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28 September 2012

Dear Cathryn

ORR's Output and Financial Issues Consultations

I am writing in response to ORR's output and financial issues consultations, published on 1 August. We welcome the opportunity to respond and debate the issues set out in these documents. As you will be aware we have already written regarding a number of these issues earlier this year.

The issues raised in these consultations are fundamental to our ability to work with the rest of the industry to deliver improved service and value for rail users. In our view it is essential that the periodic review improves the clarity and simplicity of the regulatory regime, and reinforces the ability of management throughout the industry to make the right decisions and improve efficiency. We therefore welcome our ongoing discussion with you about the approach to regulation and we see this as an important part of the consultation process.

With regards to the outputs consultation, as we have discussed previously, a key area of concern for us is that there needs to be flexibility in the way that we deliver CP5 outputs. Given that there is uncertainty about the optimal outputs that will be required by the end of CP5 a change control process is also essential to ensure appropriate delivery and value for money. Given the scale of the efficiency challenge implied by the HLOS and SOFA, the flexibilities outlined in this response are critical.

We address the detailed issues and questions, which are raised in the consultations in the attachments to this letter. There are, however, a small number of particularly significant issues, which I address in this letter. In so doing, I thought it might be helpful to frame them around the company's CP5 principles for regulation, which we have discussed previously with ORR.

Network Rail's CP5 Principles

Our key high level principles for regulation in CP5 were summarised as being:

1. **Safety** – Network Rail should be supported and encouraged to deliver continuous improvements in public, passenger and workforce health and safety. We would, of course, expect to keep ORR informed of our plans, for example, in relation to safety culture and the way in which we plan to monitor our own progress;

2. **Output based incentive regulation** – Network Rail should be effectively incentivised to deliver and outperform achievable output and efficiency targets;

3. **Simplicity and risk based approach** – The regulatory and contractual regime should be simple and targeted using a consistent risk-based approach;

4. **Partnership** – Network Rail and its customers/suppliers should be empowered to enter into various forms of partnerships or alliancing arrangements which will improve value for money without undermining network benefits or scale efficiencies;

5. **Whole-life, whole-system, risk-based optimisation** – The level of funding, the required outputs and the financial framework should enable Network Rail to manage risk and make whole-life, whole-system decisions; and

6. **Corporate development** – The regulatory regime should encourage but not predetermine the evolution of the business to facilitate improved value for money, for example through competition and risk capital.

In addition to these principles, as I am sure you will agree, one of the most significant 'post-McNulty' developments has been the creation of the Rail Delivery Group. RDG is one of the most tangible examples of the industry taking greater collective ownership for its strategic direction. I am pleased that ORR has been so supportive of RDG's work to date.

Similarly, devolution within Network Rail and the emergence of stronger collaboration with our customers and suppliers is beginning to show results in terms of improved engagement and empowerment. Again we welcome ORR's support for these initiatives which are fundamental for the longer term future of the business and the industry.

Consistent with these changes, we consider that the right 'direction of travel' for CP5 should, wherever possible, be for regulation to support the development of more industry-determined targets, consistent with top level ORR determined outputs. There are already useful examples of these from CP4, most notably through the JPIP process and the resulting Customer Reasonable Requirements. We believe that there is considerable scope for extending this into mature dialogue with our customers and funders about trade-offs during the control period to deliver 'value based' solutions for the benefit of taxpayers, customers and rail users. Such trade-offs would need to be reflected in a transparent change control process with ORR oversight.

The Outputs Consultation

Our detailed response is attached to this letter. However, it is worth setting out the framework that underpins our response. The key principles for CP5 which are most applicable to the output framework are:

- Network Rail should be incentivised to deliver and outperform achievable and easily measurable output and efficiency targets. Regulation should be based on outputs rather than inputs;

- it is critical that management has the flexibility to make sensible trade-offs in the way that we deliver required outputs, also that there is the flexibility to make trade-offs between different outputs, where this is the right thing to do from the point of view of the rail user and taxpayer;

- the regulation of enablers should not be required where the output is capable of being regulated directly;

- the regulatory and contractual regime should be simple, consistent with the principles of good regulation and focused on what matters to customers, passengers and freight users;

- a risk-based approach to regulation would focus regulatory attention on areas where it matters most, for example where the company has a well developed plan which has the support of its customers and other stakeholders, this would be subject to less regulatory time than would otherwise be the case; and

- the approach to regulation should focus on what really matters for rail users and for the economy, with clear and simple targets that avoid perverse outcomes.

There needs to be clarity about the purpose of each regulatory output and indicator and the consequence associated with deviation from the forecast trajectory. There also needs to be recognition by ORR of the level of confidence of delivery of outputs. We propose that regulatory output targets are more at threshold rather than higher aspirational levels. Not all indicators should become targets and indicators or enablers should be treated as such – the focus should remain on the underlying purposes so that any measures do not constrain progress.

Recently we have also discussed with ORR our plans for improvements in asset management and what this means for regulation. We have agreed to hold further discussions on the suite of leading indicators which we are developing for use within the business and for our Board. We hope that this will also prove useful in a regulatory context and our response in this area is subject to this ongoing dialogue.

Network Rail welcomes the innovation funding provided for in the HLOS / SOFAs and it considers that much more needs to be done in this area to provide for a sustainable level of research and development expenditure in the railway. We therefore intend to develop proposals in conjunction with RDG to address this issue.

Key Areas of our Response

Network Rail proposes that:

- regulatory outputs are set and targeted at a network or funder level in order that we have the flexibility to deliver these outputs in the most efficient manner;

- there will be a suite of metrics that we use to monitor our business. Some of these will have forecasts and some will be monitored actuals only. The metrics that we put in place to manage the business appropriately will be shared with ORR, along with any forecast trajectories. We will update these trajectories as necessary as the periodic review, and then the control period, progresses;

- progress in enabling areas (such as improving our capability in asset management) will be shared and discussed with ORR; and

- forecasts for some of our indicators will be agreed in conjunction with our customers, through local engagement, and will therefore have the status of customer reasonable requirements.

There are areas on which absolute clarity will need to be sought prior to the agreement of the regulatory output framework. We need to be clear about:

- the purpose of each output, indicator and enabler and the consequences associated with deviation from the forecast trajectory, where there is a forecast;
- the status of each metric – regulatory output, indicator or enabler and the difference in regulatory treatment of these;
- the level of confidence in the delivery of outputs and, reflecting this, the consequence if the plan then does not deliver the planned output;
- the need for flexibility to change forecasts at a disaggregated level;
- that it is appropriate that only high level outputs should be obligations; and
- the need for change control of top level outputs.

Safety and Sustainable development – although we agree with the use of a level crossing risk reduction plan, we largely disagree with the other proposed metrics, either because we are already regulated in these areas by other regulators (e.g. the Environment Agency) or because we believe that the metrics are inappropriate.

Network Capability, Enhancements, Capacity and Network Availability – we are broadly supportive of the ORR's proposals and they align with our current thinking.

Train service reliability – we propose that PPM and CaSL at a funder level are the regulated outputs and that we need a change control process at this level. All other measures below this would be indicators. However to justify our performance plan in the SBP, we would include TOC PPM trajectories to show the assumptions underpinning the 92.5%. These numbers would be refined and updated in our CP5 delivery plan and agreed with TOCs via the rolling two year JPIP process. The JPIP numbers would then become customer reasonable requirements and it is through this process that the TOCs would have recourse to the regulator. This is contrary to ORR's proposed position of PPM and CaSL potentially being regulated outputs at an operator level.

Asset Management – ORR is considering using the Asset Management Excellence Model (AMEM) as a regulated output, along with asset data quality and ORBIS and NOS milestones. Our preferred position is that any proposed asset management metrics are used as indicators. We agree that the AMEM enabler will be a useful tool to monitor our capability and we would expect to discuss our plans with ORR with particular focus on the ultimate purpose of these measures. This issue will need to be developed further through the dialogue referred to above.

Other - ORR proposes a range of other metrics that could be used in a regulatory approach in CP5, including indicators to cover supply chain, innovation, project and programme management. We recognise that these could be useful tools to help us manage improvement in our capability. We would expect to share our improvement plans, including forecast trajectories where appropriate, and review progress with ORR.

However, we strongly believe that these plans and trajectories should not become regulatory targets as they are input-based metrics and if they were used inappropriately they would decrease the flexibility of the company to deliver efficiently. It would also appear to be contrary to the ORR principle of a simplified regulatory structure which is output based.

The Financial Issues Consultation

Taken in the round, ORR's financial issues proposals could significantly reduce the degrees of financial freedom we would have, compared to CP4.

We are also concerned, more generally, about ORR's 'direction of travel', which could take us further away from being regulated in the same way as other companies without explicit justification or full understanding of potential consequences. We consider that there is a risk that ORR's proposals could lead to us being, in effect, 'managed for cash'. We recognise that this is not ORR's intention. It is, therefore, welcomed that ORR recognises that it would still expect us to have sufficient balance sheet headroom to manage business risks during the control period. However, we are concerned that this headroom could become theoretical if reported profits are negative.

Our detailed response is attached to this letter. However, we set out the key areas of our response below.

Key Areas of our Response

ORR's approach: We do not agree with suggestions that Network Rail only seeks to improve when beaten with regulatory 'sticks'. Whilst the company is not the finished article, it is performing well in a number of different areas. Notably, safety and performance are at record levels. The company has also made consistent and significant efficiency improvements. Indeed, Sir Roy McNulty notes that by the end of CP5 on the current glide path we will have met his base efficiency improvements. We consider that our people are committed to improving the railway for the benefit of passengers and funders.

Inflation impact on CP5 charges: We have already written to your team with regards to ORR's proposals on how inflation should be dealt with in our charging framework. As you will know, we do not accept the suggestion that this policy would improve our incentive to manage our costs. We, like all other regulated companies, have a natural incentive to beat our efficiency targets and to manage the impact of inflation on these costs. By contrast, we consider that government is best placed to manage inflation risk. However, we do understand that DfT has difficulty dealing with the impact of inflation in its annual budgets as it has a cash settlement from governments. For this reason, we do not object to the concept that ORR proposes, for practical reasons. However, we consider that ORR should commit to an automatic adjustment in CP6, for the difference in outturn versus determined inflation. More complicated mechanisms are unnecessary and potentially confusing. ORR would also need to allow Network Rail extra borrowing headroom (in our debt/RAB limit) to accommodate the risk that its inflation allowance is below outturn inflation.

Support costs: Of course Network Rail seeks to manage the cost and outputs from BTP and RSSB. However, we do not consider that these costs are fully 'controllable' by Network Rail. We do not consider that because we have one director on the respective boards that we are able to exercise influence to an extent that these costs should be included in any efficiency or performance assessment in CP5. Moreover, this view confuses the role of these directors with our role as customers for these organisations. Our limited ability to influence these costs means that ORR's suggestion that we should have a 'geared' exposure to these costs being higher than forecast is unreasonable and would have no beneficial incentive properties.

Appropriate commercial freedom: We consider that consistent with our move to make more of our business contestable to third parties, we should be able to compete in new areas of business where we can offer value for money services. We look forward to engaging further with ORR on this important enabler.

Balance sheet headroom: Early clarity is needed from ORR on the quantum of additional debt/RAB ratio that we will be allowed during CP5 over and above the central CP5 forecast. Early this summer we shared our detailed analysis of our CP5 risk exposure with ORR. This indicates that we will require around 3% additional debt/RAB ratio for higher debt if the business risks that we face materialise. ORR's proposal of an *ex ante* assessment of inflation for our CP5 charges annual indexation could necessitate further debt/RAB ratio 'headroom' on top of this. We also consider that there is a need for dialogue with ORR about the minimum acceptable financial performance by Network Rail, in the context of the adjusted WACC and other proposals.

Re-openers: We are open to reforming the re-opener provisions, subject to ORR allowing the company sufficient balance sheet headroom to manage the business risks that we will face in CP5.

Reversibility: We consider that any unconventional regulatory approaches (such as adjusted WACC and *ex ante* inflation assessments) should be readily reversible in the event that unsupported debt or concessions are taken forward. Furthermore, we think that exiting CP5, Network Rail's regulatory framework should return to the conventional model. It would be helpful if ORR provided a firm commitment to fund Network Rail on a conventional full WACC approach in CP6.

Price control disaggregation: As you know, we welcome increased transparency of the performance and targets for each of our Operating Routes. However, we are concerned about ORR's discussion about the future regulation of the English & Welsh routes. We have no difficulty with allowed revenues being set separately for each route but we cannot understand why outperformance in one route should not be traded against potential underperformance in another route. This is no different to any other group of companies and it should facilitate efficient financing. We consider that it is a mathematical certainty that any other approach would be more expensive than is currently the case. Whilst accepting that ORR's suggestions in this area would not be implemented in CP5, we would welcome further discussion as to what ORR considers the benefits of this approach would be.

P&L credibility: We are concerned that ORR may not recognise the impact of its combined proposals on our accounting performance. We consider that it is vital that ORR shares more fully its analysis of the profit impact of its proposals, at an early stage. It is important that CP5 allows Network Rail a reasonable expectation of producing a 'fair' accounting profit. We welcome ORR's proposed funding of our in year cash financing costs during CP5, which goes some way to mitigating the significant impact of ORR's adjusted WACC approach on the company's accounting profit. As stated earlier, we consider that there would be merit in early discussion with ORR about the minimum acceptable financial performance by Network Rail in CP5.

Conclusion

We welcome ORR's latest consultations on CP5 outputs and financial issues. Whilst these are somewhat technical topics, they will affect the sustainability of the whole of the industry for years to come. It is, therefore, important that there is a thorough and robust debate about them before ORR concludes later this year.

In previous discussions we have highlighted our periodic review objectives of: **an improving and sustainable railway**; **a realistic settlement**; and an **enabling framework**. They are embedded in all of our work for PR13 and are consistent with the ORR's established principles for the periodic review. Measured against these objectives there are a number of policies that we encourage ORR to reflect on, as highlighted in this letter and our accompanying detailed response.

I think it would be useful to meet to discuss this letter. I would be happy to arrange to do so at your earliest possible convenience.

Yours sincerely

Paul Plummer

Annex A: Network Rail’s response to ORR’s consultation on financial issues for Network Rail in CP5

This annex should be read in conjunction with the covering letter from Paul Plummer to Cathryn Ross on the ORR consultations on the output framework and financial framework for CP5. The covering letter contains our high-level comments on the overall frameworks. This annex responds to each of ORR’s consultation questions. ORR structured its consultation around the following headings and the remainder of this annex follows the same structure:

1. Risk and uncertainty;
2. Cost of capital issues;
3. Amortisation and RAB related issues;
4. Corporation Tax; and
5. Other financial issues.

