGIP: Springburn to Cumbernauld; Edinburgh to Glasgow electrification; Edinburgh gateway; and Infrastructure.

4.32 For ring-fenced capped funds any underspend will be deducted (including associated capitalised financing), irrespective of whether there is an aggregate capital expenditure overspend or underspend at a portfolio level and Network Rail will not retain 25% of the underspend on these funds. No RAB additions will be made for any overspend on these funds or any associated capitalised financing.

4.33 For other funding allowances in our PR13 determination assumption we will carry out ex-post efficiency reviews during CP5 to ensure that efficient out-turn expenditure will be added to the RAB.

4.34 For enhancements included in our PR13 determination assumption and subject to bespoke target price arrangements, i.e. Crossrail, Thameslink, EGIP and Borders, overspend and underspend will be treated as stated in the relevant protocol or fixed price agreement.

4.35 For the avoidance of doubt, these ring-fenced capped funds, other funding allowances and enhancements subject to bespoke target price arrangements included in our PR13 determination assumption will not be included in the overall assessment of enhancement projects which is done at a portfolio level.

Enhancements in relation to the delivery of additional PR13 outputs

4.36 Where a government requests Network Rail to deliver additional outputs during the control period, this will not be deemed as overspend and we will specify whether the additional output will be treated as an Investment Framework scheme or an additional adjustment to the adjusted enhancement determination assumption as outlined in paragraph 4.73.

4.37 If the former treatment is used, the efficient cost (including capitalised financing costs) of delivering the outputs will be logged up for inclusion in the RAB as per the Investment Framework policy. If the latter, we will also agree at that point the efficient cost to be added to the adjusted enhancement determination assumption and the RAB roll forward process will apply.

Investments not funded by PR13 but approved by ORR through the investment framework

Background

4.38 The investment framework[63] is necessary to deal with investments that may arise between periodic reviews (or be required by third parties outside the access charges review framework). This may be as a result of, for example, changing safety requirements, newly developed enhancements to improve Network Rail's performance, or customer requirements for additional outputs. Where appropriate these schemes are added to the RAB.

4.39 In the past there have been two types of investment framework schemes: (1) external[64]; and (2) internal/Network Rail. In CP5 we have removed the 'internal/Network Rail' investment framework and replaced the policy with the 'spend to save' framework which is outlined below.

External framework

4.40 The investment framework classifies investment schemes and our approvals process from the perspective of the three main types of investors:

a) third party investors;

b) franchised operators; and

c) governments.

4.41 Efficient expenditure on schemes promoted by these investors can be logged up by Network Rail for inclusion in the RAB, subject to the criteria set out in the investment framework.

4.42 The investment framework allows Network Rail to recover its capital and financing costs for certain schemes through charges, e.g. facility charges. In such cases, capitalised financing will not normally need to be added to the RAB. Facility charges generally include two components (a) a financing charge element and (b) an amortisation element.

4.43 Where the facility charges from the scheme include a recovery of the scheme capital costs, amortisation will be deducted from the RAB. The amortisation adjustment in this instance only includes the amortisation element and not the financing charge element of the facility charge. The amortisation element will be deducted from the RAB until the end of the control

[63] The investment framework is the framework for investments outside of the periodic review. The 'investment framework consolidated policy & guidelines' document is available at: http://orr.gov.uk/__data/assets/pdf_file/0014/5720/investment_framework_guidelines_october_2010.pdf.

[64] The external part of the investment framework deals with schemes promoted by third parties, franchised operators and the governments (non-HLOS) during a control period.

period (in which the scheme is added to the RAB). This will ensure that Network Rail does not over recover its costs.

4.44 Where Network Rail does not receive charges from schemes to reimburse it for its financing costs in accordance with the investment framework, capitalised financing on the efficient costs should be logged up to the RAB in accordance with the method detailed in paragraphs 4.75 to 4.78.

Spend to save framework

4.45 The RAB roll forward process will be applied to deal with spend to save schemes but the RAB roll forward process for spend to save schemes will be amended by using different incentive strengths as set out in our PR13 determination.

4.46 The types of schemes that can be included in the spend to save framework are:

a) information management schemes;

b) plant and machinery (including wheeled plant). This is for individual projects with a total cost in excess of £5m (2012-13 prices);

c) income generating schemes that provide additional property income; and

d) other cost saving or income generating schemes. This is for individual projects with a total cost in excess of £5m (2012-13 prices).

4.47 In order for a scheme to be included in the spend to save framework, the expenditure must be efficient and the scheme must meet all the following criteria:

a) generate future cost savings for Network Rail or generate additional income;

b) for plant and machinery and other cost saving or income generating types of schemes, the benefits must be incremental to our PR13 determination:

(i) For plant and machinery schemes, they must generate efficiency savings over and above the efficiencies specified in our PR13 determination as well as demonstrating that the schemes were not planned in our PR13 determination;

(ii) For other cost saving or income generating types of schemes Network Rail must demonstrate the schemes were not planned in our PR13 determination. These types of schemes would only be included in the spend to save framework in exceptional circumstances and where Network Rail could explain to our reasonable satisfaction, why the scheme was not included in its PR13 SBP or other PR13 submissions and discussions with us. This is because our determination already provides an appropriate level of funding for Network Rail to efficiently deliver its required outputs in CP5 in a safe and sustainable way;

c) add to the economic value of the rail network, i.e. it must have a positive net present value (using the regulatory cost of capital of 4.31%);

d) be capable of being efficiently financed and delivered; and

e) for very large schemes, Network Rail can afford to finance the planned expenditure and hence the scheme would not unduly affect Network Rail's financial sustainability.

4.48 For the avoidance of doubt, schemes funded by the innovation funding mechanism are not included in the spend to save framework.

4.49 Schemes that provide additional benefits such as safety schemes are not included in the spend to save framework as they are covered by the RAB roll forward policy for additional outputs.

Financial treatment of spend to save expenditure

4.50 The incentive rates on these schemes are 20% in year one of the control period, 15% in year two of the control period, 10% in year three of the control period, 5% in year four of the control period and 0% in year five of the control period.

4.51 To give effect to these incentive rates Network Rail will:

a) add the efficient capital expenditure to the RAB in CP5 in the year it is incurred;

b) for the avoidance of doubt, not deduct incremental efficiency savings or incremental income achieved during CP5 from the value of the expenditure that will be added to the RAB;

c) add capitalised financing (to the end of the control period) to the cost of the scheme in accordance with the normal RAB roll forward rules; and

d) deduct the relevant incentive rate from the capital expenditure component of the RAB addition.

4.52 As an example, if Network Rail spends £100 (including capitalised financing costs) on a spend to save scheme in year 3, that generates £15 of income/savings by the end of the control period, this scheme would produce a net benefit to Network Rail of £5 (£15 + £90 - £100 = £5), as it would:

a) keep the £15 of income/savings generated by the scheme;

b) the RAB would increase by £90. This reflects the addition of the efficient capital expenditure and capitalised financing costs to the end of the control period (£100) less 10% of the RAB addition (given the incentive rate of 10% in year 3 of the spend to save framework); and

c) incur £100 of debt.

4.53 For information management schemes and for income generating schemes that provide additional property income, this treatment will apply to all expenditure in this category, which comprises expenditure included in our PR13 determination assumption and additional expenditure through the spend to save framework[65]. This treatment would be applied to aggregate overspend or underspend compared to our PR13 determination assumption. This is because we recognise that our expenditure assumption does not relate to particular schemes but instead it is a general assumption of the amount of expenditure that could be incurred on these schemes in CP5 and the income/additional savings that those schemes could generate.

4.54 For plant and machinery and other cost saving schemes the treatment set out above only applies to the expenditure above the level assumed in our PR13 determination assumption. For spend below the level assumed in our PR13 determination assumption for these categories of expenditure, the normal RAB roll forward rules would apply.

4.55 For the avoidance of doubt, for the purposes of this policy our PR13 determination assumption does not assume any spend on other cost saving schemes and does not cover the ORBIS project.

4.56 In CP4, we carried out an ex-post review of 'internal/Network Rail' investment framework schemes and we will carry out a similar review of the spend to save schemes in CP5 to ensure that efficient expenditure is added to the RAB only on those schemes that meet the spend to save criteria.

Innovation

4.57 In our PR13 determination, we made a provision of £50m for matched-funding for R&D and innovation. For the avoidance of doubt, this £50m is separate and in addition to the £50m provided via the HLOS innovation fund.

4.58 The RAB additions will be determined by Network Rail's governance process which will be agreed by us and non-innovation expenditure should not be treated as innovation expenditure.

Process for adding non-PR13 investment expenditure to the RAB

4.59 Additions can be made to the RAB provided the criteria set out in the investment framework are satisfied. We will check that the regulatory financial statements record all investment expenditure incurred in accordance with the criteria and processes set out in our investment

[65] For the avoidance of doubt, this treatment replaces the normal RAB roll forward rules for the capital expenditure required for these schemes.

framework consolidation document[66]. The RAB during the control period is provisional and Network Rail should record the expenditure proposed for inclusion in the RAB as the expenditure is incurred. It can only be added to the RAB up to: (a) the lower of the efficient cost, or (b) not to be exceeded cost of work. Where we deem appropriate, we will also undertake an ex-post efficiency assessment on the expenditure incurred.

4.60 No amount will be added to the RAB in relation to certain schemes if the related access agreements that provide an income stream for Network Rail have not been approved by us.

Amortisation

4.61 Amortisation is the remuneration of past investment that has been previously added to Network Rail's RAB.

4.62 Our PR13 determination remunerated capital expenditure through an allowance for amortisation, based on the long-run efficient annual average capital expenditure required to maintain the network in a steady state[67] (subject to financial sustainability considerations[68]) except for non-capital expenditure additions, which are amortised over 30 years[69].

4.63 Renewals and enhancement expenditure is added to the RAB and there is a reduction in the value of the RAB to reflect the amortisation (or depreciation) of the assets over time. See Annex A, Statement 2a: RAB (Regulatory financial position).

4.64 The outstanding amount of the non-capital expenditure RAB additions will be reported in the regulatory financial statements as a memo item. See Annex A, Statement 2b: RAB - Reconciliation of expenditure.

Amortisation of investment framework schemes

4.65 Amortisation will also be deducted from certain categories of non-PR13 enhancement expenditure that will be added to the RAB through the investment framework. As a basic principle, amortisation will be deducted from non-PR13 enhancement schemes where Network Rail is being reimbursed for the scheme's capital cost through a charge (or is deemed to receive an economic benefit equivalent to the amortisation charge).

[66] The 'investment framework consolidated policy & guidelines' document is available at: http://orr.gov.uk/__data/assets/pdf_file/0014/5720/investment_framework_guidelines_october_2010.pdf.

[67] Note that amortisation based on average long-run steady state renewals does not fund the original construction cost of an enhancement, just the renewals needed to maintain the asset in a suitable condition.

[68] As noted in Chapter 14 of our PR13 determination, this amounts to £2bn for CP5.

[69] See paragraphs 12.234 to12.238 of our PR13 determination. A more detailed discussion of our PR13 amortisation rules is also covered in these paragraphs.

4.66 The amortisation charge to be deducted from the RAB should be equal to the income that Network Rail receives as a reimbursement for the scheme's capital cost (as set out in paragraph 4.43).

Adjusting for under delivery of outputs

4.67 The following financial performance adjustments will also be used to adjust the value of Network Rail's RAB:

a) sustainability;

b) level crossings;

c) asset management;

d) enhancements;

e) adjustment to enhancements due to a material unforeseen cost increase attributable to Network Rail that directly results in a funder change controlling the scope of the project (see paragraph 3.92); and

f) network capability.

4.68 Subject to the provision in paragraph 3.37, we will not make further value-based adjustments to the RAB for under delivery of outputs relating to train performance and network availability in CP5.

Presentation of the RAB in the regulatory financial statements

4.69 Statement 2a: RAB (Regulatory financial position) of the regulatory financial statements provides details of the roll forward of the RAB from year to year.

4.70 Statement 2b: RAB - reconciliation of expenditure of the regulatory financial statements reconciles:

a) the renewals and enhancement assumptions in our PR13 determination (as updated, where relevant, by the Hendy report and any other adjustments – see paragraphs 3.16 to 3.19); with

b) the renewals and enhancements added to the RAB; and either

(i) actual renewals expenditure per Statement 9a: Analysis of renewals expenditure; or

(ii) actual enhancement expenditure per Statement 3: Analysis of enhancement expenditure of the regulatory financial statements.

Renewals reconciliations

4.71 The process for reconciling renewals expenditure is:

a) firstly, the renewals assumption in our PR13 determination is recorded;

b) secondly, any changes to the renewals assumption in our PR13 determination that have been agreed by us are recorded. This includes:

(i) deferrals of expenditure from CP4 to CP5; and

(ii) any other adjustments agreed with us;

c) thirdly, all adjustments to the renewals expenditure per the RAB roll forward policy are recorded. This includes:

(i) deferrals or accelerations within CP5; and

(ii) adjustments for efficient underspend or overspend, including where appropriate the 25% retention of any efficient underspend or overspend.

The total after step (c) is the renewals RAB addition per Statement 2a: RAB (Regulatory financial position) of the regulatory financial statements.

4.72 In order to derive actual renewals spend, the renewals RAB addition per Statement 2a: RAB (Regulatory financial position) is then adjusted for:

a) any overspend that was deemed manifestly inefficient and does not qualify for addition to the RAB;

b) the removal of any capitalised financing adjustments included in the RAB addition for renewals;

c) the removal of the adjustment for the 25% retention of underspend or overspend included in the RAB addition for renewals; and

d) the removal of any other necessary adjustment(s) (including an explanation of the adjustment(s)).

The total after step (d) is actual renewals expenditure per Statement 9a and 9b: Analysis of renewals expenditure.

Enhancements reconciliations

4.73 The process for reconciling enhancements expenditure is:

a) firstly, the enhancements assumption in our PR13 determination is recorded;

b) secondly, any changes to the enhancements assumption in our PR13 determination that have been agreed by us are recorded. This includes:

   (i) deferrals of expenditure from CP4 to CP5;

   (ii) changes resulting from the Hendy report, where relevant, and any other adjustments – see paragraphs 3.16 to 3.19;

   (iii) deferrals of expenditure from CP5 to CP6;

   (iv) any other changes that have gone through change control; and

   (v) any other adjustments agreed with us;

c) thirdly, all adjustments to the enhancements expenditure per the RAB roll forward policy are recorded. This includes:

   (i) deferrals or accelerations within CP5; and

   (ii) adjustments for efficient underspend or overspend, including where appropriate the 25% retention of any efficient underspend or overspend;

d) fourthly, add all non-PR13 enhancements in accordance with investment framework policy including the related capitalised financing and amortisation adjustments where appropriate[70].

The total after step (d) is the enhancements RAB addition per Statement 2a: RAB (Regulatory financial position) of the regulatory financial statements.

4.74 In order to derive actual enhancement spend, the enhancement RAB addition per Statement 2a: RAB (Regulatory financial position) is then adjusted for:

a) any overspend that was deemed manifestly inefficient and does not qualify for addition to the RAB;

b) remove any capitalised financing adjustments included in the RAB addition for enhancements;

c) where appropriate, remove the adjustment for the 25% retention of overspend or underspend included in the RAB addition for enhancements; and

d) any other necessary adjustment(s) (including an explanation of the adjustment(s)).

[70] For the avoidance of doubt, non-PR13 enhancements will not be subject to the 25% pain/gain mechanism.

The total after step (d) is actual enhancement expenditure per Statement 3: Analysis of enhancement capital expenditure of the regulatory financial statements.

Capitalised financing

4.75 Capitalisation of financing costs in CP5 should only be applied to certain items of expenditure incurred by Network Rail that were not funded by our PR13 determination and are eligible for RAB addition under the RAB roll forward mechanism. These are:

a) where appropriate the difference between the actual CP5 opening RAB and the opening RAB assumed in our PR13 determination;

b) adjustments for changes to our PR13 determination, agreed with us;

c) adjustments for the under delivery of outputs;

d) the adjustment for deferral or bringing forward of renewal or enhancement expenditure within CP5;

e) addition/deduction of efficient underspend or overspend; and

f) certain investments not funded through PR13, but approved by us for addition to the RAB where the income being received by Network Rail did not include the reimbursement of financing costs (see paragraphs 4.38 to 4.44 for details).

4.76 For the avoidance of doubt, the following items will not be adjusted for capitalised financing:

a) our PR13 renewals and enhancement assumptions (as updated as a result of the Hendy report and any other adjustments – see paragraphs 3.16 to 3.19);

b) the adjustment for the 25% retention of overspend or underspend i.e. the adjustment that ensures that the retained benefit or loss of an overspend or underspend is equal to 25%;

c) indexation adjustments;

d) adjustments for amortisation; and

e) certain investments not funded through PR13, but approved by us for addition to the RAB, where the income being received by Network Rail includes the reimbursement of financing costs (see paragraphs 4.38 to 4.60 for details).

4.77 For the purposes of calculating the appropriate RAB adjustment for capitalised financing, any relevant expenditure should be assumed to have been incurred mid-way through the year.

The addition should be calculated with reference to the allowed return assumed in our PR13 determination, i.e. 4.2191%[71].