In some instances, issues raised in the consultation document do not directly relate to one of the consultation questions, we have commented on / responded to these issues under the heading Other Remarks.

So as to create a standalone response and to ease readers’ understanding of Network Rail’s views, we have reproduced ORR’s views at the start of each section.

1. Risk and uncertainty

ORR’s key messages

- ORR’s proposals are consistent with its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.
- By allocating risks to Network Rail ORR believes that it gives Network Rail an incentive to efficiently manage those risks. If ORR allocates to Network Rail the risks that it is best placed to efficiently manage, it considers that this will help incentivise improvements in efficiency and value for money.
- Given the changes since PR08, most notably that it is unlikely that Network Rail will issue unsupported debt in CP5, ORR is proposing to reduce the headroom available to Network Rail.
- ORR is proposing to set an ex-ante assumption for both general inflation and input price inflation in its determination of access charges for CP5.
- ORR is proposing not to provide Network Rail with an in-year risk buffer.

- ORR is proposing to simplify the mechanism to re-open Network Rail's access charges review.
- ORR is proposing to compensate Network Rail for changes to ORR's assumptions on the licence fee and safety levy and business rates (if Network Rail has negotiated business rates efficiently).
- ORR's current thinking is that the level of financial indebtedness in each year of CP5 should at no point exceed a limit set between 70-75%. It considers that this will have the effect of incentivising Network Rail to control its costs.

Response to consultation questions

Q3.1: What are your views on our proposed approach to indexing Network Rail's allowed revenue and RAB for inflation. In particular, that we are proposing to set an ex-ante assumption for both general inflation and input price inflation in our determination of access charges for CP5?

Given the significance of this proposal we have already written to ORR setting out our emerging view. We also sent a discussion paper by Oxera setting out its view in relation to this issue, which is appended to this response.

In our opinion, this issue solely relates to appropriately apportioning risk between Network Rail and its funders. As a matter of principle, we believe that governments are best placed to manage inflation risk and that there is already an effective incentive on the company to manage the impact of exogenous changes in inflation. Therefore, we would support a continuation of the existing approach to indexation or a more traditional RPI-X approach, reflecting the fact that inflation is mainly an uncontrollable exogenous factor.

We do, however, understand that DfT and Transport Scotland has difficulty dealing with inflation in their annual budgets because they receive a cash settlement from government. We do not, therefore, object to the proposal for practical reasons. However, we do consider that it would be more appropriate to rationalise this proposal on the basis that it provides budgetary certainty for funders, rather than cost management incentives for Network Rail. Whatever approach is adopted, unnecessary complexity should be resisted.

Lack of Regulatory Precedent

We believe that there is virtually no regulatory precedent for ORR's proposed approach to indexing our allowed revenues based on an *ex ante* inflation assumption. Typically, other regulators adopt an RPI-X approach to expressing the link between inflation and incentive targets. This reflects the fact that regulators typically consider inflation to be exogenous to regulated companies. The traditional RPI-X approach also avoids the requirement to forecast inflation several years ahead, which would be very challenging at any time but particularly challenging in the current economic climate where inflation is volatile due to the recession, banking crisis and resultant substantial quantitative easing programme.

If this proposal were to be implemented it would increase Network Rail's risk exposure and undermine regulatory certainty. Therefore, it would be important that this was reflected in our cost of capital, the debt/RAB headroom and the approach to financial sustainability.

Lack of Incentive Properties

We strongly consider that if ORR applies an *ex ante* inflation assumption when determining our revenue requirement it would not strengthen the incentives that we face to manage our costs. Like all other regulated companies, we have a natural incentive to outperform our efficiency targets. If we are able to keep input cost changes below the UK general inflation level this will contribute to us meeting and hopefully outperforming the efficiency challenge set by ORR.

However, even if one accepts that there is an incentive effect from setting an *ex ante* inflation assumption, it would appear to really matter whether ORR's assumption turns out to be above or below outturn inflation. One could argue that if outturn inflation is lower than that assumed by ORR, it would blunt the incentive that Network Rail faces to manage input cost changes. To the extent that the opposite is the case when inflation is high, there could be unintended consequences in terms of unsustainable cost reductions since we are already incentivised to achieve sustainable efficiencies.

Impact on customers

We consider that ORR's proposal to log-up any difference between assumed and outturn inflation could create intergenerational issues whereby future customers pay higher charges to fund benefits enjoyed by current customers. This would be the case under either a RAB or opex memorandum adjustment in CP6 but would be more smoothed under a RAB approach.

As we explained in our presentation at ORR's September workshop, there is another potential consequence of ORR's indexation proposal. By the start of CP6, Network Rail's prices could potentially be some way adrift from being cost reflective. To the extent that ORR's indexation assessment is different from outturn inflation, there will be a 'gap' between prices and our cost base. At the start of CP6 this gap will need to be addressed. This could result in a potentially significant price increase or decrease for customers. This effect is over and above the effect already described whereby any under or over-recovered CP5 revenue would need to be addressed in subsequent control periods.

We note that one way of mitigating against the creation of intergenerational issues and a 'gap' between costs and prices would be to limit the application of ORR's *ex ante* inflation assumption to the network grant and fixed track access charges and continue to index other charges by RPI. This would have the benefit of providing DfT and Transport Scotland with budgetary certainty whilst still maintaining the link between other access charges and our cost base. It would also reduce Network Rail's exposure to financial risk within CP5.

Impact on debt/RAB and financial sustainability

The potential impact of ORR's proposal is contingent on the extent to which outturn inflation diverges from ORR's *ex ante* inflation forecast. If ORR's assumption is perfectly aligned to outturn inflation there would be no impact on Network Rail's finances. However, as Oxera note, under a realistic possibility that outturn inflation is 2% higher than ORR's assessment each year, the total impact on cash flows over the period could be equivalent to as much as 3% on debt/RAB. If the 2% deviation in outturn inflation is higher than ORR's indexation allowance, the additional debt that we would incur in order to meet this exposure would have to be serviced in future control periods, increasing our future funding requirement. We note comments by ORR at its September workshop that it would be likely to add any under-recovered revenue to CP6 allowed revenues by way of the opex memorandum account, which could reduce the net risk on the company.

Network Rail welcomes the fact that ORR recognises changing the way it indexes allowed revenues will increase our financial risk and that it would need to take account of this when determining its policies elsewhere in the financial framework, for example, the restriction on the level of financial indebtedness and the treatment of financial sustainability[1]. We respond in more detail on what we consider to be an appropriate restriction on the level of financial indebtedness in response to question 3.5, below.

Deadband

We believe that ORR's proposal to place a deadband around its *ex ante* inflation assumption (beyond which ORR would assess if the variances were material enough to re-open the price control) is too complex. It also appears inconsistent with ORR's proposal for fewer re-openers. Instead, we consider that if ORR decided to make an *ex ante* inflation assumption, a better approach would be for ORR to incorporate sufficient debt/RAB headroom in the periodic review settlement and commit to an automatic adjustment in CP6. This approach would provide greater regulatory certainty. We consider that there should be no deadband based on the difference between outturn inflation and ORR's *ex ante* inflation assumption.

[1] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.22

As stated above, this could still potentially blunt Network Rail's efficiency incentives within CP5 and create intergenerational inequities. However, it would avoid unnecessary complexity and other potentially unintended or perverse consequences.

Efficiency adjustment

We note that ORR states that any difference between its assumed level of inflation (including input price inflation) and actual inflation (including input price inflation), that it thinks is efficient, could be logged up to CP6[2]. It is not clear to us from the consultation document how ORR would assess whether the variance between actual inflation and its *ex ante* assessment is efficient. We consider that separately identifying the impact of actual inflation from the many other factors that affect costs would be extremely difficult to carry out objectively. Moreover, it places ORR in the position of having to second guess detailed management decisions and trade-offs. We believe that because inflation is beyond our control (but we are already incentivised to manage the impact of inflation on our costs), any variance between assumed and actual inflation should not be subject to an *ex post* efficiency assessment. We believe that a better approach would be to have a simple, automatic mechanism for logging up/down variances. This would avoid introducing further complexity and uncertainty into the regulatory regime, remove the subjectivity associated with an *ex post* efficiency assessment and the associated transaction costs.

ORR's September Workshop

At ORR's recent industry workshop on its Financial Issues consultation, some stakeholders commented that in unregulated sectors companies would seek to reduce their costs rather than pass on their input inflation into prices that they charge their customers. This clearly cannot always be the case otherwise there would be no inflation in the UK. In addition, we would point out that the way in which companies cut costs is often to reduce their outputs. For example, if a retail chain experienced increased input costs it may decide to close some of its stores. Network Rail is constrained by its regulatory commitments to fixed outputs. We cannot reduce the number of trains that run on our network or close stations or branch lines as a way of reducing our costs. If we are able to achieve real efficiencies we should do so regardless of whether inflation happens to be above or below some forecast at an arbitrary point in time.

We also note that passenger train operators are themselves protected from the effects of inflation in the way that their annual fare adjustments are agreed as part of their franchise contracts. Annual regulated fare changes are linked to RPI.

[2] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.19 (c)

Treatment for the RAB

We welcome ORR's proposal to continue to adjust Network Rail's RAB by actual movements in general inflation in order to avoid eroding the real value of the regulatory asset base.

Indexation of Renewals

As set out in our response to ORR's May 2011 consultation, we acknowledge the theoretical rationale for using IOPI to index our renewal costs. In practice, however, we have found it to be volatile, difficult to forecast and an inaccurate reflection of our costs, which has resulted in planning uncertainty. We consider a better approach would be to index our costs using RPI. We believe that this would result in greater planning certainty, which is very important for the business. However, if that RPI indexation were to be based on an *ex ante* assumption we would need to revisit whether some form of input price protection is required.

Q3.2: What are your views on our proposal not to provide Network Rail with an in-year risk buffer?

In our response to ORR's consultation on incentives we stated that we strongly considered that we would need some form of risk buffer in CP5 to help us manage the business risks that we face. However, we also stated that we were open to considering different types of risk buffer such as a balance sheet risk buffer. We noted that in the absence of a risk buffer we would not be able to adopt a whole-life approach and longer term costs would almost certainly increase.

Whilst we consider that there are good reasons for retaining an in-year risk buffer, for example, for financial sustainability reasons. We note that, at present, government finances are highly constrained and, therefore, not providing Network Rail with an in-year risk buffer will be attractive to funders because, in the short term, it would result in a lower funding requirement.

We are content to manage any adverse risks 'crystallising' using a balance sheet risk buffer rather than an in-year P&L risk buffer. However, it is vital that we are provided with sufficient balance sheet headroom to borrow additional funds should business risks materialise. The absence of an in-year risk buffer and sufficient balance sheet headroom would increase the likelihood of ORR having to re-open its determination in order to address any unexpected 'cost shocks'. We consider that it would be more appropriate for Network Rail to manage any 'cost shocks' through a suitable risk buffer, rather than ORR addressing them through re-opening its determination. If ORR had to re-open its determination in this situation it would undermine the need for Network Rail to be focussed on addressing the commercial issues.

Early this summer we shared with ORR analysis of our CP5 risk exposure[3] and the additional balance sheet headroom required to manage our business risks. The analysis indicated that any debt/RAB limit should be set at least 2-3 percentage points higher than that implied by Network Rail hitting its CP5 financial performance targets on average. We consider this to be a minimum based on specific identifiable risks under normal circumstances. This analysis did not consider the additional risk that would be imported if ORR adopted an *ex ante* inflation approach, as it now proposes. We discuss what we consider to be an appropriate restriction on the financial indebtedness, taking into account the accumulative risks that we face, in response to question 3.5, below.

P&L Sustainability

It also appears to us that that this proposal, like most of ORR's other proposals, centre on the financing effects on Network Rail. To some extent this is understandable as the ability to raise finance is a very important issue for companies. However, in order to maintain the credibility of the regulatory regime and for investors in Network Rail's debt to have confidence in the company, there is a need to be mindful of the P&L impact of ORR's policies. Whilst Network Rail is currently somewhat sheltered from the full vagaries of the financial markets by the government backed indemnity, the company retains the long-term ambition of raising risk capital unsupported by this indemnity. We understand that ORR supports the company's ambitions in this respect.

In order to be in a position to generate interest in raising unsupported debt, Network Rail will need to demonstrate that it is a credible entity that it is capable of generating sustainable profits and cash flow.

Seen in the round, ORR's current package of proposals would be likely to leave Network Rail, on central PR13 projections, generating little or no cash flow from operating activities during CP5. ORR's proposals would also leave the company's P&L with very little headroom to absorb the impact of cost variability and we would contend that any investors in Network Rail could consider it to be insufficiently profitable to justify investing in the company. We consider that investors in Network Rail would demand a profitability cushion. In addition, Network Rail is to be exposed to significant levels of incremental risk at least in part beyond its control, which could result in losses within the P&L and negative operating cash flows.

Irrespective of whether Network Rail seeks to raise unsupported debt in CP5, we consider that the company's profitability needs to be sustainable and provide sufficient headroom to absorb potential adverse outcomes. ORR has stated that it does not consider that Network Rail should have an in-year P&L risk buffer in CP5, but should instead borrow more money if risks crystallise during the control period. Stakeholders should be clear that if this situation comes about Network

[3] CP5 risk buffer analysis paper

Rail could make substantial and sustained P&L losses during CP5. We consider that this could seriously undermine the credibility of the company and of the regulatory regime for CP5 and beyond.

For the avoidance of doubt, we consider that if Network Rail were to raise unsupported debt in CP5 it would require an in-year P&L risk buffer in order to satisfy the cash flow coverage ratios required by rating agencies. We note that although ORR links the proposed removal of the in-year risk buffer to the fact that Network Rail is unlikely to issue unsupported debt in CP5, it is not clear what ORR would do as and when unsupported debt / risk capital is introduced.

We believe that it is also important to be transparent about the fact that although not providing Network Rail with an in-year risk buffer will result in a lower funding requirement in the short term, any additional funds borrowed to meet adverse risks materialising will have to be financed in future control periods. This will increase the overall level of future funding. However, we recognise that this is at least partially offset by the proposed approach to amortisation.