4.78 For the designated categories shown in paragraph 4.75, capitalised financing should therefore be applied using the following formula:

Capitalised Financing = [RoR x (2 x A + B)]/(2 - RoR)

where:

A = The opening balance (including capitalised financing);

B = Adjustments during the year[72]; and

RoR = The appropriate allowed rate of return (i.e. 4.2191%).

[71] This vanilla return is on a semi-annual basis and was used in our PR13 determination for financial modelling purposes and is consistent with the headline annual average return allowed in our PR13 determination of 4.31%.

[72] In the case of the effect of the difference between the actual CP5 opening RAB and the assumption we made in our PR13 determination for the opening RAB, the adjustment is treated as being made at the beginning of the first year of CP5, rather than an adjustment during the first year of CP5.

5. Other considerations in the regulatory financial statements

Disaggregation between England & Wales and Scotland

5.1 PR13 determined largely separate price controls for Network Rail's activities in both England & Wales and Scotland in line with separate HLOSs and 'Statements on the public Financial resources Available' ('SoFAs'). Therefore as in CP4, Network Rail's regulatory financial statements in CP5 will report separate disaggregated information on the company's financial performance in England & Wales and Scotland, as well as Great Britain as a whole. In our PR13 determination we said that there will be improvements in financial reporting for Scotland. Therefore Network Rail is required to provide better explanations for variances for Scotland in the regulatory financial statements.

Disaggregation by operating route

5.2 We saw our PR13 determination as an important facilitator and driver of industry reform – in particular through our key transformational goals. One of the key transformational goals included a more disaggregated approach – increasing transparency and access to information, facilitating greater localism, and supporting more disaggregation in the industry (for example through Network Rail devolution). Disaggregation will provide a more comparative approach to regulation and a better understanding of costs, revenues and subsidy across the sector.

5.3 We therefore require Network Rail to publish financial information showing its financial performance, subcategories of income and expenditure, RAB and debt levels by each operating route.

Disaggregation of alliances

5.4 We will also require Network Rail to present financial information on its alliances. Alliances in this context can be defined as an agreement between Network Rail and one or more train operators establishing an alliance in which those parties work jointly to carry out or otherwise share the risk of activities on a part of the network. Network Rail is required to publish both quantitative and qualitative data about alliance arrangements.

Structure for disaggregated regulatory financial statements

5.5 The structure for the regulatory financial statements for Great Britain, England & Wales, Scotland and each operating route are set out in Annex A.

Cost allocation

5.6 A high proportion of Network Rail's expenditure on operating, maintaining, renewing and enhancing the network is directly attributable to operating routes and other specific geographic areas, including Scotland. However, some of the company's costs are incurred centrally and are not directly allocated to any geographic area (e.g. information systems costs and human resources costs). Network Rail will need to allocate an appropriate share of its central costs to England & Wales and Scotland, and each operating route.

5.7 The rules Network Rail uses for these allocations need to be consistent with the high-level principles and the specific rules set out in Annex B.

Corporation tax

5.8 In our PR13 determination, we decided to take our view of Network Rail's latest forecast of CP5 opening tax balances based on our view of Network Rail's forecast efficient position at 31 March 2014 (i.e. the end of CP4), rather than use the PR08 approach. We will collect information on Network Rail's corporation tax liabilities to monitor our PR13 determination and inform future periodic reviews, as we separately fund Network Rail's corporation tax liabilities as described in our PR13 determination[73].

Opex memorandum account

5.9 As set out in our PR13 determination, Network Rail needs to include in the opex memorandum account any appropriate underspend or overspend that is required to be logged up.

5.10 This account will be reported on in Statement 10: Other information of the regulatory financial statements. For the avoidance of doubt this account is not part of the RAB and no capitalised financing is added to the account in CP5. Any adjustments to CP6 funding will be made at the next periodic review (to take effect from 1 April 2019).

Net debt and financial indicators

5.11 The purpose of the Statement 4: Net debt and financial indicators is to assess Network Rail's performance in England & Wales, Scotland and each operating route against our regulatory assumptions for net debt and the financial assumptions that underpinned our PR13 determination[74].

[73] See paragraphs 12.353 to 12.367 of our PR13 determination.

[74] For the routes, we provided indicative financial information in Annex D of our PR13 determination.

Network Rail (High Speed) Limited

5.12 HS1 Limited has contracted with Network Rail (High Speed) Limited for it to operate, maintain and renew the High Speed 1 line. Most of the resources that Network Rail (High Speed) Limited uses to carry out these activities are provided by Network Rail.

5.13 Therefore, it is important that the charges that Network Rail makes to Network Rail (High Speed) Limited are transparent and cost reflective and that there is no cross-subsidy as these costs are not remunerated through Network Rail's access charges reviews.

5.14 In order to help ensure that the charges are transparent and cost reflective, Network Rail will provide an up to date detailed description of its methodology for allocating/charging its costs to Network Rail (High Speed) Limited and will keep an up to date register of the assets that are being used to provide services to HS1 together with the methodologies used to recover the costs of those assets.

Annex A: Required statements and disclosures

Statements

Unless we say otherwise the information required by this Annex will be published in Network Rail's regulatory financial statements and covered by the audit opinion[75].

Primary regulatory financial statements (for Great Britain, England & Wales and Scotland)[76]

1. Summary regulatory financial performance - for current and prior year[77] and a cumulative total.

2. RAB analysis:

   (a) RAB (regulatory financial position) - summary of Network Rail's RAB compared to our PR13 assumption and for each year of CP5; and

   (b) RAB - reconciliation of expenditure - a reconciliation of the difference between (1) our PR13 determination assumptions for renewals and enhancements (as updated as a result of the Hendy report and any other adjustments – see paragraphs 3.16 to 3.19), (2) the RAB additions for renewals and enhancements and (3) the actual expenditure for renewals and enhancements for each year of CP5 and a cumulative total. The statement will also include a summary of the breakdown of the key elements of renewals and enhancement underspend or overspend and, as a footnote, the balance on non-capex RAB additions as well as the amount spent on innovation.

Other regulatory financial statements (for Great Britain, England & Wales and Scotland)

3. Analysis of enhancement capital expenditure - for current year and a cumulative total.

4. Net debt and financial indicators - for current year and a cumulative total.

5. Total financial performance analysis:

   (a) Total financial performance - for current year and a cumulative total;

[75] The commentaries that are included in the regulatory financial statements will be subject to a review by the auditors or independent reporters and not an audit.

[76] These statements are referred to as "primary statements" for the purposes of Condition 11.

[77] In relation to prior year we mean for years two to five of CP5, except in *Statement 1: Summary regulatory financial performance* where the comparative will also need to be included for year one. This is due to the difference in the categorisation of income and expenditure from PR08 to PR13.

(b) Renewals variance analysis - for current year and a cumulative total;

(c) Enhancement variance analysis - for current year and a cumulative total; and

(d) REBS performance - for the cumulative total. (Not required for Great Britain or England & Wales as our PR13 determination is the baseline for Scotland)

6. Analysis of income:

(a) Analysis of income - for current and prior year and a cumulative total;

(b) Analysis of other single till income - for current and prior year and a cumulative total; and

(c) Analysis of income by operator - for each year of CP5 and a cumulative total.

7. Analysis of network operations expenditure, support costs and traction electricity, industry costs and rates:

(a) Analysis of network operations expenditure, support costs and traction electricity, industry costs and rates - for current and prior year and a cumulative total;

(b) Analysis of network operations expenditure and support costs by activity - for each year of CP5;

(c) Insurance reconciliation - for current year. This regulatory financial statement will not be covered by the audit opinion but will be reviewed by the auditors; and

(d) Network operations and support costs reconciliation from gross expenditure to net expenditure - for current year and a cumulative total.

8. Analysis of maintenance expenditure:

(a) Summary - for current and prior year and a cumulative total;

(b) Summary head count by activity - for each year of CP5;

(c) Analysis of maintenance expenditure by Maintenance Delivery Unit ('MDU') - for each year of CP5. This regulatory financial statement will not be covered by the audit opinion but will be reviewed by the auditors; and

(d) Analysis of maintenance head count by MDU - for each year of CP5. This regulatory financial statement will not be covered by the audit opinion but will be reviewed by the auditors.

9. Analysis of renewals expenditure:

(a) Summary statement - for current and prior year and a cumulative total; and

(b) Detailed statement - for current year and a cumulative total.

10. Other information:

(a) Schedule 4 and 8 income and costs - for current and prior year and a cumulative total;

(b) Opex memorandum account - for current and prior year and a cumulative total;

(c) Compliance with licence limits - for current year and a cumulative total (where relevant); and

(d) Income and costs from alliances - for current year and a cumulative total.

11. Analysis of Network Rail charges to Network Rail (High Speed) Ltd for work on HS1 - for current year and a cumulative total. This regulatory financial statement will not be covered by the audit opinion but will be reviewed by the auditors.

12. Analysis of Network Rail's performance on the volume incentive - for current year and a cumulative total. This regulatory financial statement will be reviewed by the independent reporters.

13. Analysis of Network Rail's maintenance volumes, unit costs and expenditure - for current year and a cumulative total. This regulatory financial statement will be reviewed by the independent reporters.

14. Analysis of Network Rail's renewals volumes, unit costs and expenditure - for current year and a cumulative total. This regulatory financial statement will be reviewed by the independent reporters.

Note: At the moment we do not require any additional accounting information to be provided for NRIF, in addition to the information in the statutory financial statements.

Other disaggregated regulatory financial statements

The following statements should be provided on an operating route basis[78]:

1 Summary regulatory financial performance (statement 1 in the template).

2 RAB analysis (statement 2a, 2b in the template):

(a) RAB (regulatory financial position); and

(b) RAB - reconciliation of expenditure.

3 Enhancements expenditure (statement 3 in the template).

4 Debt (statement 4a in the template).

5 Total financial performance (statement 5a, 5b, 5c, 5d in the template):

(a) Total financial performance;

(b) Renewals variance analysis;

(c) Enhancement variance analysis; and

(d) REBS performance.

6 Income (statement 6a in the template).

7 Network operations expenditure, support costs, traction electricity, industry costs and rates (statement 7a in the template[79]).

8 Maintenance expenditure (statement 8a in the template).

9 Renewals expenditure (statement 9a in the template).

[78] Note: The total of the operating routes will be equal to Network Rail in total per the '*RAGs – template for CP5 regulatory financial statements'*.

[79] Net traction electricity costs should be disclosed by route.

10 Other statements (statement 10a, 10b, 10d in the template):

(a) Schedule 4 and 8 income and expense;

(b) Opex memorandum account; and

(c) Income and costs from alliances.

12 Network Rail's performance on the volume incentive (statement 12 in the template). This regulatory financial statement will be reviewed by the independent reporters.

13 Maintenance volumes, unit costs and expenditure (statement 13 in the template). This regulatory financial statement will be reviewed by the independent reporters.

14 Renewals volumes, unit costs and expenditure (statement 14 in the template). This regulatory financial statement will be reviewed by the independent reporters.

Unlike in CP4, we will no longer require (1) the analysis of maintenance expenditure and (2) the analysis of renewals expenditure statements by strategic route as they are produced based on an allocation process that Network Rail has said it can readily repeat if required.

Other required disclosures for each year

(For Great Britain and where relevant England & Wales and Scotland):

1 Supporting notes as appropriate.

2 Accounts prepared under the Companies Act 2006 (including relevant statements procured from Network Rail Infrastructure Finance PLC).

3 Reconciliations with statutory accounts, e.g. for opex, RAB and net debt.

4 Reconciliation of net debt per the regulatory financial statements with net debt per the definition in network licence Condition 3: Level of financial indebtedness.

5 Statement of adequacy of management and financial resources and the related statement confirming that Network Rail is not aware of any changes to its forecasts that would have a material effect on the forward looking financial indicators. This regulatory financial statement will not be covered by the audit opinion but will be reviewed by the auditors.

6 Statement under network licence Condition 3 in relation to the level of financial indebtedness.

7 Auditors' and independent reporters' reports.

8 Income and expenditure statements for each managed station. This information will not be published in Network Rail's regulatory financial statements or covered by the audit opinion but will be reviewed by the auditors.

9 Draft and (where available) final corporation tax computation. This information will not be published in Network Rail's regulatory financial statements or covered by the audit opinion.

10 Other (see paragraph 2.33).

Publication and audit

This Annex and the spreadsheet: 'RAGs – template for CP5 regulatory financial statements' contain details of the information for CP5 that will be published by Network Rail and covered by the audit opinion or reviewed by the independent reporters. For the avoidance of doubt, unless we say otherwise the information will be published and covered by the audit opinion or the review by the independent reporters.

Network Rail would not be required to include in the published regulatory financial statements (although the information would still be provided to us) an item where publication would or might seriously and prejudicially affect the interests of Network Rail. For this purpose Network Rail shall (except so far as we consent to Network Rail not doing so) refer for determination by us any question as to whether any such publication would or might seriously and prejudicially affect the interests of Network Rail.

Template regulatory financial statements

The template regulatory financial statements are included in the spreadsheet: 'RAGs – template for CP5 regulatory financial statements'. Unless otherwise agreed with us, monetary amounts included in the regulatory financial statements should be presented in £m to zero decimal places[80] and percentages and ratios should be presented to two decimal places.

[80] Except for *Statement 6c* for Great Britain, England & Wales and Scotland, which should be presented in £m to one decimal place.

Annex B: Guidelines for preparing the regulatory accounts

Income

1 The following guidelines should be applied when preparing the regulatory accounts.

2 Unless we agree, income will be recorded in the regulatory financial statements on the same basis as it was treated in our PR13 determination. In order to compare Network Rail's performance with the assumptions in PR13, it is necessary for Network Rail to prepare its regulatory financial statements on a basis that is consistent with our PR13 determination.

3 In certain cases the income will be presented differently in Network Rail Infrastructure Limited's statutory accounts in order to comply with financial reporting standards. For the avoidance of doubt, it is for Network Rail to decide what information it includes in its statutory accounts.

4 In the event that the basis of allocating income between any of the sub-categories changes, the change should be disclosed in the narrative to the regulatory financial statements.

5 Network Rail is required to analyse its income on a basis that is consistent with the categorisation used in our PR13 determination.

6 Total income consists of franchise access income, grant income, rebates and other single till income.

7 Other single till income, includes the following types of income:

(a) property income - revenue generated from the licensee's non-operational property portfolio, including the proceeds of disposals and any adjustments for commercial operational expenditure. This includes income from investment schemes such as shared value[81], hypothecated gains[82] and development gains[83] and income from these investment schemes need to be disclosed separately;

[81] Shared value is where Network Rail takes a share of the gains generated by a development which benefits from access rights to its land. In general, the uplift in value from a shared value scheme will take the form of additional revenue to Network Rail, and/or a corresponding increase in the value of Network Rail's assets. If there is a demonstrable increase in the value of Network Rail's assets, the value of this increase would be eligible in principle

(b) freight income - net income from track access charges paid by freight train operators and coal spillage charges;

(c) open access income - net income from track access charges paid by passenger train operators not operating under any form of franchise agreement;

(d) stations income - net income from station access agreements (for managed stations and franchised stations);

(e) depots income - net income from depot access agreements;

(f) finance and facility charges;

(g) income from HS1 (profits);

(h) insurance recharges income; and

(i) other - other single till income generated by the licensee from sources other than those described above. For the avoidance of doubt it does not include investment income.

8 The templates for the analysis of income are shown in *Statement 6a: Analysis of income*, *Statement 6b: Analysis of other single till income* and *Statement 6c: Analysis of income by operator*.

Expenditure

General

9 The following guidelines should be applied when preparing the regulatory financial statements.

10 Unless we agree, expenditure will be recorded in the regulatory financial statements on the same basis as it was treated in our PR13 determination.

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for addition to the RAB, assuming that the additional revenue from the scheme was sufficient to cover the additional return on the RAB and that the increase meets our criteria for efficiency.

[82] Where a developer offers to carry out an enhancement in return for, for instance, acquiring Network Rail land for development is hypothecated gains. In order to provide incentives on Network Rail to seek further gains where appropriate, a proportion of any hypothecated gains over and above the forecast in our PR13 determination will be eligible for addition to Network Rail's RAB.

[83] Development gains are gains other than gains from shared value or hypothecated gains.

11 In the event that there has been a material change to the basis of allocating expenditure between any of the sub-categories, the change should be disclosed in the narrative to the regulatory financial statements.

Network operations expenditure, support costs and traction electricity, industry costs and rates

12 This category will include total network operations expenditure, support costs and traction electricity, industry costs and rates consistent with our PR13 determination. Support costs will include Network Rail Insurance Limited's total profit/loss from operations. Details of Network Rail Insurance Limited's total profit/loss from operations, investment revenues, finance costs, profit/loss before tax, tax and profit/loss for the year attributable to equity shareholders will be provided in a note to Network Rail's regulatory financial statements (under statement 7c).

13 Unless we agree otherwise, the definitions of activities - e.g. the definition of HR - are per Network Rail's PR13 submissions.