Contingency

ORR states that it will review the appropriate amount of contingency that it should include in its estimates of enhancement costs and that it is investigating the extent to which Network Rail includes contingency in maintenance and renewals unit costs in its business planning[4]. For enhancements, our spot estimates of early GRIP stage projects are uplifted to reflect the expected increases in anticipated final costs throughout the life cycle of projects (for example increases in scope). Our approach is consistent with DfT's Webtag requirements. For projects in later stages of development, the anticipated final costs contain quantitative risk assessments designed to increase the accuracy of our project cost forecasting. For maintenance and renewal our forecasts are based on expected costs and we do not include any additional overlay for contingency or risk. It is essential that sufficient contingency is included in project costs and that the approach to the financial framework reinforces the criticality of this issue.

Q3.3: What are your views on our proposal to simplify the mechanism to re-open Network Rail's access charges review by removing some of the specific re-openers?

Network Rail supports the inclusion of re-openers in the access charges review as a means of managing material unforeseen risks materialising. Furthermore, it is content with ORR's proposal to simplify the mechanism to re-open the review by removing some of the specific re-openers. Network Rail notes, however, that ORR's proposal to reduce the number of re-openers increases its exposure to

[4] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.35

financial risk, which should be reflected in its cost of capital. Furthermore, Network Rail considers that the exclusion of the AICR re-opener should at least be capable of being reversed, during the control period, if Network Rail seeks to issue unsupported debt. In this context we suggest that there is merit in reforming this provision since there is no material downside in doing so.

Scottish re-opener

Network Rail is content with ORR's proposal to retain a specific re-opener for expenditure in Scotland, recognising that an issue that might be material in Scotland may not be material for Network Rail as a whole.

Simplicity

As stated above, we believe that ORR's proposal to include a deadband around its *ex ante* inflation forecast is likely to be too complex and is also inconsistent with this proposal to simplify re-opener mechanisms. In order to provide certainty for the industry and facilitate Network Rail adopting a whole-life approach to managing longer term costs we would reiterate the importance of providing us with sufficient balance sheet headroom to manage business risks. We consider that, in the first instance, this headroom should be used to manage any unforeseen business risks that materialise, not a re-opener.

Reversibility

Rather than incorporating a specific re-opener in relation to industry reform we consider that ORR's unconventional regulatory approaches (such as adjusted WACC and *ex ante* inflation assessments) should be readily reversible in the event that reforms such as unsupported debt or concessions are taken forward. Furthermore, we believe that on exiting CP5, Network Rail's regulatory framework should return to the conventional model.

Q3.4: What are your views on our proposed treatment of traction electricity, industry costs and rates, e.g. BT police costs?

Traction electricity

In respect of traction electricity ORR states that:

- It will expose Network Rail to some of the costs associated with transmission losses, reflecting its ability to control these costs[5];

- It will determine an efficient level of costs and set an *ex-ante* allowance with the risk of the outturn, on those aspects of the cost such as

[5] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.54

transmission losses that are controllable by Network Rail, being different taken by Network Rail[6];

- Metered train operators will be billed on the basis of consumption, with a mark-up based on a challenging but achievable level of losses[7];

- It will allocate the year-end volume wash-up between unmetered services and Network Rail, to reflect its respective ability to manage the risk[8];

- Network Rail's own use of traction electricity will be treated as a controllable cost[9]; and

- It will include costs sufficiently controllable by Network Rail in efficiency and performance assessments in CP5[10]

Network Rail is broadly content with ORR's proposals in respect of the framework of incentives for traction electricity costs and charges in CP5.

Network Rail is currently consulting on the actual level of AC losses[11], and plans to consult on DC losses later this year. In principle, ORR's proposal to allow Network Rail to recover a challenging but achievable level of losses is reasonable. We are keen to work closely with ORR to determine how this may be set, using evidence-based targets.

Network Rail and the industry will require more detail in respect of ORR's proposals to adjust the way in which volume wash-up risk should be allocated in CP5 in order to be able to consider ORR's proposals appropriately.

Network Rail supports the proposal for its own use of traction electricity to be treated as a controllable cost.

BT Police and RSSB costs

In respect of BT Police and RSSB costs, ORR proposes determining an efficient level for Network Rail's share of these costs and setting an *ex ante* allowance with Network Rail being exposed to the risk of the outturn being different[12]. This is consistent with the current approach.

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[6] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[7] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[8] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.55
[9] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.56
[10] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.57
[11] This consultation closes on 12 October 2012, and is available to download here: http://www.networkrail.co.uk/PeriodicReview2013.aspx
[12] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.58

ORR also states that one way of increasing the incentive on Network Rail would be to expose it to the whole costs of BT Police and RSSB, rather than just its share of these costs. This would be achieved by ‘gearing’ Network Rail’s exposure to these costs, whereby if outturn costs were different to ORR’s allowance, Network Rail would be exposed to 100% of the difference.

Network Rail does not consider that it was appropriate for ORR to expose it to variances in BT Police and RSSB costs in CP4 and, therefore, strongly believes that it should not be exposed to variances in these costs in CP5. We do not consider that because we have one director on the respective boards that we are able to exercise influence to an extent that these costs should be included in any efficiency or performance assessment in CP5. Our limited ability to influence these costs means that ORR’s decision to expose us to them has negligible incentive properties and increases our exposure to what is largely an uncontrollable cost.

We consider that these costs are very different from controllable support costs and thus should be treated differently. We strongly consider that a better and more equitable approach would be to treat them in the same way that ORR proposes treating the ORR licence fee and safety levy. Network Rail would still use its influence over the level of costs and it would still need to manage the financial consequences of any variations.

Given we do not consider that we have sufficient influence such that we should be exposed to variances in BT Police and RSSB costs, we strongly consider that we should not be exposed to the total of these costs rather than our own share. Increasing the incentive strength in respect of cost categories that we have a very limited ability to influence would only serve to further increase our risk exposure, resulting in higher/lower windfall gains/losses.

We also note that the Network Rail director on the BT Police and RSSB boards has a legal obligation to these organisations when he works in these capacities. This duty would conflict with ORR’s view that they should use their influence to Network Rail’s advantage. Clearly we would exert our influence as a customer and to improve efficiency but that is a different matter which should not be confused with governance roles.

In summary, we consider that continuing to expose Network Rail to its share (or a higher share) of BT Police and RSSB costs represents an inequitable transfer of risk to Network Rail that could reduce financial sustainability. We also consider that ORR’s policy should be reflected in our cost of capital.

Licence Fee and Safety Levy

Network Rail supports ORR's proposal not to expose it to variances in the ORR licence fee and safety levy[13]. ORR correctly identifies that these costs are not controllable by Network Rail and thus any variance between forecast and outturn costs should be logged up/down in the next control period. As stated above, we believe that BT Police and RSSB costs should be treated in the same way. We also consider that the costs of the independent reporters should be treated in the same way as the licence fee and safety levy.

Business Rates

Network Rail supports ORR's proposal not to expose it to variations in business rates, subject to Network Rail being able to show that it has negotiated efficiently with the Valuation Office Agency (VOA)[14]. However, this should not put ORR in a position of having to second guess management decisions and trade-offs.

We consider that ORR's current approach to assessing Network Rail's efficiency in the 2010 negotiation has the following major issues:

- The assessment of efficiency has lasted too long and thus, there should be a timetable for the resolution of the efficiency assessment in CP5 and a definition of what efficient negotiation looks like.

- In the current assessment of efficiency ORR appears to be defining efficiency as: *"Network Rail must demonstrate after the event that there was nothing it could have done that could conceivably have resulted in a better outcome"*. We have two points with regards to this:

    - This process requires us to demonstrate an efficient process occurred. External experts noting that the result of the negotiation was significantly better than a standard application of the valuation officer's approach has not been sufficient to satisfy ORR.

    - This definition of efficiency effectively equates to requiring perfection. We consider that it is possible to be a highly skilled negotiator and negotiate efficiently with the VOA without reaching perfection.

To mitigate these issues in CP5 we believe any *ex post* assessment of negotiation efficiency should be undertaken by an independent third party (e.g. an independent reporter) and that the primary focus should be on our processes.

[13] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.62
[14] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 3.64

Q3.5: What are your views on our current thinking that the maximum level of financial indebtedness that Network Rail can incur should at no point exceed a limit set between 70-75% in CP5?

If ORR implements its proposal not to provide Network Rail with an in-year P&L risk buffer it would make setting the maximum level of financial indebtedness (balance sheet risk buffer) even more significant. In addition, as ORR recognises, its proposal to index allowed revenues based on an *ex ante* inflation assumption will increase Network Rail's financial risk and this would also need to be taken into account when setting the maximum level of financial indebtedness and Network Rail's cost of capital for CP5.

Our current view is that it is too early to assess the appropriate limits of Network Rail's level of financial indebtedness for CP5. This can only be considered when we have a greater understanding of ORR's approach to financial sustainability, and the approach to efficiency and investment costs which need to be considered following the submission of our Strategic Business Plan in January 2013. Prior to this, we cannot indicate whether the range proposed by ORR will be sufficient.

We have, however, performed some initial analysis in relation to this issue. As noted, above, we have already provided ORR with analysis in relation to the balance sheet headroom that we would require to manage business risk and unexpected fluctuations in cash flow in CP5 in the absence of an in-year P&L risk buffer. This analysis indicated that if a balance sheet risk buffer approach is to be pursued in CP5; the debt/RAB limit should be set at least 2-3 percentage points higher than the limit implied by Network Rail hitting its CP5 financial performance targets on average. We consider this to be a minimum based on specific identifiable risks under normal circumstances. We will update this analysis in our SBP.

This analysis did not consider the significant uncertainty associated with enhancements. However, we note that the substantial uncertainty associated with early-stage HLOS schemes, which amount to c. £4bn, reinforces the need for a reasonable amount of balance sheet headroom. The analysis also did not consider the impact of ORR's new proposal to index allowed revenues based on an *ex ante* inflation assumption because ORR only made this proposal clear in August 2012. These indicate a number of potential reasons why the level of financial headroom needs to be higher than that which would arise from the removal of the P&L risk buffer alone.

Considering ORR's proposals more generally, including the proposals not to provide Network Rail with an in-year P&L risk buffer and apply an *ex ante* inflation assumption in the round, our initial view is that the debt/RAB limit should be set at least 5-6% higher than the limit implied by Network Rail hitting its CP5 financial performance targets on average. We will revaluate this view following confirmation of ORR's decisions on risk and uncertainty and in the context of ORR's approach to efficiency and investment, and would not expect ORR to come to a firm view until these issues have been subject to consultation. We note that several regulated utilities in the water sector have a debt/RAB ratio in excess of 75%.

Innovation

If we are not provided with sufficient balance sheet headroom it could result in the company adopting a more conservative approach to innovation and thus result in fewer initiatives to improve efficiency. Network Rail welcomes the innovation funding provided for in the HLOS / SOFAs and considers that much more needs to be done in this area to provide for a sustainable level of research and development expenditure in the railway. We, therefore, intend to develop proposals in conjunction with RDG to address this issue.

2. Cost of capital issues

ORR's key messages

- ORR considers that its proposals will help to deliver its key transformational goals, especially having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money and improving transparency.
- ORR decided in its May 2012 document, that the cost of capital that it allows Network Rail will reflect the risk profile of the company. However, ORR have decided that it will only allow Network Rail to recover ORR's forecast of its efficient financing costs in charges levied reflecting that it does not pay dividends and is financed by government backed debt.
- If there were a significant change in the industry affecting Network Rail (e.g. if the company were to let a concession), ORR would evaluate the consequences with Network Rail, DfT, Transport Scotland and other stakeholders and if the changes are not material ORR considers it could log up/down the effect of the initiative on Network Rail and adjust Network Rail's allowed revenue, and if appropriate, its RAB for CP6. If the initiative has a material effect on Network Rail then ORR could re-open the price control.
- ORR is proposing to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail benefits from.
- ORR is proposing to take account of the impact of embedded debt in its forecast of efficient financing costs.
- ORR will identify the risks that Network Rail faces as part of its report on Network Rail's cost of capital for its draft determinations.

- ORR intends to roll forward the debt assumption used in CP4 for efficient movements in debt.
- ORR will assess financial sustainability ‘in-the-round’ and has set out its initial view of the financial indicators that it will use in PR13.

Response to consultation questions

Q4.1: What are your views on how we could handle an industry reform initiative, e.g. further alliances or a concession?

We welcome the statement from ORR that, as a general principle, it supports preserving the option of introducing risk capital into Network Rail[15]. In considering how we will finance our activities, Network Rail continues to be positive about the benefits of introducing risk capital and considers that it should be regulated in a way that preserves the options for changes to its financial structure.

Reversibility

ORR notes that in an extreme case, where all of Network Rail’s business was sold to another party, which is conventionally funded by unsupported debt and equity, then it would unwind the effects of the adjusted WACC approach[16]. Network Rail welcomes this statement and considers that ORR’s adjusted WACC approach should be readily reversible back to the more conventional full WACC. In addition to the extreme case highlighted by ORR, we consider that this reversal will be necessary if Network Rail were to issue unsupported debt or concession part of its infrastructure in CP5.

We believe that the approach to unwinding the adjusted WACC should be mechanistic and set-out as part of ORR’s CP5 determination. This would provide certainty and avoid undue complexity. We would welcome further discussion with ORR in relation to this issue.

Alternative Approach

ORR considers an alternative approach where, if the industry reform is not material, it could log up/down the effect of the change on Network Rail and adjust Network Rail’s allowed revenue, and if appropriate, its RAB for CP6[17]. If the initiative has a material effect on Network Rail, ORR states that it could re-open the price control. Network Rail does not support this alternative approach due to its complexity and the uncertainty it would create for both Network Rail and potential investors.

[15] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.8
[16] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.13
[17] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.14

Q4.2: What are your views on our proposal to set the FIM fee reflecting a long-run view of the credit enhancement that Network Rail is provided with?

Network Rail is content with ORR's proposal to set the FIM fee based on a long-run view of the credit enhancement that Network Rail is provided with. We consider that the FIM fee should be based on the long-run average maturity of debt issued.

The range, 78 to 129 basis points, which ORR assumed in its Advice to Ministers document in relation to the FIM fee, appears reasonable.

As set out in our response to ORR's consultation on incentives, we consider that there would be merit in the FIM fee (and the equity surplus under the adjusted WACC approach) being paid direct to HM Treasury, rather than the DfT. This would avoid potentially unduly influencing DfT policies due to it being in receipt of these sums.

Q4.3: What are your views on our proposal to take account of the cost of embedded debt in our forecast of efficient financing costs?

We welcome the fact that ORR recognises that Network Rail is best placed to manage its financing costs because it understands the risks and how to finance those risks better than other stakeholders[18]. We also welcome the fact that ORR proposes to fully take into account the cost of embedded debt[19]. We consider that if ORR did not fully take into account our embedded debt costs it would unfairly penalise us for reasonable historic financing decisions. We note, however, that ORR states that it will only allow embedded debt costs to be included in its PR13 determination for CP5, where they can be shown to have been incurred efficiently[20]. It is not clear to us how we can demonstrate that these financing costs have been incurred efficiently. We would welcome ORR setting out how it would make such an assessment.