14 The templates for the analysis of network operations expenditure, support costs and traction electricity, industry costs and rates are shown in *Statement 7a: Analysis of network operations expenditure, support costs and traction electricity, industry costs and rates, Statement 7b: Analysis of network operations expenditure and support costs by activity, Statement 7c: Insurance reconciliation* and *Statement 7d: Network operations expenditure and support costs reconciliation from gross expenditure to net expenditure*.

Maintenance

15 Maintenance expenditure relates to activities that counter the wear, degradation or ageing of the existing infrastructure so that the required standard of performance is achieved.

16 Maintenance expenditure generally includes:

(a) expenditure incurred in repairing (but not replacing) infrastructure assets and routine over-hauls;

(b) the cost of preventative work designed to protect assets from future failure;

(c) the cost of asset inspection; and

(d) the cost of all small-scale replacement work excluded from the definition of renewals expenditure.

17 The templates for this analysis are shown in *Statement 8a: Summary analysis of maintenance expenditure, Statement 8b: Summary analysis of maintenance headcount by activity, Statement 8c: Analysis of maintenance expenditure by MDU and Statement 8d: Analysis of maintenance headcount by MDU*.

Renewals expenditure

18 Renewals expenditure relates to activities where an existing infrastructure asset has deteriorated so that it can no longer be maintained economically but has to be replaced as a whole or in part. Such expenditure does not result in any change or enhancement of the performance of the original asset.

19 Network Rail's reactive maintenance expenditure (excluding structures inspections) on structures and operational property should be categorised as maintenance expenditure in order to be consistent with the treatment adopted in our PR13 determination. This includes reactive maintenance expenditure (excluding structures inspections) on:

(a) underbridges, overbridges, footbridges, earthworks, coastal and estuarial defences, culverts, retaining walls and tunnels; and

(b) stations, depots and lineside buildings.

20 The templates for this analysis are shown in *Statement 9a: Summary analysis of renewals expenditure* and *Statement 9b: Detailed analysis of renewals expenditure*.

Enhancements

21 Enhancement expenditure is defined as capital expenditure, usually involving engineering work, which improves capacity or capability (e.g. allowing heavier loads on the track) relative to the current state of the network. Usually outputs are required at specific times (in contrast to most renewals) because they are often linked to wider railway improvements, such as the introduction of longer trains.

22 Enhancement expenditure is reported separately as shown in *Statement 3: Analysis of enhancement capital expenditure*.

High-level principles

23 The high-level principles that Network Rail needs to use when preparing its regulatory financial statements are:

(a) **Causality.** Income and costs should be allocated in relation to the activities which cause the income to be earned or the costs to be incurred;

(b) **Objectivity.** The regulatory financial statements will be prepared without unduly prejudicing Network Rail or any part of Network Rail or any other entity;

(c) **Consistency.** Where practical, the regulatory financial statements should be prepared on a consistent basis from year to year and when there are changes to the Guidelines, Network Rail should restate the previous year's regulatory financial statements; and

(d) **Transparency.** All the methods used to prepare the regulatory financial statements including the methods used to allocate income and costs between each operating route should be transparent.

Disaggregated operating route accounting principles

24 Network Rail's disaggregated operating route regulatory financial statements will be covered by the audit opinion or the independent reporter's report. In preparing these regulatory financial statements, Network Rail will need to follow our high-level principles as set out in paragraph 23 and Network Rail will need to explain to us any material changes in the approach that it takes to allocate income and expenditure between operating routes.

25 Network Rail's income and expenditure are classified into the following three main categories dependent upon how the items are managed:

(a) directly attributed - route managed. Income and expenditure in this category is currently managed at route level, e.g. signallers. As there is alignment between management responsibility and the route, such items are relatively straightforward to account for at a route level;

(b) centrally managed - attributable to routes. Income and expenditure in this category is not currently managed at a route level, e.g. route based teams managed outside of the operations and maintenance functions. However, even though the management responsibility may not be locally based the income is earned and costs are incurred locally, so attributing these items to routes should be relatively straightforward. The main issue is likely to be that some maintenance and renewals projects cover more than one route or are network-wide, so some apportionment may be required for cross-route/network-wide projects; and

(c) centrally managed - network wide. Income and expenditure in this category is incurred for the whole network or company as a whole, e.g. insurance costs. These items can only be allocated to a route by apportioning the income and expenditure across the routes.

26 Network Rail has said that direct attributed - route managed income and expenditure includes:

(a) TOC fixed track access income (although it needs to be allocated from TOC to route);

(b) TOC variable track access income;

(c) managed stations income (non-retail);

(d) signallers;

(e) route management team (customer relationship executives and route enhancement managers etc.);

(f) managed stations operations & maintenance costs;

(g) other operations costs;

(h) maintenance delivery units;

(i) other maintenance costs of the main asset types, e.g. track, signalling, telecoms, electrification and plant and machinery;

(j) route maintenance teams;

(k) national delivery service - operations delivery;

(l) asset management - inspections and information collection;

(m) renewals and enhancements projects that are specific to a region or where costs can be allocated to a number of routes; and

(n) route based support functions such as finance and human resources.

27 Network Rail has said that centrally managed - attributable to routes income and expenditure includes:

(a) income - station retail, property rent and property development and sales;

(b) traction electricity (income and cost);

(c) maintenance - operational telecoms contracts;

(d) certain renewals and enhancements (although some apportionment may be required for cross-route/network-wide projects); and

(e) national delivery service - stock management and rail grinding.

28 Network Rail has said that centrally managed - network wide income and expenditure includes:

(a) operations and customer services - train planning, performance analysis, HQ operations & customer services and stations development;

(b) property - offices & accommodation;

(c) maintenance - property (including operational and non-operational) and structures maintenance and HQ Maintenance teams;

(d) asset management - engineering strategies & policies, CP6 planning and business improvement;

(e) national delivery service - management team and fleet maintenance;

(f) corporate services - finance (non-route based), human resources (non-route based), information management & corporate development, planning and regulation, legal and board and government & corporate affairs;

(g) central - insurance and property and support recharges to projects; and

(h) renewals and enhancements relating to assets that cover the entire network (e.g. IM).

29 The grouping of the above income and costs into the different types above could change, if we agree, as Network Rail refines its methods of preparing the regulatory financial statements for each operating route.

Annex C: Condition 3 and 11 of Network Rail's network licence

Condition 3: Financial indebtedness

Extracted from Network Rail's network licence:

3.1 Except with the written consent of ORR, the licence holder shall use reasonable endeavours to ensure that at any time the amount of financial indebtedness of:

(a) the licence holder;

(b) Network Rail Infrastructure Finance PLC; and

(c) any subsidiaries of the licence holder or Network Rail Infrastructure Finance PLC

does not exceed the limits set out in Table 3.1. The limits on financial indebtedness are expressed in Table 3.1 as a percentage of the Value of the RAB.

Table 3.1: Restrictions on the ratio of financial indebtedness to the Value of the RAB

Financial year	Limit
2014-15	*75%*
2015-16	*75%*
2016-17	*75%*
2017-18	*75%*
2018-19	*75%*

3.2 The limit in Table 3.1 which applies in 2018-19 shall also apply to each subsequent financial year unless ORR determines different limits following consultation with the licence holder.

3.3 If at any time the total amount of financial indebtedness of the licence holder, any subsidiaries of the licence holder, Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance exceeds the limit set out in Table 3.1 applicable to that financial year the licence holder shall, within such time period as ORR may notify as being appropriate in the circumstances:

(a) provide to ORR details of the steps it intends to take to reduce the amount to that limit or below;

(b) take those steps; and

(c) provide to ORR evidence that it has taken those steps.

3.4 The licence holder shall:

(a) provide, from time to time as requested by ORR and in any event every year in the regulatory financial statements the licence holder prepares pursuant to condition 11, confirmation that, in respect of the financial year to which the statements relate, it has complied, and, in respect of the following financial year, it is not aware of any circumstances which will prevent it complying and it is likely to comply, with condition 3.1 and (where applicable) condition 3.3 and, if so requested by ORR, evidence in support of that confirmation; and

(b) notify ORR immediately in writing if at any time the licence holder becomes aware of any circumstance that means it is no longer complying, or that causes it no longer to have the reasonable expectation that it is likely to comply, with condition 3.1 and (where applicable) condition 3.3.

3.5 Except with the written consent of ORR the licence holder shall pay the Secretary of State, at least annually, a fee in respect of the state financial indemnity.

3.6 In this condition:

"financial indebtedness"	means the sum of: (a) all financial liabilities arising from all transactions (including any forward sale or purchase agreement) which have the commercial effect of a borrowing; (b) any counter-indemnity obligation in respect of any guarantee, indemnity, bond, letter of credit or any other instrument issued by a bank or financial institution; and (c) any guarantee, indemnity or similar assurance against financial loss of any person in respect of any item referred to in paragraph (a); less (d) cash and cash equivalents which are assets or investments that are held for the purpose of meeting short-term cash commitments or other investments with a maturity of twelve months or less for the purpose of pre-funding the repayment of financial indebtedness. For the purposes of this condition: (a) financial indebtedness excludes:

(i) any financial indebtedness between the licence holder or any of the licence holder’s subsidiaries and Network Rail Infrastructure Finance or any of Network Rail Infrastructure Finance’s subsidiaries;

(ii) any financial indebtedness between the licence holder and any of its subsidiaries;

(iii) any financial indebtedness between any of the licence holder’s subsidiaries;

(iv) any financial indebtedness between Network Rail Infrastructure Finance and any of its subsidiaries; and

(v) any financial indebtedness between any of Network Rail Infrastructure Finance’s subsidiaries;

(b) financial indebtedness is:

(i) calculated by reference to the principal amount outstanding of any such financial indebtedness (and no mark to market value will be used to calculate its amount); and

(ii) measured as specified in the regulatory accounting guidelines, issued in accordance with condition 11, in force at the applicable time;

(c) where financial indebtedness denominated in a foreign currency is hedged by a foreign currency derivative transaction protecting against or benefiting from fluctuations in foreign exchange rates, the principal amount outstanding shall be calculated by reference to the sterling amount payable under the relevant derivative;

"Network Rail Infrastructure Finance"	has the meaning given to it by condition 4.32;
"state financial indemnity"	means the financial indemnity provided by the Strategic Rail Authority on 29 October 2004 (and transferred to the Secretary of State on 26 June 2005), which is available until 2052; and
"Value of the RAB"	means the value of the licence holder's assets calculated in accordance with the regulatory accounting guidelines, issued in accordance with condition 11, in force at the applicable time.

Guidance for the calculation of net debt for Network Rail's network licence Condition 3: Level of financial indebtedness

1. Network Rail's network licence condition 3: Level of financial indebtedness places limits on the levels of Network Rail's financial indebtedness. The following guidance applies.

2. Unless we otherwise agree, with the exception of the requirements of Network Rail's network licence condition 3: Level of financial indebtedness, the measurement of the liabilities, assets or investments for the purpose of that condition will be in accordance with

the measurement of the liabilities, assets or investments for the purposes of Network Rail's Companies Act 2006 accounts.

3. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of change in value.

4. Licence condition 3: Level of financial indebtedness uses a purposive type of definition of financial indebtedness. It is also useful to clarify what we mean by financial indebtedness by providing some specific examples of financial instruments that would be included in the definition. These examples are set out in the following paragraph.

5. Financial instruments that would be included as financial indebtedness include:

(a) moneys borrowed;

(b) any acceptance credit;

(c) any bond, note, debenture, loan stock or other similar instrument;

(d) collateral;

(e) working capital facilities;

(f) gilt locks;

(g) any redeemable preference share;

(h) any finance or capital lease;

(i) any foreign currency derivative transaction protecting against or benefiting from fluctuations in foreign exchange rates;

(j) any counter-indemnity obligation in respect of any guarantee, indemnity, bond, letter of credit or any other instrument issued by a bank or financial institution; and

(k) any guarantee, indemnity or similar assurance against financial loss of any person in respect of any item referred to in paragraphs (a) to (i) above.

Condition 11: Regulatory accounts

Extracted from Network Rail's network licence:

Purpose

11.1 The purpose of this condition 11 is to procure the provision of annual information on the financial performance and financial position of the licence holder, Network Rail Infrastructure Finance and any subsidiaries of Network Rail Infrastructure Finance which:

(a) is relevant to ORR and other persons for the assessment and determination of the licence holder's access charges; and

(b) allows the financial performance and financial position of the licence holder to be monitored against the Determination Assumptions.

General duty

11.2 To achieve the purpose in condition 11.1, the licence holder shall prepare regulatory financial statements in relation to itself and, unless ORR otherwise consents, to Network Rail Infrastructure Finance in accordance with the following paragraphs of this condition 11 and any Regulatory Accounting Guidelines from time to time issued by ORR.

11.3 The licence holder shall, and shall procure that any affiliate or related undertaking of the licence holder and Network Rail Infrastructure Finance shall, maintain such accounting records, other records and reporting arrangements as are necessary to enable the licence holder to properly prepare the regulatory financial statements required by condition 11.2. The licence holder shall maintain all systems of control and other governance arrangements that ensure the information collected and reported to ORR is in all material respects accurate, complete and is fairly presented and that all control and other governance arrangements are kept under regular review by the directors of the licence holder so that they remain effective for this purpose.

Specific obligations

11.4 The financial statements referred to in condition 11.2:

(a) shall be prepared in respect of the financial year ended 31 March 2002 and (save as otherwise provided in this condition 11 or the Regulatory Accounting Guidelines) on a consistent basis in respect of each financial year;

(b) shall be prepared such that, so far as is reasonably practicable, the definition of items in primary statements; the valuation of assets and liabilities; the treatment of income and expenditure as capital or revenue; adjustments in respect of the provision, utilisation, depreciation and amortisation of assets and liabilities; and any other relevant accounting policies shall be consistent with:

(i) ORR's valuation of the Regulatory Asset Base for the purpose of determining access charges for the access review periods specified in the Regulatory Accounting Guidelines; and

(ii) the Determination Assumptions for the access review periods specified in the Regulatory Accounting Guidelines;

(and so that where the presentation of an item in the primary statements departs from the basis for the Regulatory Asset Base or the Determination Assumptions, a reconciliation shall be included by way of a note);

(c) shall include, as a primary statement, a statement of regulatory financial performance comparing income and expenditure, for the access review periods specified in the Regulatory Accounting Guidelines with the Determination Assumptions;

(d) shall include all details reasonably necessary to reconcile items included in the primary statements with any corresponding items in annual statutory accounts for the access review periods specified in the Regulatory Accounting Guidelines; and

(e) shall include narrative explaining the material variances from the previous year and from the Determination Assumptions.

Sufficiency of resources

11.5 The licence holder shall make a statement, which shall be approved by a resolution of the board of directors of the licence holder and signed by a director of the licence holder pursuant to that resolution, certifying the adequacy (or otherwise) of the management and financial resources, personnel, fixed and moveable assets, rights, licences, consents and facilities of the licence holder for the period of 12 months commencing on the date of the statement.

11.6 The statement made under condition 11.5 shall be in one of the following forms:

either:

(a) “After making enquiries, and subject to the outcome of any access charges review which is due to be concluded within the 12 month period referred to in this statement, the directors of the licence holder have a reasonable expectation that the licence holder will have available to it, after taking into account in particular, but without limitation:

(i) any dividend or other distribution, loan repayments or other sums due which might reasonably be expected to be declared or paid by the licence holder;

(ii) any mortgage, charge, pledge, lien or other form of security or other encumbrance; and

(iii) any indebtedness or guarantee;

sufficient resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents, and facilities, on such terms and with all such rights, to enable the licence holder to: (a) properly and efficiently carry on the Permitted Business; and (b) comply in all respects with its obligations under the Act and under its network licence, for the period of 12 months referred to in this statement."

or:

(b) "After making enquiries, and subject to the outcome of any access charges review which is due to be concluded within the 12 month period referred to in this statement, the directors of the licence holder have a reasonable expectation, subject to the factors set out below, that the licence holder will have available to it, after taking into account in particular, but without limitation:

(i) any dividend or other distribution, loan repayments or other sums due which might reasonably be expected to be declared or paid by the licence holder;

(ii) any mortgage, charge, pledge, lien, or other form of security or other encumbrance; and

(iii) any indebtedness or guarantee,

sufficient resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents, and facilities, on such terms and with all such rights, to enable the licence holder to: (a) properly and efficiently carry on the Permitted Business; and (b) comply in all respects with its obligations under the Act and under its network licence, for the period of 12 months referred to in this statement. However, they would like to draw attention to the following factors which may cast doubt on the ability of the licence holder to do this."

or:

(c) “In the opinion of the directors of the licence holder, the licence holder will not have available to it sufficient resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents, and facilities, on such terms and with all such rights, to enable the licence holder to: (a) properly and efficiently carry on the Permitted Business; and (b) comply in all respects with its obligations under the Act and under its network licence, for the period of 12 months referred to in this statement.”

11.7 The licence holder shall submit to ORR details of the main factors which the directors of the licence holder have taken into account in making the statement under condition 11.5 and the information specified in the Regulatory Accounting Guidelines. In the case of a statement of the kind contemplated by condition 11.6(b) the licence holder shall also submit with the statement a description of the factors which may cast doubt on the ability of the licence holder to carry on the activities authorised by this licence.