Network Rail is content with ORR's suggestion[21] that it is not necessary to consider other ways of reducing the interest rate risk that Network Rail faces, for example through indexing movements in the risk free rate, due to complexity that this would introduce.

[18] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.20
[19] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.23
[20] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 32
[21] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.25

Q4.4: What are your views on how we are proposing to assess financial sustainability?

ORR notes that when considering the long-term financial sustainability of Network Rail one should consider the following questions, in particular[22]:

- Is the level of debt appropriate for a company such as Network Rail?
- Can the debt be re-financed when appropriate and serviced efficiently?

We consider that Network Rail's CP5 forecast debt levels are entirely appropriate and sustainable as long as the regulatory regime remains consistent and robust. The regulatory asset base effectively provides for our revenues to be set such that our sunk costs can be recovered from remaining access charges.

We consider that our investment costs should be considered over a suitable long-run period in order to ensure that they are financeable over the useful life of the network's assets.

However, whilst total debt levels may be sustainable relative to the RAB we would want to be assured that we would be in a position to efficiently service our debt from current earnings in CP5. ORR recognised in CP4 the importance of maintaining interest cover ratios (e.g. AICR) as well as balance sheet ratios, and whilst the debt/RAB headroom and FIM may provide financial headroom within CP5, we consider that it is important that ORR continue to take account of ongoing service cover ratios as well as balance sheet ratios to ensure that Network Rail remains financially sustainable for the longer-term beyond CP5.

We note that ORR's policy decisions (e.g. to apply an adjusted WACC) and proposals (e.g. removing the in-year P&L risk buffer) would result in higher absolute debt levels and a less favourable debt/RAB ratio than if there was a continuation of the CP4 approach in CP5. In addition, ORR's proposal to apply an *ex ante* inflation assumption increases Network Rail's financial risk and could result in higher financing costs and / or difficulties if Network Rail were to attempt to issue unsupported debt. It is also important to note that although ORR's policy decisions/proposals result in a lower funding requirement in the short term, the total amount of money required by Network Rail in CP5 will remain unchanged and it will, therefore, have to borrow additional funds to meet this requirement, increasing the overall level of funding in future control periods.

Currently Network Rail can refinance its debt as and when appropriate, however, if there was a downgrade in the UK's credit rating then ORR's approach could impact on the cost of refinancing. In addition, if Network Rail's profitability is adversely impacted by ORR's CP5 determination then its cost of borrowing could

[22] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.53 (b)

potentially increase as investors could potentially deem the company to be more reliant on government backing.

Financial Indicators

Network Rail is content with ORR's initial view[23] that the financial indicators used in PR08 remain suitable for PR13. Assessing our gearing based on the debt/RAB ratio is consistent and comparable with other regulated utilities. We also consider that the other coverage ratios highlighted by ORR remain important in ensuring longer-term financial sustainability, and await ORR's detailed proposals as to how the different ratios will be assessed.

P&L Sustainability

As stated above, it appears that most of ORR's proposals centre on the financing effects on Network Rail and to some extent this is understandable as the ability to raise finance is a very important issue for companies. However, in order to maintain the credibility of the regulatory regime and for investors in Network Rail's debt to have confidence in the company, there is a need to be mindful of the P&L impact of ORR's policies. Whilst Network Rail is currently somewhat sheltered from the full vagaries of the financial markets by the government backed indemnity, the company retains the long-term ambition of raising risk capital unsupported by this indemnity. We understand that ORR supports the company's ambitions in this respect.

In order to be in a position to generate interest in raising unsupported debt, Network Rail will need to demonstrate that it is a credible entity that it is capable of generating sustainable profits and cash flow.

Seen in the round, ORR's current package of proposals would be likely to leave Network Rail, on central PR13 projections, generating little or no cash flow from operating activities during CP5. ORR's proposals would also leave the company's P&L with very little headroom to absorb the impact of cost variability and we would contend that any investors in Network Rail could consider it to be insufficiently profitable to justify investing in the company. We consider that investors in Network Rail would demand a profitability cushion. In addition, Network Rail is to be exposed to significant levels of incremental risk at least in part beyond its control, which could result in losses within the P&L and negative operating cash flows.

Irrespective of whether Network Rail seeks to raise unsupported debt in CP5, we consider that the company's profitability needs to be sustainable and provide sufficient headroom to absorb potential adverse outcomes. ORR has stated that it does not consider that Network Rail should have an in-year P&L risk buffer in CP5, but should instead borrow more money if risks crystallise during the control

[23] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.58

period. Stakeholders should be clear that if this situation comes about Network Rail could make substantial and sustained P&L losses during CP5. We consider that this could seriously undermine the credibility of the company and of the regulatory regime for CP5 and beyond.

For the avoidance of doubt, we consider that if Network Rail were to raise unsupported debt in CP5 it would require an in-year P&L risk buffer in order to satisfy the cash flow coverage ratios required by rating agencies.

Q4.5: What are your views on our proposal to keep the introduction of the adjusted WACC approach as simple and transparent as possible by calculating efficient financing costs on a cash basis and by taking the normal regulatory approach to indexing the whole of the RAB?

ORR discusses two different approaches to implementing the adjusted WACC approach in its ‘purest’ form.

The first suggests that ORR could not index the part of the RAB that is associated with nominal debt. We consider that this would have the effect of permanently reducing the enterprise value of the company. We consider that this would not only be inconsistent with regulatory precedent but would also extend the adjusted WACC approach beyond CP5. Our understanding is that ORR’s intention is to adopt the adjusted WACC approach for CP5 only in recognition of exceptionally constrained government finances.

The second ORR approach would be to only fund Network Rail’s cash interest costs excluding the inflation component of financing costs on nominal debt. As ORR highlights itself, if it implements this approach there could be significant financial sustainability issues that would need addressing in some other way.

We, therefore, agree with ORR’s proposal to calculate efficient financing costs on a cash basis and take the normal regulatory approach to indexing the whole of the RAB. Unless there is strong reason for doing otherwise Network Rail should continue to be regulated in the same way as any other normal company.

However, we do not agree with ORR’s characterisation of indexing our nominal debt as *“compensating [the company] twice”.* ORR’s decision to not provide us with the funding associated with the equity component of our cost of capital means that we will be funded significantly less than would be the case under the conventional regulatory approach. Given the extent to which the adjusted WACC approach reduces the company’s funding, it seems inappropriate to characterise this approach as ‘over compensation’.

Other remarks

Treatment in CP6

We consider that as part of its final determination ORR should provide a firm commitment or presumption that it would fund Network Rail based on the conventional full WACC in CP6, rather than an adjusted WACC. This would provide early certainty in relation to the level of our future funding and represent a commitment to a more financially sustainable approach

As stated above, Network Rail welcomes the fact that ORR recognises[24] that if its entire business was sold to another party that is conventionally funded by unsupported debt and equity, then it would be appropriate to unwind the effects of the adjusted WACC approach.

Non-HLOS investment schemes

We welcome the statement[25] from ORR that the full cost of capital will continue to be used in the investment framework for calculating the financing costs of non-HLOS investment schemes.

Semi-annual approach

ORR considers that it should continue using the semi-annual approach to calculate Network Rail's forecast of efficient financing costs, as it appropriately adjusts for the timing of cash flows[26]. ORR also states that for its draft and final determinations it will look closely at Network Rail's phasing of its cash flows in its SBP and it will not simply assume that Network Rail's cash flows should be spread evenly through the five-year control period or spread evenly during a year. Hence, although ORR is proposing to retain the semi-annual approach, it may amend the calculation if it considers that the phasing of cash flows materially affects its forecast of efficient financing costs[27].

Network Rail is content with ORR's proposal to retain and potentially amend the semi-annual approach to calculating efficient financing costs but would not want to introduce undue complexity into the forecasting process.

Split Cost of Capital

ORR states that any advantage that a split cost of capital could offer in terms of preventing arbitrage of the WACC (effectively by increasing gearing while continuing to earn a cost of capital that reflects a split between debt and equity)

[24] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.13
[25] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.7(a)
[26] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.39
[27] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.40

is not relevant at the moment for Network Rail[28]. Network Rail considers that although there could have been a way of creating a concept of ‘historic assets’ and ‘new assets’, with different risk levels for each, on balance, a split cost of capital approach would be too complicated. For the longer term, Network Rail remains of the view that it maybe appropriate to consider a RAB buy-back which could have a similar impact to a split cost of capital.

3. Amortisation and RAB related issues

ORR’s key messages

- ORR considers that its proposals will help to deliver its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.
- ORR is consulting on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation.
- ORR is proposing to largely keep the overall approach to the RAB roll-forward the same as in PR08 but believes that there are some issues that it needs to consider such as: it is minded not to index renewals for changes in input prices and it is considering how to take account of the difficulty that it has experienced in CP4 in confirming that renewals underspends have been efficient.
- ORR states that the investment framework will continue to fund investments that customers and funders want Network Rail to undertake outside of the periodic review process.
- ORR states that as it decided in PR08, it will only allow capex to be added to the RAB and is proposing to keep using the opex memorandum account.

Response to consultation questions

Q5.1: What are your views on the treatment of reactive maintenance and how to calculate average long-run steady state renewals for the amortisation calculation?

Reactive maintenance

ORR is considering whether reactive maintenance costs should be remunerated in the year concerned (i.e. for the purpose of calculating the revenue requirement treating them in the same way as operating and other maintenance costs). It

[28] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 4.27

considers that this would improve transparency as Network Rail currently accounts for reactive maintenance costs as operating costs in its statutory accounts and capital expenditure (renewals) in its regulatory accounts (to be consistent with ORR's PR08 determination). This means that at the moment Network Rail needs to provide a reconciliation of maintenance and renewals costs between its statutory and regulatory accounts[29].

Network Rail considers that it is not appropriate, at this stage, to remunerate reactive maintenance costs in the year concerned for the following reasons:

- we are continuing to improve our understanding of civils assets and the optimum asset policies. It is, therefore, possible that there could be a significant increase in preventative maintenance which would impact our funding requirement in CP5;

- it is likely that there will continue to be differences between financial and regulatory accounts and, therefore, making an adjustment in respect of reactive maintenance is unlikely to result in alignment; and

- the regulatory treatment reflects how we currently manage civils expenditure.

Amortisation

ORR states that given the adjusted WACC approach and the associated adjustment to amortisation for financial sustainability reasons, Network Rail's revenue requirement is unlikely to be affected by the way it calculates average long-run renewals. However, ORR considers that it is still important to make an appropriate calculation of long-run renewals as it wants to present charges before and after the adjusted WACC approach[30]. ORR believes that the main issues it needs to consider when calculating average long-run steady state renewals are[31]:

- whether the amortisation charge should take account of the scope for future efficiency improvement after CP5; and

- the period of time that should be used as a proxy for the long-run period (ORR proposes a 30-year period from 2014/15).

Network Rail agrees that the calculation of long-run steady state renewals continues to be important. It also agrees that it is important to present charges before and after the adjusted WACC adjustments. We consider that this will provide transparency in respect of our overall revenue requirement, including the

[29] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 517
[30] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.19
[31] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.20

funding associated with the equity element of our WACC. Only presenting access charges net of the adjusted WACC adjustment would understate our revenue requirement and not fully reflect the risks that we face as a business. Being transparent will also make it easier to understand the longer-term framework when the adjusted WACC approach ceases to apply. However, it is not clear to us that the unadjusted charges should necessarily be based on a different approach to amortisation.

Network Rail agrees that it is appropriate to take into account future scope and frontier shift efficiency in the amortisation calculation, but notes the challenges associated with estimating efficiency improvements. Furthermore, we consider that the more costs that are not funded during the control period in which they fall due, the more debt that we will have to incur to meet this financial exposure. This additional borrowing will reduce financial sustainability and result in higher charges in future control periods, potentially causing intergenerational issues.

We note that in PR08, and for the IIP, the amortisation calculation was based on a 35-year period. Our initial analysis indicates that the difference between basing the amortisation calculation on a 30-year period rather than a 35-year one is negligible. However, we would welcome further discussion with ORR in relation to why it is proposing to amend the calculation.

Network Rail supports an amortisation adjustment in CP5 to improve the company's financial sustainability. The level of the adjustment will depend on other financial assumptions in ORR's determination and we will continue to engage with ORR in relation to this issue.

Q5.2: What are your views on our proposal not to index renewals for changes in input prices and how should we take account of the difficulty that we have experienced in CP4 in confirming that renewals underspends have been efficient?

As noted in our response to Q3.1, above, while we acknowledge the theoretical rationale for using IOPI, in practice we have found it to be volatile, difficult to forecast and an inaccurate reflection of changes in our costs, which has resulted in planning uncertainty. We consider a better approach would be to index our costs using RPI. We believe that this would result in greater planning certainty, which is very important for the business. However, if that RPI indexation were to be based on an *ex ante* assumption we would need to revisit whether some form of input price protection is required.

We note that there is currently a broader discussion ongoing with ORR in relation to measuring financial performance in CP5. We consider that, in order to avoid some of the difficulties experienced in CP4, it is important that any new approach in CP5 is simple to understand and explain. There are a range of factors that have an impact on measuring financial performance and we do not consider that it is sensible to isolate just one of these, input prices. However, we believe that the approach to assessing the efficiency of renewals underspend could be improved by distinguishing between 'investment' (non-railway infrastructure such as IT systems) and 'renewals' (railway infrastructure such as track renewals).

Q5.3: What are your views about legacy debt and RAB?

Network Rail supports ORR's view that there could be a value for money case for a 'RAB clean-up' where government would pay down the part of Network Rail's debt which relates to historic non-capex additions to the RAB. In turn, ORR would make a corresponding RAB adjustment reducing the future funding requirement. We are, however, mindful of the fact that this is ultimately a decision for government and that its finances are highly constrained at present.

Q5.4: What are your views on our proposal to keep using the opex memorandum account?

Network Rail supports retaining the opex memorandum account in CP5 in order to avoid distorting the value of the RAB.

ORR is proposing to release its forecast of the value of the opex memorandum account at 31 March 2014, evenly over CP5, in order to smooth the effect on charges. ORR also considers that any difference between the forecast position at 31 March 2014 and the outturn on this account should be adjusted for in CP6, in the same way that other variances between the outturn position in 2013/14 and its PR13 assumption will be adjusted for[32]. Network Rail is content with ORR's proposed treatment of the opex memorandum account but notes that the capitalised financing cost is not taken into account.