11.8 The licence holder shall -

(a) notify ORR in writing immediately if its directors become aware of any circumstance that causes them no longer to have the reasonable expectation expressed in the most recent statement made under condition 11.5 in the forms set out in condition 11.6; and

(b) subject to complying, as if it were a company whose ordinary shares are for the time being admitted to the Official List of the UK Listing Authority, with the listing rules of the Financial Services Authority acting in its capacity as a competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000, publish its notification to ORR in such form and manner as ORR may direct. This notification will include the information specified in the Regulatory Accounting Guidelines in relation to the operation of the re-opener provisions.

Regulatory Accounting Guidelines

11.9 ORR may from time to time issue Regulatory Accounting Guidelines, which may:

(a) further specify the accounting policies, format and content of the financial statements and the matters to be shown or reported in them;

(b) provide for appropriate segmental analysis and/or further breakdown of any items contained in the financial statements;

(c) provide for specification or description of any transactions or arrangements between the licence holder and any affiliate or related undertaking (including, without limitation, so as to enable ORR to monitor compliance with the conditions of this licence);

(d) further include provision requiring the licence holder to prepare and publish information in respect of proposed enhancements which the licence holder shall log up as enhancement expenditure, and annually, information on those enhancements actually made; and

(e) specify the provision and/or publication of such other information as ORR may reasonably require in order to monitor the licence holder's financial performance and financial position or assist in the determination of the licence holder's access charges.

Auditors

11.10 The licence holder shall procure a report by the Auditors addressed to ORR:

(a) stating whether, in their opinion, the regulatory financial statements (other than those referred to in condition 11.10(c)) and information on proposed enhancements have been prepared in accordance with this condition, including Regulatory Accounting Guidelines;

(b) stating whether, in their opinion, the regulatory financial statements present fairly the financial performance and financial position of the licence holder and (to the extent that they relate to Network Rail Infrastructure Finance) of Network Rail Infrastructure Finance in accordance with this condition and any Regulatory Accounting Guidelines; and

(c) stating whether the information on enhancement expenditure produced in accordance with condition 11.9(d) has been prepared in accordance with the Regulatory Accounting Guidelines and is consistent with such expenditure presented in the primary financial statements.

11.11 Each statement made under condition 11.5 shall be accompanied by a report prepared by the Auditors and addressed to ORR, stating whether the Auditors are aware of any inconsistencies between that statement and any supporting statements and either the financial statements referred to in condition 11.2 or any information which the Auditors obtained in the course of their audit work for the licence holder and, if so, the report of the auditors should state what the inconsistencies are.

11.12 The licence holder shall enter into a contract of appointment with the Auditors which shall include a term that the Auditors will provide such further explanation or clarification of their reports and such further financial information in respect of the matters which are the subject of their reports as ORR may reasonably require for the exercise of its functions, including, in relation to monitoring, compliance by the licence holder with the conditions of this licence.

Publication and provision of information

11.13 The licence holder shall deliver to ORR a copy of the financial statements together with any information provided for in the Regulatory Accounting Guidelines, the Auditors' report referred to in condition 11.10 and the statement referred to in condition 11.5 as soon as reasonably practicable and in any event not later than 1 July following the end of the financial year to which they relate (or a later date approved by ORR). The financial statements, information, the Auditors' report referred to in condition 11.10 and the statement referred to in condition 11.5, subject to any modifications approved by ORR, (including the deletion of any information the publication of which ORR is satisfied would or might seriously and prejudicially affect the interests of the licence holder or any other person), shall be published within one calendar month of delivery to ORR and then made available to any member of the public on request.

11.14 With a view to enabling the licence holder to comply with its obligations under condition 11.2, the licence holder shall, unless ORR otherwise consents, procure from Network Rail Infrastructure Finance a legally enforceable undertaking or undertakings in favour of the licence holder which shall require Network Rail Infrastructure Finance to prepare and give to the licence holder financial statements in relation to Network Rail Infrastructure Finance and its subsidiaries in such a form and covering such periods as may be specified in any Regulatory Accounting Guidelines from time to time issued by ORR.

11.15 The licence holder shall:

(a) deliver to ORR evidence (including a copy of all such undertakings) that the licence holder has complied with the obligation to procure any undertaking pursuant to condition 11.14;

(b) inform ORR immediately in writing if the directors of the licence holder become aware that any undertaking procured pursuant to condition 11.14 has ceased to be legally enforceable or that its terms have been breached; and

(c) comply with any direction from ORR to enforce any of the undertakings procured pursuant to condition 11.14.

11.16 In this condition:

"Auditors"	means the person appointed by the licence holder for the purpose of reporting on the regulatory financial statements

	referred to in this condition 11;
"Determination Assumptions"	means any assumptions (including their definitions and bases of measurement) from time to time notified to the licence holder by ORR as assumptions that have been used for determining access charges;
"Network Rail Infrastructure Finance"	has the meaning given to it by condition 4.32;
"Regulatory Accounting Guidelines "	means any guidelines issued by ORR from time to time in accordance with condition 11.9;
"Regulatory Asset Base"	means the value of the licence holder for regulatory purposes.

Annex D: Regulatory good practice

1. Other UK sector regulators require the companies they regulate to prepare annual regulatory financial statements and provide other information. This requirement is usually contained within the licences of the regulated companies. We have taken due account of good practice from other sectors in preparing these Guidelines.

2. The Department of Trade and Industry's ('the DTI's') Green Paper on utility regulation, A Fair Deal for Consumers published in 1998, suggested that there would be benefits if regulated companies were to produce more standardised regulatory financial statements. In particular this would facilitate wider understanding of regulatory issues. Following the Green Paper, an inter-regulatory working group on regulatory financial statements was set up to identify and develop areas of consistency within published regulatory financial statements. These Guidelines have been designed, in so far as possible, to adopt the set of common regulatory accounting principles agreed by the working group.

3. The main elements of these high-level principles are:

   a) regulatory financial statements will be prepared and audited using the common regulatory accounting framework devised by the working group. Where there are any conflicts between Regulatory Accounting Guidelines and any other Generally Accepted Accounting Practice, then the Regulatory Accounting Guidelines will take precedence;

   b) where practical, there will be consistency between the formats of the regulatory financial statements used in the industries regulated by the members of the working group;

   c) where appropriate, actual performance will be compared to the assumptions underlying price controls;

   d) the requirements for the audit of the regulatory financial statements will become more clearly defined (this is described in more detail in Chapter 2); and

e) regulatory financial statements will be published no later than four months after the regulatory accounting year end; and, where appropriate, the regulatory financial statements will include additional information that will enhance understanding of the regulated companies' performance.

4. Each regulator has a different emphasis in developing regulatory accounting arrangements depending on the structure of the industry that it regulates. Where there are significant differences between regulators, these derive primarily from the structure of the industry rather than from differences of principle.

5. For example, in the telecommunications industry, regulatory accounting arrangements are designed to reflect the development of competition and the importance of monitoring and detecting anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination. In areas where there is currently little competition between networks, such as water and sewerage, the focus is on ensuring that regulatory accounting arrangements provide consistent and transparent financial information in order to monitor performance and support the resetting of price controls.

Annex E: Worked examples of the AMEM and Data quality adjustments to financial performance

1. Annex E provides worked examples of how the methods of adjusting financial performance would be calculated for AMEM and Data quality.

Asset Management Excellence Model (AMEM)

2. A total value (£20m) is placed upon Network Rail improving from its PR13 SBP position to its PR18 SBP targets (see columns 1-3, Table E.2). The total value is then related to the gap between current scores and targets in a weighted manner, placing greater significance on the scores that are further from their target (the weighting factors are given in Table E.1). The weighted contributions of each category (see column 5, Table E.2) are then summed to form a weighted total gap to target of 88 points. Each weighted point is therefore valued at $£\,{}^{20}\!/_{88}\,m$.

Table E.1: AMEM weighting bands

Score	Weighting
<64	3x
64-68	2x
68-70	1x
70-72	Nil (if outturn score is in this range and all reasonably practicable steps have been taken to achieve 72%) 1x in all other cases

Table E.2: AMEM scoring system

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5
AMEM category	**Score at PR13 SBP**	**Target for PR18 SBP**	**Unweighted contribution** **(col 3 – col 2)**	**Weighted contribution**
1 - Asset management strategy & planning	65.8	72.0	6.2	(68.0 - 65.8) = 2.2 (72.0 - 68.0) = 4.0 **Multiplying by weighting:** 2.2x2 + 4x1 = **8.4**
2 - Asset management decision making	58.7	72.0	13.3	(64.0 - 58.7) = 5.3 (68.0 - 64.0) = 4.0 (72.0 - 68.0) = 4.0 **Multiplying by weighting:** 5.3x3 + 4x2 + 4x1 = **27.9**
3 - Lifecycle delivery activities	69.2	72.0	2.8	(72.0 - 69.2) = 2.8 **Multiplying by weighting:** 2.8x1 = **2.8**
4 - Asset knowledge enablers	60.7	72.0	11.3	(64.0 - 60.7) = 3.3 (68.0 - 64.0) = 4.0 (72.0 - 68.0) = 4.0 **Multiplying by weighting:** 3.3x3 + 4x2 + 4x1 = **21.9**

5 - Organisation & people enablers	67.3	72.0	4.7	(68.0 - 67.3) = 0.7 (72.0 - 68.0) = 4.0 **Multiplying by weighting:** 0.7x2 + 4x1 = **5.4**
6 - Risk & review	60.8	72.0	11.2	(64.0 - 60.8) = 3.2 (68.0 - 64.0) = 4.0 (72.0 - 64.0) = 4.0 **Multiplying by weighting:** 3.2x3 + 4x2 + 4x1 = **21.6**
Total weighted gap to target				**88.0**

3. At PR18, if a score falls below target, then the gap to target is calculated in weighted points, and multiplied by $£\,{}^{20}\!/_{88}\,m$ to determine the financial adjustment to be applied for that category. If there were no improvement over the whole of CP5, then the financial adjustment would be $88 \times £\,{}^{20}\!/_{88}\,m = £20m$. For the avoidance of doubt, if the score is equal to or above 72%, there is no allowance for outperformance of outputs, i.e. if a score above 72 per cent is achieved, then no positive adjustment is made.

4. Worked example – AMEM.

Table E.3: AMEM worked example

AMEM category	PR18 SBP Score	Weighted gap to target	Financial adjustment (fraction)	Financial adjustment
1 - Asset management strategy & planning	71.8	0.2x1 = **0.2**	-*	-*

2 - Asset management decision making	66.3	1.7x2 + 4x1 = **7.4**	7.4/88 x £20m	8.4% of £20m = £1.7m
3 - Lifecycle delivery activities	75.8	Exceeds target	-	-
4 - Asset knowledge enablers	68.2	3.8x1 = **3.8**	3.8/88 x £20m	4.3% of £20m = £0.9m
5 - Organisation & people enablers	73.2	Exceeds target	-	-
6 - Risk & review	70.4	1.6x1 = **1.6**	-*	-*
Absolute total		**13.0**		
Total after accounting for uncertainty (reduced for scores that fall in the 70-72% range)		**11.2** (13.0 - 0.2 - 1.6)	11.2/88 x £20m	12.7% of £20m = £2.5m

* The adjustment is nil if the outturn is in the range 70%-72% and Network Rail demonstrates all reasonable steps have been taken to achieve the 72% target, to allow for inherent uncertainties in the assessment process.

Data Quality

5. The adjustment methodology for data quality is similar to that for AMEM, except that scores are quoted discretely (e.g. A3) rather than on a continuous scale (e.g. 73.7%); there are four primary asset groups, each composed of a varying number of sub-categories; and there is no allowance made for uncertainty in the scoring methodology.

6. A total value ($£20m$) is placed upon Network Rail improving from its PR13 SBP[84] position (see Table E.5) to its PR18 SBP target of A2 for every asset. The total value is evenly split between the four primary asset groups, i.e. each asset group is exposed to 25% of $£Dm$, and further split within an asset group to produce a percentage exposure at the sub-category level (see column 3, Table E.5).

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Table E.4: Data Quality Weighting bands

Score	Weighting
B4, A5, B5, B6, A6	6
B3, A4	3
A3,B2	1
A2, A1, B1	0

Table E.5: Data quality scoring system

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6
Primary asset group	**Sub-category**	**% exposure to £20m**	**PR13 grade**	**PR13 numerical score**	**Weighted contribution (Col.3 x Col.5)**
Track	Plain Line	12.5%	B3	3	0.375
	Switches & Crossings	12.5%	B3	3	0.375
Signalling	Interlockings	5.00%	A2	0	-
	Signals	5.00%	A3	1	0.05
	Train Detection Equipment	5.00%	A3	1	0.05
	Point Operating Equipment	5.00%	A3	1	0.05
	Level Crossings	5.00%	A2	0	-
Electrical	Telecoms	4.17%	B4*	6	0.252

power & telecoms	High Voltage Switchgear	4.17%	B4*	6	0.252
	Transformers	4.17%	B4*	6	0.252
	Overhead Line Equipment	4.17%	B2	1	0.042
	Conductor Rail	4.17%	B4	6	0.252
	High Voltage Cables	4.17%	B4*	6	0.252
Civils & buildings	Buildings	6.25%	B1	0	-
	Underline Bridges	6.25%	B5	6	0.375
	Overline Bridges	6.25%	B5	6	0.375
	Earthworks	6.25%	B4*	6	0.375
Total weighted contribution					3.327

* Note that at the time of the PR13 SBP there were 5 sub-categories that had not had their scores evaluated, and for the purposes of this calculation they are all assumed to be at B4.

7. The sub-category discrete scores are converted into numerical scores (see Table E.4) which are bigger the further they are from target. The score and the exposure are then multiplied to produce a weighted contribution for each sub-category (column 6, Table E.5). The value of each “weighted point” is therefore $£\,{}^{20}\!/_{3.327}\,m$.

8. At the PR18 SBP, any sub-category score that falls below A2 will trigger a financial adjustment equal to the new weighted score for that category, multiplied by the value per weighted point of $£\,{}^{20}\!/_{3.327}\,m$. For the avoidance of doubt, if the score is equal to or above A2, there is no allowance for outperformance of outputs, i.e. if a score above A2 is achieved, then no positive adjustment is made.

9. Worked example – Data quality. In this worked example, it has been assumed that the grade for each sub-category will improve to a minimum of A3, with no improvement in grades already at A3 or higher

Table E.6: Data quality worked example

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7
Primary asset group	**Sub-category**	**% exposure to £20m**	**PR18 SBP grade (April 2017)**	**PR18 SBP numeri-cal score (April 2017)**	**Weighted score (Col.3 x Col. 5)**	**Financial adjustment (as a % of £20m) (Col.6 x 3.327)**
Track	Plain Line	12.50%	A3	1	0.125	3.8%
	Switches & Crossings	12.50%	A3	1	0.125	3.8%
Signalling	Interlockings	5.00%	A2	0	-	-
	Signals	5.00%	A3	1	0.05	1.5%
	Train Detection Equipment	5.00%	A3	1	0.05	1.5%
	Point Operating Equipment	5.00%	A3	1	0.05	1.5%
	Level Crossings	5.00%	A2	0	-	-
Electrical power & telecoms	Telecoms	4.17%	A3	1	0.042	1.3%
	High Voltage Switchgear	4.17%	A3	1	0.042	1.3%
	Transformers	4.17%	A3	1	0.042	1.3%
	Overhead Line Equipment	4.17%	A2	0	-	-
	Conductor Rail	4.17%	A3	1	0.042	1.3%

	High Voltage Cables	4.17%	A3	1	0.042	1.3%
Civils & buildings	Buildings	6.25%	A1	0	-	-
	Underline Bridges	6.25%	A3	1	0.063	1.9%
	Overline Bridges	6.25%	A3	1	0.063	1.9%
	Earthworks	6.25%	A3	1	0.063	1.9%
Total weighted contribution					0.798	**24.0% of £20m = £4.8m**

Annex F: ORBIS Milestones

1. Annex F details the ORBIS milestones and the target dates according to our PR13 determination.

Table F.1: ORBIS Milestones and target dates

Capability	Milestone description	Date
Track Linear Asset Decisions Support (LADS) will bring together disparate track data sources to enable NR to target work more efficiently	National roll-out complete	May-14
Signalling Signalling Decision Support (SDS) will bring together disparate signalling data sources to enable NR to target work more efficiently	Data specification complete, including for core data	Jan-15
	National roll-out complete	Sep-15
Electrification & Plant Electrification & Plant Decision Support (E&PDS) will bring together disparate E&P data sources to enable NR to target work more efficiently	Data specification complete, including for core data	Apr-15
	National roll-out complete	Dec-15
Structures Ellipse replaces CARRs (Civils Asset Register & Reporting system) as the master system for Civils Structures	Data specification complete, including for core data	Jun-14
	Asset hierarchies established and Ellipse designated as master system for Civils	Jun-16
GEOGIS decommissioned	GEOGIS will be replaced by strategic Asset Management Platform systems	Dec-16
Handheld - Fault and incident data capture app roll-out complete	The new app will allow maintenance staff to enter fault data into handheld devices and for this to be electronically transmitted to control centre staff	Aug-14

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Any enquiries regarding this publication should be sent to us at contact.cct@orr.gsigov.uk