Other remarks

Network Rail considers that the current RAB roll-forward process is complex and not well understood and thus we support simplifying it in CP5, where possible. We have commented on the specific areas identified by ORR for potential refinement, below[33]:

- Network Rail supports ORR's proposal[34], where possible, to treat enhancement overspends in England & Wales and Scotland consistently.

- Network Rail supports the consistent treatment of renewals and enhancements and, therefore, considers that the enhancements deadband should be removed. This would mean that we are exposed to 25% of any enhancements overspend (that is not manifestly inefficient)

[32] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.38
[33] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35
[34] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35(c)

but do not bear the first £50m of enhancements overspend. However, we recognise that there are inherent differences between these two cost categories, for example, costing enhancements is intrinsically more uncertain. We also note that, in practice, projects often comprise both renewals and enhancements and we deliver these projects as a single programme.

- Network Rail does not consider that the RAB policy should distinguish between unit cost and scope variances because this introduces unnecessary complexity and places undue focus on the respective aspects of the variances when it is the aggregate number that is most relevant. We believe that the RAB roll-forward mechanism should be simple and symmetric whilst being clear on the treatment of incremental activity. Consistent with this, we do not consider that it is appropriate to have an asymmetric mechanism for logging up/down renewals (currently the inclusion of renewals overspend in the RAB is subject to an *ex post* efficiency assessment by ORR, unlike renewals underspend). We believe that a better approach would be to remove the *ex post* efficiency assessment and have a simple automatic mechanism for logging up / down renewals. This would be more equitable, reduce complexity and remove the transaction costs associated with the *ex post* efficiency assessment.

- Network Rail supports ORR's proposal[35] to improve transparency by setting out in its determination criteria for when a failure to deliver outputs or maintain the serviceability and sustainability of the network would require a RAB adjustment. The RAB should represent the value that has been achieved by the company in delivering outputs. If outputs have not been delivered the RAB should reflect that. This should also be reflected in REBS.

- We do not, however, consider it appropriate to make an adjustment to reported efficiency in relation to any failure to deliver outputs or maintain the serviceability and sustainability of the network. We consider that as long as efficiency has been appropriately calculated it will exclude any missed outputs as it is part of a balanced scorecard, including outputs.

- We also consider that in CP5 a more balanced approach should be taken than is currently the case in assessing the extent to which Network Rail has achieved its targets. We think that it cannot be right that if the company has met, say 19 out of 20 of its targets, and achieved significant efficiency that it should be deemed to have 'failed'. A balance scorecard approach would allow trade-offs to be made. Absent such trade-offs, it

[35] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 5.35(e)

could be necessary to ‘spend’ significant sums to achieve the last output, where such expenditure could well be very poor value for money.

- Network Rail agrees that, at present, there is lack of clarity in respect of how ORR would adjust for a failure to deliver outputs or maintain the serviceability and sustainability of the network. Hence, we would support the development of further guidance in relation to how any adjustment would be quantified and the potential scale of the adjustment.

4. Corporation tax

ORR’s key messages

- ORR’s decision on the treatment of Network Rail’s corporation tax costs is unlikely to have significant financial implications for Network Rail in CP5 (as a result of its brought forward corporation tax losses and the effect of the adjusted WACC approach). But it is still important that ORR set out clearly its approach to corporation tax as the effect on corporation tax of income and expenditure decisions in CP5 will affect future control periods and can be material.
- In PR08, ORR determined the overall incentive strengths on income and expenditure on a net of tax basis and it is now consulting on whether it should retain that approach or whether another approach would be more appropriate.

Response to consultation questions

Q6.1: What are your views on the options we set out for our approach to corporation tax in CP5?

ORR considers that there are two main options for how it rolls-forward corporation tax balances from CP5 into CP6[36]:

- Take the PR08 approach which is the same approach as ORR used to roll-forward corporation tax balances from CP4 to CP5 and is consistent with its overall approach to risk and incentives, as it thinks it is appropriate that Network Rail is exposed to the net of tax effect of an underspend/overspend in income and expenditure; or

- Take a simpler approach to the roll-forward of corporation tax balances and just use its forecast of Network Rail’s efficient CP5 opening balances as the basis of its calculation of Network Rail’s efficient corporation tax payments in CP5, given that Network Rail is not forecasting to make

[36] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 6.17/6.18

significant corporation tax payments in CP5 and may not be affected by corporation tax incentives.

Network Rail generally favours taking a simpler approach to the roll-forward of corporation tax balances, where possible, but it is not clear that this is delivered by either of ORR's proposals. Before this process is determined the calculation of the regulatory estimates of tax opening balances and annual costs should be reviewed in some detail to ensure that, within reason, the calculation is as representative of tax legislation as is possible. Any differences arising solely from modelling assumptions which are incorrect or over-simplified should be identified and clarified.

Corporation tax is highly complex and technical and Network Rail considers that there would be considerable merit in simplifying the regulatory treatment of its corporation tax. We also believe that PR13 provides a suitable opportunity for such simplification. For example, ORR considers that in CP3 it 'pre-funded' Network Rail for c. £1.3bn of future corporation tax. Whilst we disagree with ORR on this point[37], if ORR confirms its previous decision we believe that the best way forward would be to wrap up all such issues into a one-off RAB adjustment at the start of CP5. This would create a more transparent and easier to understand tax position for the future.

In its consultation document, ORR makes a number of very detailed statements regarding Network Rail's corporation tax. Because of the very specialist nature of corporation tax, we intend to engage with ORR separately in relation to these issues.

5. Other financial issues

ORR's key messages

- ORR is proposing to allow part of Network Rail's income to be provided directly by the governments through network grants, which will be set ex-ante for each year of CP5, as it did in CP4.
- ORR will review the activities that Network Rail may be allowed to carry out in addition to its core business and consult on the options for its financial ring-fence in its draft determinations and conclude in its final determinations. This will help ORR to deliver its key transformational goals, especially aligning incentives and having a clear focus on what matters to passengers, freight customers and taxpayers – particularly improving value for money.

[37] We wrote earlier this year setting out the reasons why we consider that ORR is mistaken with regards to its view that Network Rail has been pre-funded for future corporation tax liabilities. Our letter included a paper written by Oxera, which sets out its views on the matter.

- In its May 2012 document, ORR proposed that it will disaggregate the effect of the PR13 financial framework, (e.g. it will set out indicative interest costs for the operating routes). This is consistent with its key transformational goals, especially 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) will provide for a more comparative approach to regulation and a better understanding of costs, revenues and subsidy across the sector.

Response to consultation questions

Q7.1: What are your views on our proposal to allow part of Network Rail's income to be provided directly by the governments through a network grant, which will be set ex-ante for each year of CP5?

We agree with ORR that it would be preferable if all our income came from franchised train operators and other customers. However, we are sensitive to arguments for the continuation of network grants to Network Rail. We also note that investors in Network Rail bonds appear to draw comfort from the fact that we receive a large proportion of our income in direct government funding.

Network Rail, therefore, supports ORR's proposal to allow part of its income to be provided directly by the governments through a network grant. Network Rail is also content with ORR's statement that, in order to improve transparency, it will include an *ex ante* schedule of network grants for each year of CP5 in its draft and final determinations.

We support the continuation of the provision in track access contracts that automatically increases track access charges, if the governments do not pay network grants according to a pre-determined schedule, to ensure that we recover the revenue we need to finance the business.

Q7.2: What are your views on the activities that Network Rail should be allowed to carry out?

We welcome ORR's statement that it will start to discuss with stakeholders the activities that Network Rail should be permitted to carry out under the provisions of its network licence[38]. We have recently written to ORR outlining our initial views in relation to this issue and look forward to engaging further with ORR on this important enabler[39].

[38] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.27
[39] Financial ring-fence issues paper

Network Rail considers that, consistent with its move to make more of its business contestable to third parties, it should be able to compete in new areas of business where it can offer value for money services.

At present, there are several activities not considered by ORR to be permitted business (or ancillary to it) and, therefore, Network Rail has sought consent from ORR or these have been allocated as *de minimis* (often following dialogue with ORR). We believe that the majority of these activities could be considered as permitted business or ancillary to it. For example, property activities are now a core area of our expertise, the income from which directly funds railway investment, yet our engagement in this activity is still subject to a formal consent from ORR.

To date, the financial ring-fence has not prevented us from fulfilling our purpose, role and vision. However, in advance of CP5 we would like to discuss with ORR the potential for 'reclassifying' certain activities as permitted business, not least because the *de minimis* facility (at least within the current prescribed limits) may be exhausted over the course of the next control period.

As part of the discussion paper that we recently provided to ORR we set out five potential options in relation to the ring-fence licence condition. We have not yet reached any firm conclusions about the best option and would welcome further discussion with ORR.

Q7.3: What are your views on increasing the strengths of the incentives on Network Rail to materially outperform our determination and to avoid materially failing to deliver our determination and should we consider more heavily incentivising genuine 'game changing' initiatives

ORR identifies a number of issues in relation to outperformance in the context of 'game changes'[40]:

- How does it distinguish between normal efficiency savings and outperformance?
- Should any changes to incentives be symmetrical?
- How does it improve incentives without overly complicating the reporting process?
- How does it distinguish between a 'game changer' and a normal efficiency initiative?

[40] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.43

During CP4 Network Rail identified the fact that longer term improvements would become increasingly difficult in the present business model. As a result, we decided to devolve much more accountability to a local level, to enter into alliancing arrangements with our customers, to change the way we deliver projects and to focus much more on culture change across the company. These game changers are critical for the long term but they create challenges for the short term and the business should be encouraged to make such choices.

However, Network Rail considers that the practicalities, complexities and transaction costs that would result from more heavily incentivising 'game changers' would significantly outweigh any potential benefits. It is also not clear to us how ORR would separately identify 'game changers' from other efficiency initiatives. Furthermore, if ORR's proposal were to be implemented it could create an undue focus on developing efficiency initiatives that are 'game changers' to the detriment of 'ordinary' initiatives. Therefore, we do not support distinguishing between efficiency initiatives.

We believe that the incentive framework should, as far as reasonably possible, be simple and symmetrical. If the incentives that we face are not symmetrical (e.g. we retain a greater proportion of out performance beyond a certain threshold) the chosen benchmark is likely to become 'too important'. The framework should also be sufficiently flexible to evolve in light of choices such as those outlined above.

Other remarks

Disaggregation

ORR states that, subject to further consultation, it envisages being in a position to undertake financially separate price controls for CP6. Therefore, in order to facilitate this in CP5 it will[41]:

- improve transparency by providing information on revenues and costs at the operating route level;

- make its assessments that underpin its calculation of Network Rail's revenue requirement (e.g. expenditure assessments at the operating route level where possible); and

- when it is confident that its operating route assessments are robust, consider making operating route determinations of revenues, charges and outputs (e.g. operating route variable charges).

[41] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.38

We welcome increased transparency of the performance and targets for each of our Operating Routes. However, we are concerned about ORR's discussion about the future regulation of the English & Welsh routes. We have no difficulty with revenues being set separately for each route but we cannot understand why outperformance in one route should not be traded against potential underperformance in another route. This is no different to in any other group of companies and it should facilitate efficient financing. We consider that it is a mathematical certainty that any other approach would be more expensive than is currently the case. Whilst accepting that ORR's suggestions in this area would not be implemented in CP5, we would welcome further discussion as to what ORR considers the benefits of this approach would be.

ORR also states that given that Network Rail has devolved responsibility for its operations to an operating route level it will focus its disaggregation in England & Wales on the operating route level, instead of other levels of geographical separation[42]. Network Rail welcomes ORR recognising that any other form of disaggregation would run counter to how the company is managed. However, we reiterate our view that we cannot understand why outperformance in one route should not be traded against potential underperformance in another route.

In addition, ORR states that it will assess amortisation by operating route and publish its assumptions[43]. Network Rail considers that given that there are only two government funders for CP5, amortisation should be assessed at the England & Wales and Scotland level and then apportioned to operating routes.

ORR believes separate risk and uncertainty provisions, such as re-openers by operating route, are unnecessary[44]. Network Rail agrees with ORR as long as the company is permitted to manage risk and uncertainty at a company-wide level.

ORR states that it will not make separate cost of capital assumptions and financeability adjustments by operating route[45]. Network Rail agrees with this as, consistent with managing the operating routes as a portfolio, we also raise and manage debt centrally at the NRIL level.

ORR confirms that it will determine separate outputs, access charges and regulatory frameworks for Network Rail in England & Wales and in Scotland, whilst taking account of the fact that Network Rail is a single company[46]. Network Rail is content with ORR's position in this respect. However, as set out in our response to the outputs consultation, it is critical that we have the flexibility to make sensible trade-offs in the way that we deliver required outputs and that we

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[42] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.39
[43] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (a)
[44] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (b)
[45] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 7.41 (c)
[46] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 9

have the flexibility to make trade-offs between different outputs, where this is the right thing to do from the point of view of the rail user and taxpayer. Moreover, given the need to maintain alignment between Network Rail and train operator outputs and to offer better value for money, we believe that it is imperative that there is a framework that allows us to make trade-offs across the routes in relation to what we deliver in CP5. We would do this by way of publishing our CP5 delivery plan, subsequent to ORR's determination.

ORR also states that improving the interfaces between the different players in the industry, for example, by facilitating alliances, efficiency benefit sharing at the route-level and bespoke arrangements where these improve whole sector working will drive greater value for money for customers and taxpayers[47]. Network Rail welcomes ORR's position on this issue. Indeed, one of our principles for CP5 concerns partnership. We consider that Network Rail and its customers/suppliers should be empowered to enter into various forms of partnerships or alliancing arrangements, which will improve value for money without undermining network benefits or scale efficiencies.

[47] ORR, PR13 consultation on financial issues for Network Rail in CP5, Paragraph 8(c)

Annex B: Network Rail's Response to ORR's consultation on Network Rail's output framework for 2014-19

This annex should be read in conjunction with the covering letter from Paul Plummer to Cathryn Ross on the ORR consultations on the output framework and financial framework for CP5. The covering letter contains our high-level comments on the overall frameworks.

The annex responds to each of ORR's consultation questions. ORR structured its consultation around the consultation questions, and the remainder of this annex follows the same structure.

In some instances, issues raised in the consultation document do not directly relate to one of the consultation questions, we have commented on / responded to these issues under the heading Other Remarks.

So as to create a standalone response and to ease readers' understanding of Network Rail's views, we have summarised ORR's views at the start of each section.

Q1: Do you agree with our proposals for outputs and indicators for passenger train service performance? Should we retain the sector level outputs for PPM and CaSL (for England & Wales?) Is there more we need to do to ensure consistency with franchise obligations?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
PPM	National (E&W, Scotland)	Output (set in HLOSs)	HLOSs
PPM	By operator	Output (forecast in SBP, set in delivery plan)	Passenger satisfaction outcome
CaSL	National (E&W, Scotland)	Output (set in DfT HLOS)	HLOS
CaSL	By operator	Output (forecast in SBP, set in delivery plan)	Passenger satisfaction outcome
Right time performance	By operator	Indicator (forecast in SBP)	Passenger satisfaction outcome
Average lateness	By operator or service group	Indicator (not forecast, but actuals monitored)	Passenger satisfaction outcome

Measure	Disaggregation	Status (& where set)	Main rationale
Network Rail caused passenger train delay minutes	Network Rail route	Indicator (forecast in SBP)	Passenger satisfaction outcome
Suite of cause of delay indicators (as used in Network Rail own reporting)	Various, including Network Rail route	Indicator (monitored)	Passenger satisfaction, HLOS
Worst performing routes (indicators of success of plan to address)	Specific to route	Indicator (monitored)	Passenger satisfaction, DfT HLOS

Response to consultation question

The HLOSs require a national CP5 exit level of PPM and CaSL for England and Wales, and a franchise CP5 exit level of PPM for Scotland. We propose that the top level regulated outputs should be at a national level, consistent with our key principles, in order to give flexibility of delivery. Therefore PPM and CaSL at this level should be the regulated outputs.

Our plan will be based on the expected outcome of the delivery of the HLOS requirements in these areas. There will be uncertainty in this delivery given the current industry understanding of input / output relationships and we will attempt to quantify the level of confidence in our plan in the Strategic Business Plan. Therefore, we propose that that it is appropriate that there be a threshold level of performance associated with the plan, that is agreed with the ORR as reasonable delivery. There will also be uncertainty in the delivery of plan due to:

- changing requirements of funders, as expressed through the refranchising process;
- a changing balance of outputs being better value for money and more aligned with industry requirements (e.g. increased capacity); and
- revision of our bottom up plans, in light of the first two bullet points, leading to a change in probability of delivery of the regulated outputs.

It is therefore essential that there is a change control process for our regulated outputs to take account of the above. Our plan will set out the key assumptions to allow such a process to work effectively.

Network Rail supports the proposal not to have sector level outputs. These should not be replaced with company level regulatory targets.

We propose that TOC level forecasts of PPM and CaSL are published in the SBP, consistent with the above. These would then be refreshed in the CP5 delivery plan as planning assumptions. These forecasts will be refined with the TOCs through the JPIP process and will become customer reasonable requirements. Setting the forecasts of PPM and CaSL via the JPIP process also supports the requirement for a change control process to reflect the overall impact of changes to the disaggregated outputs agreed through the JPIP process. The JPIP process itself allows TOCs recourse to the ORR if they feel that Network Rail is not planning for appropriate improvements in performance. However the initial discussions should be directly between Network Rail and TOCs.

We would welcome further discussion with ORR and our customers on the CaSL metric in order to ensure that there are not contradictory incentives to those generated by the PPM metric. On days of severely disrupted performance, the priority should be to transport the maximum number of people to their destination, which is supported by the TOCs but can be contrary to the CaSL output.

Network Rail will be setting delay minutes reduction targets for each route for Network Rail caused delay and agrees that these will be an indicator as they are a metric by which we manage the business. However, we propose that the measure of delay minutes be aligned with that used in the franchise agreement and that only above threshold delays be included. Clarifying the definition of delay to exclude subthreshold delay would align the Network Rail reporting principles to those used by TOCs, remove obstacles in current delay attribution, and reduce the need for side agreements and helps to create an improved delay capture environment.

Network Rail also proposes that consideration be given to TOC delay minutes in order to drive consistency of incentive. We note that we are responsible for the TOC on TOC delay minute forecast and would like this to be included in the JPIP process.

At a TOC level, we propose that individual baskets of measures are agreed with each TOC through local level discussions and as such this level of detail would not be published in the CP5 Delivery Plan, but we would include it in the JPIPs which we would share with ORR.

Right time train service performance data has been subject to much discussion at NTF, partly as there is a concern that it could drive perverse behaviours. We will not forecast ‘right time’ performance given that these are new metrics, but we will report it at a TOC level. We recognise that having right time as an indicator may be helpful in driving customer focussed improvements for some services and therefore will discuss with each TOC whether it is appropriate for inclusion in the JPIP basket of measures.

We are not clear on the definition of average lateness as intended by ORR at this stage. We propose that an average lateness metric, if important to our customers, be included in the JPIPs as an indicator.

In response to the proposal to have indicators demonstrating the improvement of worst performing routes, Network Rail would welcome dialogue with ORR to agree the definition of 'route' in the consultation and the linkage with economic value as required by the HLOS.

We strongly support the alignment of the Network Rail obligations and those obligations on franchised operators set through the refranchising process. We propose that obligations set in new franchises are consistent (both metrics and targets) with those set for Network Rail via the periodic review process. The absence of such alignment of TOC obligations with Network Rail obligations reinforces the necessity for a change control process to realign Network Rail's obligations with those set for industry via the refranchising process.

Q2: Do you agree with our proposals for an output and indicators for freight train service performance?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Freight measure of cancellations & significant lateness	To be decided	Output (forecast in SBP, set in draft determination)	Freight customer satisfaction outcome
Network Rail caused freight train delay minutes	Network Rail route	Indicator (forecast in SBP)	Freight customer satisfaction outcome
Suite of cause of delay indicators (as used in Network Rail's own reporting)	Various, including Network Rail route	Indicator (monitored)	Freight customer satisfaction, HLOS

Response to consultation question

Network Rail recognises the importance of a performance obligation to our freight customers and supports a freight performance metric as a regulated output. The freight industry still supports the introduction of a freight delivery metric (FDM) as the main measure of Network Rail freight performance during CP5. This metric will measure the percentage of freight commercial services that do not reach their destination within 15 minutes of their booked arrival time and which have either been cancelled, or delayed by 15 or more minutes by Network Rail or a non FOC commercial operator.

We agree that FDM should replace delay/100km as the regulated output. However, FDM has not yet been formally agreed as the appropriate measure with all FOCs and ORR. Subject to us agreeing the appropriate metric and target with our customers, we propose to forecast the new metric in the SBP in line with ORR's proposals.

We do not believe it is sensible to disaggregate targets at a FOC level as the competitive nature of the freight business means it is impossible to know who will operate which flow in forthcoming years and performance depends upon the flow rather than the operator. Annual performance plans will be produced for each FOC and these will include forecast metrics and measurable plans for each operator.

We propose to forecast delay/100 km as an internal performance indicator only as it underpins FDM targets.

We are in the process of developing other KPIs around planning and control although these are not expected to be fully developed when we publish the SBP. We will be open with the ORR about our ongoing plans and agree that indicators for monitoring purposes should be agreed from this suite of KPIs for CP5.

Q3: Do you agree that outputs for Network Rail in relation to named projects, capacity metrics and funds should be project-specific milestones defined in the enhancements delivery plan? Do you have any comments on how useful the enhancements delivery plan has been in CP4? What are your views on indicators to measure the efficiency and effectiveness of the use of the funds?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Enhancement scheme delivery milestones	Specific to enhancement location	Output (set in delivery plan)	HLOSs
Enhancement scheme indicators for schemes associated with HLOS funds (e.g. average scheme BCR)	Specific to enhancement scheme	Indicator (not forecast, monitored)	Support for economic growth outcome, HLOSs

Response to consultation question

We support ORR's proposal to continue with CP4 arrangements for named projects. We think the current change control process works well and that it has become less bureaucratic. We recommend that it only operates at relatively high level. Minor changes should not require change control (for example minor edits in the scope description should not require change control but a change in scope should).

Once the schemes required to deliver additional capacity have been agreed we agree with the proposal to monitor delivery in the same way as for named projects.

We strongly believe the CP4 arrangement for funds has worked well and delivered good value for money for funders. Whilst some of the ORR proposals are reasonable, we are concerned that others are too cumbersome and will lead to an ineffective and inefficient arrangement. Indicators that report the benefit of the expenditure might be appropriate for some funds, but not all, and they will need to be chosen very carefully to reflect the actual output delivered. In our view an average BCR is not likely to be effective but a high level output for, say, the number of schemes/stations completed would be more appropriate. We propose that delivery milestones associated with funds are set at a high level, such as scheme completion dates only, rather than intermediary dates as the latter would lead to too many separate milestones.

Whilst we undergo the process for agreeing the governance arrangements for each fund (led by POG), we will consider whether there is a fund appropriate metric that will add value to the governance arrangements and discuss this on an individual basis with industry and the ORR.

Other remarks

With reference to paragraph 3.23, we are concerned that it is not clear how the value for money requirements in the Secretary of State's guidance to ORR (paragraphs 12 – 22) are intended to work in practice, particularly how the guidance will be applied. We would welcome dialogue with ORR to arrive at a common view on this in order to determine how the portfolio of projects we put forwards to deliver the capacity requirements will be assessed.

With regard to involving representatives of passengers and freight end users (paragraph 3.26), we think it would be unwieldy and ineffective to directly involve freight end users and passengers in deciding how funds are spent. The direct involvement should be with operators. The views of end users would be better sought in a wider overall planning arena through RUS consultations and wider stakeholder events rather than through specific fund governance meetings.

For large scale (not typical enhancement) projects, we are concerned that the proposal as drafted is very open ended as there is no indication on what would constitute a large project. This will be further discussed in the asset management section of this response.

Q4: We propose to define delivery plan milestones to ensure Network Rail delivers a plan to reduce risk at level crossings, and to use certain indicators to monitor Network Rail's delivery of these outputs and its wider legal obligations. Do you agree with this approach?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Level crossing risk reduction plan delivery milestones	Specific locations on network	Output (forecast in SBP or delivery plan – to deliver reductions in level crossing risk funded by HLOS)	HLOS
Level crossing risk reduction measure Level crossing closures (Scotland)	tbd	Indicator (forecast in SBP – to deliver reductions in level crossing risk funded by HLOS)	HLOS
Red Zone Working	tbd	Indicator (forecast in SBP)	Workforce safety
RM3 excellence in health & safety culture & risk control	tbd	Enabler (forecast in SBP)	Management maturity
Precursor Indicator Model – infrastructure failures	tbd	Indicator (forecast in SBP or delivery plan)	Asset management
Workforce safety	tbd	Indicator (forecast in SBP or delivery plan)	Workforce safety
Passenger safety index	Network Rail total	Indicator (monitored)	Passenger safety

Measure	Disaggregation	Status (& where set)	Main rationale
Number of enforcement actions against Network Rail or subcontractors	Network Rail total	Indicator (monitored)	Passenger and workforce safety

Response to consultation question

Safety is our number one priority, and as such it is vitally important that the monitoring framework drives the right behaviours from both our internal staff and our external stakeholders.

Regardless of whether the measures are regulated outputs or indicators, monitoring and reporting a given metric focuses those involved towards performance against that metric. It is of critical importance that the output framework incentivises Network Rail and its stakeholders towards focusing on the desired outcome of minimising safety risk, without unnecessarily diverting attention towards more input focused measures.

For too long, Network Rail has been fairly criticised for being on the back foot, reacting to issues arising from the regulator or elsewhere. But, our compelling and straightforward safety vision summarised as ‘Everyone home safe, every day’, and the ambitious and comprehensive strategy for safety and wellbeing represent a vital change. Along with our more probing corporate safety assurance, these represent Network Rail seizing our agenda for safety. A monitoring framework that focussed on isolated inputs would risk distraction from that agenda and consequent lost opportunity.

ORR proposes a range of potential metrics to measure Network Rail’s performance in CP5. While we agree that some of these measures are appropriate for CP5, we believe that some would not drive the required behaviours and would increase the regulatory burden. ORR proposes a number of indicators that do not align with how we plan to monitor our business. For example, some measures focus on too narrow a metric. Focusing on a specific element of safety management runs the risk of driving improvements in an input, rather than the actual outcome of minimising safety risk

We agree with the principle that there should be a regulated output associated with the level crossing requirements stated in the HLOS. We also propose that as we develop our suite of internal KPIs, we share these with the ORR as indicators for CP5. We recognise that an area for development over the end of CP4 and through CP5 will be the development of our safety culture and that the way in which we measure improvement in this area should be shared with ORR.

We agree that level crossing risk reduction plan delivery milestones are an appropriate measure to assess the delivery of the outputs that the governments have decided to purchase in this area. We will set out high level delivery milestones in our SBP, with greater detail in our subsequent delivery plan, with changes to the baseline in CP5 being subject to the standard change control process. We will develop separate plans for England & Wales and Scotland.

While we agree that a level crossing risk reduction measure would be useful for monitoring the benefits of the outputs purchased by governments, we do not believe that a specific measure of level crossing closures in Scotland is an appropriate approach. We recognise that in the Scottish HLOS, Scottish Ministers referenced level crossing closures. However, focusing only on the closure of level crossings may not deliver the greatest value for money solution for reducing risk at level crossings. Consequently, we will be proposing a programme of level crossing risk reduction measures (which will include some closures) in both England & Wales, and Scotland. It would be more appropriate for there to be an indicator of the overall level of risk reduction, rather than a narrow, potentially less effective, focus on closures.

We recognise the significant risks of workers being struck by trains but do not believe that singling out what is currently known as red zone working to be the most effective approach to reducing workforce risk. The changes to the Rule Book have already removed the terms red and green zone working. Our intended deployment of technology already used in some European railways will involve protection that is safer than some aspects of what is known as green zone working. Having a metric that focuses solely on the level of red zone working could be counter-productive to Network Rail focusing on the overall outcome we wish to achieve of minimising safety risk. It would be a perverse incentive to inadvertently encourage, in some places, more dangerous forms of working simply because they were classified as red zone. We therefore do not support the use of a red zone working measure.

We strongly believe that a PR13 measure based on the rail management maturity model would equate to focusing on inputs, a principle we disagree with. RM3 was fundamentally designed as a qualitative and illustrative tool to to encourage railway businesses to excellent management systems, and not as a numeric tool. We recognise its value, alongside other management system benchmarking tools and will be using it in CP5 to qualitatively inform our understanding of our risk management, but using it in isolation, and specifically with an artificial focus on abstract numerical scores would be a misuse of the tool. We therefore do not support the use of a RM3 as a forecast enabler. We would welcome further discussion with you on the indicators and tools that could be used to inform our discussions with you on safety performance.

We believe that a broader Precursor Indicator Model (PIM) could provide a useful tool for understanding changes in the underlying safety risk. However, we believe that focusing purely on infrastructure failures looks at too narrow a part of the overall picture. We would also question the worth of providing speculative forecasts for this measure. We therefore propose to report in line with a broader PIM measure, and not to produce a speculative forecast.

During CP5 we will be monitoring workforce safety. In the IIP we provided workforce FWI forecast split by England & Wales and Scotland. We do not propose a further level of disaggregation than that of funder level although will refresh our forecasts in the SBP.

The passenger safety index should be part of the PIM. In the IIP we provided passenger FWI forecast split by England & Wales and Scotland. We do not propose a further level of disaggregation than that of funder level although we will refresh our forecasts in the SBP.

We do not believe that the number of enforcement actions against Network Rail or our contractors to be a useful metric. The metric could be heavily influenced by ORR's approach to issuing enforcement notices, a pattern which already seems to show inconsistency between operational teams and individual inspectors that does not align with underlying risk. Arguably partly a metric of regulator approach than just safety performance, such a metric would be prone to skew depending whether inspectors choose to target isolated simple weakness with many separate notices or a more systemic and significant issue in one notice with wider scope. We would hope and expect ORR to opt for a more direct and constructive dialogue on any concerns and therefore believe this measure not to be a meaningful metric.

In situations where companies are part of a joint venture, enforcement notices have been issued to all parties. This artificially increases the number of notices served and would potentially act as a disincentive to partnership working. This would be an unacceptable outcome as we view increasing the level of partnership working as essential to delivering value for money in CP5, in line with our key principles. We therefore do not support the use of the number of enforcement actions as a measure.

Q5: Do you have a proposal for an alternative to the existing network availability (for reducing disruption from engineering works) outputs, which could be viably implemented in time for the start of the next control period? If the existing outputs are retained do you have any proposals to improve them?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
PDI-P [or alternative measure proposed by industry]	Network total	Output (forecast in SBP, set in determination)	Passenger satisfaction outcome
PDI-F [or alternative measure proposed by industry]	Network total	Output (forecast in SBP, set in determination)	Freight customer satisfaction outcome

Response to consultation question

Network Rail is in the process of developing, with industry, new metrics for network availability. For TOCs, this metric will be based around the working timetable, for FOCs around the ability to provide freight customers with a source to destination route. ORR has been involved in the development of the new metrics and we would welcome the opportunity in the near future to discuss further their development. These metrics are not expected to be approved by industry in time to forecast them in the SBP. We therefore propose to forecast PDI-P and PDI-F in the SBP and agree that they are used as regulated outputs. We agree that the metrics should be retained as network totals.

The revised metrics can be disaggregated to a lower level and we propose that, although the network forecast in the CP5 delivery plan be used as an indicator, that the disaggregated level be one of the first items in the possession indicator report.

Further possession indicator report metrics are evolving and we will need to work with ORR and industry to define the purpose of each one. We propose to publish them on our portal transparently and in alignment with our route reporting. There will be a challenge to network availability in CP5 given the level of work taking place on the network. We will need to develop robust measures internally and will share these with ORR.

Q6: Should we introduce a measure of the efficiency of the use of possessions, and if so how could this be defined?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Possession indicator report metrics	Various, including by operator	Indicator (monitored)	Passenger & freight customer satisfaction outcomes

Response to consultation question

We believe that schedule 4 is the existing incentive to utilise possessions effectively and therefore that an additional metric would add to the regulatory burden without providing further value. Network Rail must agree our access plans with our customers and look at the amount of work done and disruption caused. There is currently a workstream in place looking at how we can better record data with regard to how we use the possession time and we would welcome the opportunity to discuss this with ORR at the appropriate time.

Q7: Do you agree that we should retain the CP4 network capability output? Do you have a view on the usefulness of the indicators suggested, or any further suggestions for improvement?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Track mileage and layout, line speed, gauge, route availability and electrification type	As defined in sectional appendices, GEOGIS database and national gauging database	Specific output to maintain at end-CP4 level subject to network change control process (included in determination)	Passenger, freight customer satisfaction outcomes, TS HLOS

Response to consultation question

Network Rail supports retaining the network capability measure from CP4 through to CP5. If the sectional appendices, GEOGIS database or national database are replaced by different systems that contain the same information, the new systems should represent the level of disaggregation required.

Q8: We want to improve the definition of the existing station condition output (SSM – station stewardship measure) and introduce a new measure – SSM+ - which provides a clearer disaggregation for measuring condition and better, value based, weights. Do you agree with this new approach?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Station stewardship measure	tbd	Output (SSM forecast in SBP and set in draft determinations' timing for SSM+ output TBD)	Passenger satisfaction outcome

Response to consultation question

Network Rail plans to continue to use the station stewardship measure throughout the next control period, using the measure through CP5 will enable clear continuity of asset condition. However, we note that the changing responsibility for the stations on the network will impact on the validity of the metric as it becomes applicable to a reducing number of stations. We therefore propose that the metric be an indicator in CP5 to reflect the fluidity of station accountability. Also, as SSM is only one component of the station environment that influences customer experience, we consider that indicator status would be more appropriate. We will forecast SSM in the SBP and refresh our forecast in the CP5 Delivery Plan and then following the publication of the 2014 Annual Return.

Network Rail supports the ORR led development of the revised station stewardship measure and a move to it in principle. We would like there to be clarity and industry agreement on the measure prior to the start of CP5 although recognise that this would require urgent work over the next six months prior to industry consultation. We also consider that a shift from SSM to SSM+ during the control period supports the use of these measures as indicators rather than as regulated outputs. SSM+, as a measure dependent on remaining asset life, is more supportive of a sustainable asset management outcome that an improved passenger satisfaction outcome.

Q9: Do you agree that we should retain the current CP4 measure of depot condition but treat this as an indicator rather than an output?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Depot average condition score	tbd	Indicator (forecast in SBP or delivery plan)	Passenger/freight customer satisfaction

Response to consultation question

Network Rail supports the use of the measure of depot condition as an indicator in CP5. This will be forecast in the SBP, refreshed in the CP5 Delivery Plan and then again following publication of the 2014 Annual Return. Network Rail is currently considering refining the LDM measure to introduce the weighting of components and proposes to share this development with ORR with an expectation that it is the refined measure that becomes the indicator in CP5. We would also welcome discussion on how, given a reducing population of depots within Network Rail accountability, the migration of depots out of the LDM measure should be appropriately managed. We support the continuation of a split of the measure between England & Wales and Scotland.

Q10: Do you agree with the proposed new approach to strengthen the focus on further asset management improvement? Do you have any specific comments on the detailed measures?

ORR's key messages

The ORR sees the need to have indicators covering all the following areas:

- capability, through the asset management excellence model and/or the PAS 55 standard;
- the quality of the asset policies and their delivery in terms of maintenance and renewals work; and
- the quality of information held about assets.

The impact of this will be measured through:

- the condition of the assets;
- the performances of the asset; and
- monitoring the delivery of projects designed to improve asset management.

The quality of asset management will be measured using AMEM (the Asset Management Excellence Model) which is currently in use. The ORR wishes to agree a trajectory for Network Rail's required capability and monitor this on an operating route basis where appropriate. In addition, the ORR also proposes that Network Rail should be required to gain full organisation-wide certification against the BSI PAS 55 measure for asset management.

Network Rail needs to set out improved indicators of asset condition, by asset type based on robust degradation analysis. The ORR would like to see more clarity of reporting of asset condition through the introduction of a simple grading system.

The ORR expects Network Rail to define a framework which can be populated with indicators to give a view of its asset performance across the board, aggregated by asset type and operating route.

There are projects such as ORBIS and the new operating strategy which will improve asset management. The ORR will monitor these closely during CP5 through milestones in the delivery plan.

Response to consultation question

Recently we have discussed with ORR our plans for improvements in asset management and what this means for regulation. We have agreed to hold further discussions on the suite of leading indicators which we are developing for use within the business and for our Board. We hope that this will also prove useful in a regulatory context and our response in this area is subject to this ongoing dialogue.

Network Rail agrees that there should continue to be a strong focus on asset management in order to enable the delivery of the required outputs for CP5 in a sustainable manner and that part of this is to continue to develop our capability in CP5 for delivery in CP6 and beyond. The monitoring of asset management should be consistent with the Network Rail key principles for CP5 and the ORR key principles set out within the consultation. Fundamentally, asset management enables delivery of the regulated outputs in CP5, however, we recognise that there is also a need for ORR to be assured that the outputs are being delivered in a sustainable manner and that Network Rail's asset management capability continues to improve for the benefit of CP6 and beyond.

As part of our focus on asset management Network Rail will pursue full organisation certification of BSI PAS 55, a specification for the optimised management of physical assets. We agree that achievement of this certification can be used as an indicator of our developing asset management capability. In 2014 this standard is planned to be replaced by a new ISO 55000 series of international asset management standards that are currently under development.

On publication, Network Rail will review potential certification to the ISO 55000 series.

Beyond formal certification, Network Rail intends to continue measuring its development of asset management capability in CP5 using the asset management excellence model used during CP4. AMEM allows Network Rail to benchmark its performance against a number of other companies and sectors, and to track its developing position against a dynamic 'best practice' position.

Although we intend sharing the outputs of the AMEM assessments with ORR, we do not believe the AMEM is an appropriate regulatory obligation, for the following reasons:

- we do not believe that we should be set targets on how we achieve our outputs as well as what outputs need to be achieved;
- the AMEM is a dynamic model, subject to regular review by AMCL. This means that the baseline is not fixed, so long-term targets are difficult to set (i.e. even maintaining a constant AMEM score may reflect significant improvement);
- a limited number of the criteria from the model cannot be monitored separately due to the interdependent nature of the criteria; and
- whilst we seek to improve our capability scores, as our knowledge improves, it may become apparent that we need to change our specific action plans so that we continue to focus on the areas that deliver most benefit.

Network Rail would welcome discussion with ORR about how and at what level we plan to forecast AMEM for CP5 to enable management of the business. The focus should be on the underlying purposes and should make use of indicators rather than being driven by them.

We are committed to meaningful cross-route benchmarking of key aspects of asset management capability (e.g. asset data quality, people competence), and we intend to develop appropriate measures to reflect this. However, we intend to use the complete AMEM model at national-level only, reflecting our national asset management policies and framework. We do not believe the AMEM is an appropriate tool to manage asset management capabilities at a route level, due to the different asset bases in each route (which the model will reflect in differing scores when assessing understanding and implementation of asset policies). Additionally, the priority areas for improvement for any given route will be dependent on the asset make up of that route, therefore there would need to be a very detailed baseline of each routes capability to establish a sufficient understanding upon which to prioritise an improvement plan, and measure the subsequent rate of progress.

We note that the assessment of our asset policies is ongoing, and recognise that ORR will require assurance that they are being delivered against. We will provide ORR with that assurance in the same manner with which we assure ourselves of appropriate delivery. We will state volumes of renewals and maintenance works in our CP5 delivery plans and will share delivery progress against these. We agree that these should be indicators as this provides Network Rail flexibility in how it delivers across the network, recognising changing network priorities and developing asset management competence. We note that these forecasts will continue to be updated.

The consultation document makes reference to the separate monitoring of 'major renewals projects'. We would welcome discussion with ORR as to what constitutes a 'major renewals project' but agree that, as we monitor delivery of these projects ourselves, this will also be shared with the regulator to provide it with assurance.

We are currently developing a framework of asset management KPIs, including asset performance and simple asset condition measures and these will be included in our Strategic Business Plan. The framework will include a revised Asset Stewardship indicator at asset and route level, and we intend to use these as the indicators for CP5. We will share further detail with ORR by 31/10/12.

ORR suggest that projects such as ORBIS (Offering Rail Better Information Services – our key asset information improvement programme) and elements of the new operating strategy be monitored via milestones in the delivery plan. The operating strategy is embedded in our route renewals and maintenance plans and therefore it is not practical to measure its delivery separately to the delivery of the overall plan. The delivery of the operating strategy will be reflected through the opex efficiency run rate, which will be shared with ORR through the control period. However, we recognise that the ORBIS programme is a significant enabler to the delivery of CP5 outputs and the outputs of future control periods. We therefore agree that monitoring the delivery of this programme (via sharing of our milestone plan) as an indicator of improving our asset knowledge would be appropriate.

Q11: Which, if any, of the asset management measures do you think should be regulatory obligations (equivalent to outputs), and which should be enablers/indicators?

ORR's key messages

On the one hand, creating regulatory obligations for asset management could be a way to increase the pressure on Network Rail, but it could also be argued that monitoring all these measures and considering Network Rail's performance in the round against the licence is sufficient.

At this stage the ORR is considering setting the asset management excellence trajectory, asset data quality, and ORBIS/operating strategy milestones as regulatory obligations.

Response to consultation question

Network Rail believes that all metrics included as part of the regulatory framework for asset management should have the status of indicators. We are in favour of output based regulation and asset management metrics are inputs to the delivery of the required outputs, therefore should not be regulated as outputs in their own right. The focus should be on the underlying purposes and should make use of indicators rather than being driven by them.

Q12: Recognising that certain indicators are needed to monitor HLOS delivery, and that Network Rail is in the process of deciding on further indicators, do you have views on specific environmental indicators which we should monitor?

ORR's key messages

Measure	Disaggregation	Status (& where set)	Main rationale
Indicators demonstrating reduction in carbon dioxide emissions associated with Network Rail MORE activity	England & Wales, Scotland	Indicator (forecast in SBP or delivery plan)	TS HLOS
Carbon & energy efficiency objective indicators	Tbd	Indicators (forecast in SBP or delivery plan)	DfT HLOS
Carbon embedded in new infrastructure	Tbd	Indicator (monitored)	DfT HLOS
Sustainable development KPIs used in Network Rail's own reporting [new set of measures to be proposed by NR in SBP/DP]	Network Rail route	Indicators (forecast in delivery plan, monitored)	Environmental sustainability outcome

Response to consultation question

This year we have created a new Safety & Sustainable Development (S&SD) function, merging our Corporate Responsibility and Environment Policy teams. The newly formed Sustainable Business Strategy team is leading the development of a company-wide vision and strategy for sustainable development, which will be implemented in 2013. The first phase of internal and external stakeholder consultation on our new approach has already taken place, with wider consultation planned during 2012.

We already report on a variety of sustainability metrics via our website (http://www.networkrail.co.uk/publications/sustainability-update/2012/) and would welcome sharing these with ORR.

We propose that the key indicators forecast in the SBP should be targeted on the sustainable development outputs that are covered by the HLOSs, namely; carbon emissions (scope 1 and 2). We propose that carbon emissions per train km and total carbon emissions by year and funder are forecast in the SBP as indicators.

The Scottish HLOS is quite specific in stating the need for a continuous and sustained carbon reduction per train kilometre and freight tonne kilometre in the operation, maintenance, renewal and enhancement of the network. Carbon emissions per train and freight tonne kilometre can be a slightly misleading metric if viewed in isolation. As not all emissions are driven by traffic volumes, it will be important for Network Rail to continue to report total emissions as well as the normalised measures.

It may also be open to interpretation what ‘continuous’ means in the above context. This could be interpreted either as a year-on-year reduction or over a longer time frame. If interpreted as a time frame longer than a year then greater trade-offs between cost efficiency and environmental benefits could be enabled and hence deliver greater value for money.

The consultation is not clear what exactly is meant by ‘objective indicators’ for carbon and energy efficiency. As stated above, we believe that we should be measured against outputs rather than inputs. Consequently, a suitable energy efficiency objective indicator could be for us to report our total carbon emissions.

We are currently in the process of developing a framework to assess the embedded carbon in new infrastructure. We are seeking to roll out this approach to a few major projects where the greatest benefit of reducing carbon could be realised. If this approach leads to significant benefits, we would then seek to roll this out to a greater number of projects, again on a targeted basis determined by where there would be the most benefit for us to do so. We propose that we continue with our current plans, providing updates to ORR on our progress as and when our framework starts to deliver benefits.

As our sustainable development strategy develops there may be other metrics that as a business we will wish to measure. As this development evolves, we will share this with ORR.

The below table sets out some of the sustainable development measures we already report to other regulatory authorities:

Measure	**Reason**	**Relevant Regulatory Authority(s)**
Environmental incidents	Compliance with damage regulations. Memorandum of Understanding with the Environment Agency (EA)	EA & Scottish Environment Protection Agency (SEPA) *Potentially others dependant on nature of incident (e.g. Natural England, English Heritage)*
Events of non-compliance with environmental permits *(e.g. discharge, abstraction, waste processing)*	Environmental permitting regulations	EA & SEPA
Condition of Sites of Special Scientific Interest (SSIs[48]) we own	We are expected to maintain these in current condition.	Natural England, Scottish Natural Heritage, Countryside Council of Wales
CRC carbon footprint	Carbon reduction commitment (CRC)	Department of Energy and Climate Change

We will share with ORR the information that we already provide to the other regulators. In line with the Hampton principles of regulation, we will continue to provide information to the above regulators as required under our existing obligations and hope the ORR would avoid seeking to duplicate reporting requirements in these areas.

[48] Note that Network Rail does not undertake the surveys required to formally measure condition of these sites. Our role is to maintain their condition, and the relevant regulatory authorities will measure and formally report their condition to their own timescales (typically on a 5 yearly basis).

Q13: Should we introduce a new indicator of changes in journey times? Do you have views on how this measure should be calculated? Should we also introduce a measure of accessibility to stations?

ORR's key messages

The use of enablers in CP4 has been a success which should be built on in CP5. ORR intends to retain the safety management maturity model and asset management excellence model enablers in CP5, and expect these measures to be forecast in the SBP. ORR is also considering using the under development customer service capability methodology as an enabler in CP5.

There is no obvious single measure of journey time, so the ORR is seeking views on how best the industry could measure this in CP5, in particular whether average journey times or a matrix of minimum or average journey times between defined destinations might be useful for passengers.

In line with the Scotland HLOS, the ORR will also require Network Rail to produce a plan within its SBP to ensure that opportunities to improve journey times are recognised and acted on.

Both the England & Wales and Scotland HLOSs provided funds for improvements to stations. ORR are considering whether to define a measure of accessibility or instead rely on monitoring the delivery of relevant enhancement schemes milestones.

Response to consultation question

Network Rail believes that an indicator of average journey time changes would be complex to create and implement in a meaningful fashion. However, as part of the establishment of governance arrangements for the funds specified in the HLOSs, we will examine whether there is a meaningful, value adding metric that could be applied to the fund expenditure.

Network Rail is committed to improving the inclusivity of service of our stations throughout CP5. We consider that the area of inclusivity of service is one that is already partly covered by legal requirements on the service provider at stations and that therefore a metric in this area could lead to confusion over accountability. We would support ORR development of an industry measure of inclusivity under Section 4 duties that could feed into both franchise commitments and also the Network Rail regulatory framework in CP6, but consider this an area too immature to be implemented in CP5. We would propose that funding provided via the specified funds in the HLOS be monitored through the approval of the governance arrangements of such funds, although as part of the proposal of governance arrangements, an appropriate metric for the fund could be considered.

Other remarks

The use of the safety management maturity model and the asset management excellence model enablers as part of the regulatory framework have been discussed earlier in this response. Network Rail does not support using improvement trajectories as regulatory targets.

Network Rail is developing a methodology to provide an understanding of customer service maturity. The outcome of this work will help us to consider how best to apply a customer service maturity measure across the organisation. This will in turn support our strategy for achieving a step change improvement in the delivery of customer service during CP5 and beyond. We will continue to engage ORR during the development, and will share our findings from the initial development and evaluation stage which is planned to be completed in March 2013. The next stage will involve wider engagement of stakeholders.

ORR suggests establishing an “enabler” which will measure customer service maturity. Even by positioning this as an “enabler”, it risks adding complexity to the regulatory framework, especially if ORR intends to agree a trajectory as part of PR13. At this stage of the development work, it is uncertain what the eventual framework will look like, or what form a trajectory might take. Network Rail will develop an implementation plan for CP5 but, for the reasons set out above, to formally embed measures and targets within the regulatory determination would be inappropriate.

Q14: Should we introduce a new indicator designed to measure improvements in passenger information provision and how should this be measured?

ORR’s key messages

A new licence condition was recently introduced for Network Rail and operators concerning provision of information to passengers. The ORR is considering whether to introduce an indicator covering the quality of this information.

Response to consultation question

Network Rail has a responsibility to provide quality information to TOCs in order to facilitate the provision of quality and timely information to the end user of the railway. We have liaised extensively with operators and Passenger Focus on this issue. We propose that the National Passenger Survey is a good existing measure that is fit for purpose, although we do not propose to use this as a forecast indicator.

In order to be consistent with an output based regulatory regime, an additional metric would need to be focussed on the passenger experience of information provision. Given the division of accountability in this area, it is difficult to identify a metric for which Network Rail would be fully accountable in this area. We also note that passenger information provision is an area which is subject to rapid development and change given the evolution of social media over the past couple of years. Hence describing measures and targets for six years hence is very difficult. We would welcome further dialogue with ORR on how this area could be developed further.

Q15: Should we also consider new indicators, for example covering Network Rail's supply chain management and approach to innovation?

ORR's key messages

The ORR welcomes views on how Network Rail's engagement with its supply chain could be measured, but takes the view that there is no clear case for such measurement. Similarly, the industry needs to the benefits from continued innovation and the ORR will establish governance arrangements for the new innovation fund set up by the DfT HLOS. Monitoring indicators beyond the workings of the fund are being considered but currently there is no clear case for them.

Network Rail should monitor its own capability in programme and project management, collaborative working and change management. It should propose a framework for each of these areas by which the ORR can measure progress.

Response to consultation question

We agree with ORR that an efficient and high performing supply chain is essential to the success of the rail industry and delivery of value for money. However a direct metric for Network Rail / supplier engagement would be complex and inconclusive. In addition, we conduct a Mori poll each year in which we are scored specifically on engagement and we would plan to continue to do this. We will continue to develop revised internal measures as to how we manage this side of our business and will be transparent and open with the ORR about this. We will also continue to develop our project and programme management capability and will work with ORR to demonstrate this process over the remainder of this control period and the next. As the metrics are developed that allow us to monitor this process internally, we will share and discuss them with ORR.

Governance arrangements for the usage of the Innovation Fund, described in the DfT HLOS, have been proposed to POG, TSLG and have been endorsed by RDG. We agree with ORR that there is no clear case for further indicators. However we are developing a measure that considers the benefits of innovation projects based around a rate of return for use in our own business management. As this measure is developed we propose to share this, transparently, with the ORR, and the actuals as they are measured through CP5.

Other Remarks

Network Rail welcomes the innovation funding provided for in the HLOS / SOFAs, and it considers that much more needs to be done in this area to provide for a sustainable level of research and development expenditure in the railway. We therefore intend to develop proposals in conjunction with RDG to address this issue.

Q16: Do you have views on the introduction of a new measure of how Network Rail is developing its capability as a system operator, and what the measure should cover?

ORR's key messages

The ORR plans to define measures of how well Network Rail is performing in its role as a system operator, possibly covering the following functions:

a) the process of assembling, validating and publishing the timetable;
b) possessions planning;
c) understanding capacity availability and utilisation;
d) network planning;
e) network change.

Response to consultation question

Network Rail recognises the importance of our role as a system operator in maintaining fair treatment for all operators and to provide seamless planning and operation of the network. Devolution, alliancing and potentailly concessions reinforce the need to make Network Rail's system operator activities clear and transparent. However, even without such changes, an explicit focus on system operator activities should help improve the end to end industry process for growth.

We are in the process of defining our system operator function, taking into account the emerging approach to implementing infrastructure management concessions. We are considering the functions ORR suggests as well as other potential activities relating to network enhancements and the sale of access rights. As that work progresses, Network Rail will consider what measures may be most effective to assess the development of our system operator capability and will share this with ORR and other key stakeholders. We do not consider it appropriate to define such a measure until this work is complete.

In light of the areas that ORR has suggested be covered by a system operator metric, in line with our principles we consider that those covered by existing obligations should not yet be monitored separately – for example the Network Code. There should also be focus on the output side of these areas, for example how the timetable performs rather than the operation of the process to arrive at the timetable. We agree with ORR that the capacity utilisation index is flawed and does not answer the question ‘is the most appropriate use of capacity on the network being delivered?’. We consider that this is an important area for development during CP5 such that we can potentially consider how these activities should be regulated in CP6. We are keen to work with ORR and the rest of the industry on these issues.

Q17: Should we have a mechanism to allow formal trade-offs to be made between high level outputs during the control period?

ORR’s key messages

The ORR currently does not allow ‘trading’ between high level outputs such as PPM and enhancements projects delivery. When considering whether Network Rail has breached its licence it will take into account whether it has done all it reasonably can to deliver the output, which offers some flexibility, but it could go further and allow a ‘trade-off’ between outputs in CP5. The ORR does not believe that this is appropriate for HLOS outputs. It may be more appropriate for outputs the ORR itself has set, but it is still not in favour of this option even in these cases since this would risk reopening the balance set at the final determination in terms of obligations, risk and funding.

Response to consultation question

Given experience with CP4; the challenge of getting the trade-offs right between performance, capacity and cost; the need to maintain alignment between Network Rail and train operator outputs and to offer better value for money, we believe it is imperative that there is a framework that allows us to make trade-offs across the outputs and across the routes as to what we deliver in CP5.

We note that the HLOSs are unlikely to be reissued to reflect a change in required outputs from governments. However, governments are able to signal that they require different outputs from the rail industry in a different manner, for example via a franchise specification.

Where assumptions used during the planning process evolve during the control period, or the actual situation proves different to the planning assumptions (eg increased traffic volumes), this will also be a driver for a change control process of our high level outputs.

The balance of outputs could also be reopened via changing industry requirements, for example if the locally agreed plans with our customers impact on the high level regulated outputs, but industry believes that the new balance is more in line with customer requirements.

The need for trade-offs and a change control process has also been discussed in the introduction to this response.

We believe it is essential that there is flexibility to make trade-offs between different outputs, where this is the right thing to do from the point of view of the rail user and taxpayer. This would require a clear baseline and change control process involving industry and ultimately approval by ORR. Such a process exists and works well in CP4 for our enhancement schemes.

Q18: What do you think of the idea of a scorecard to provide context to our assessment of Network Rail's performance in CP5? Do you have views on our proposed scorecard, and do you have alternative suggestions?

ORR's key messages

The ORR would like to ensure that Network Rail's performance is assessed in the context of the industry's progress in achieving the outcomes it has set for CP5 by defining and publishing a whole-industry scorecard.

This scorecard may be based on a vertical snapshot of industry performance covering measures from outcomes affecting industry's customers through to the revenues, subsidy and costs invested in achieving them. This might cover measures of:

- the outcomes it wants the industry to achieve (passenger satisfaction);
- volume measures (number of passengers choosing to travel, amount of freight shipped);
- supply measures (capacity of the service provided to achieve the volume); and
- industry finances (revenues, cost and subsidy).

The scorecard would also include the output framework.

Key drivers of desired outcomes

Outcome	Key drivers	Basis
Passenger satisfaction	Value for money (of ticket) Train service reliability Train service frequency	Initial Industry Plan, Passenger Focus responses to Initial Industry Plan, which referenced research on passenger priorities
Freight customer satisfaction	Price Reliable and consistent service Extended availability	Initial industry plans for Scotland and England & Wales
Economic growth	Train service capacity (passenger & freight) Journey time Cost efficiency Business to labour force; business to business; business – supply of goods; business- markets	HLOS
Connectivity	Train service capacity End-end journey times Accessibility	HLOS
Environmental Sustainability	Carbon emissions Cost efficiency (in support of mode shift, because rail performs well on many environmental impacts versus competing modes)	HLOS

There are a number of alternatives for the industry scorecard. One option is outlined below:

Output framework						
Outcome measures	Passenger satisfaction	Freight modal share	Support for economy (e.g. GDP growth, modal shares, ticket & freight revenue)	Connectivity (e.g. demographic breakdown of passenger numbers, % of passengers within x mins of town population > 100,000)	Direct greenhouse gas emissions	
Volume Measures	Passenger journeys	Passenger kms	Freight tonnes lifted by market	Freight net tonne km by market		
Supply Measures	Passenger train km	Passenger vehicle km	Freight train km	Freight vehicle km		
Industry finances	Ticket revenue	Freight revenue	Other revenue	Costs	Subsidy	

Response to consultation question

Network Rail supports the regulation of outputs being given context amongst the outcomes that are important for industry. We would welcome discussion with ORR on the purpose of such a scorecard and the appropriateness of the indicators contained in it. A scorecard could also contribute positively to a discussion on the purpose and need for trade-offs. We note that a number of the outputs in the framework are measured by other industry members. We do not wish to increase the regulatory burden with additional measures (on top of those agreed as part of the regulatory output framework) as part of this scorecard.