

John Thomas
Director of Competition and Regulatory Economics
Telephone 020 7282 2025
Fax 020 7282 2044
E-mail john.thomas@orr.gsi.gov.uk
18 December 2008



To addressees - see list below

Procedural approach to conducting an interim review in CP4

1. Our October Periodic Review 2008 determinations¹ set out the circumstances in which the regulatory settlement that we have determined for Network Rail for CP4 (2009-10 to 2013-14) may be re-opened. In that document, we said that we would publish a full procedural document that sets out how the re-opener provisions could be triggered and how we expect to conduct an interim review.
2. The attached paper constitutes a final version of the procedural document, which takes into account comments made by stakeholders on an earlier draft issued for consultation in July 2008. We have made a number of refinements to the process as a result of those responses, consistent with the re-opener provisions set out in our determination.
3. A copy of this document can be found on the ORR website (www.rail-reg.gov.uk).

Yours sincerely,

John Thomas

¹ Available on our website at <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>

List of addressees:

Association of Train Operating Companies
Department for Transport
Freight operating companies
HM Treasury
Network Rail
National Assembly of Wales
Passenger Focus
Passenger Transport Executives
Rail Freight Group members
Rail Industry Association
ROSCOs
Train operating companies
Transport for London
Transport Scotland

Procedural approach to conducting an interim review in CP4

Preamble

1. Our PR08 determination set out the circumstances in which the regulatory settlement that we have determined for Network Rail in CP4 may be reopened. This procedural approach document should be read in conjunction with our determination and in particular to Chapter 14 to which it cross-refers.
2. This document sets out the procedure that we expect to follow in the circumstances that one or more of the criteria for initiating an access charges review prior to 1 April 2014 (“interim review”) may have been triggered. We have developed this procedure on the assumption that any such interim review would need to be conducted as quickly as possible.

Background

3. Our determination provides Network Rail with a revenue stream that, in our view, is sufficient for it to deliver all its regulatory outputs provided that it operates efficiently. In addition, the regulatory framework provides a number of protections to Network Rail in the event of unforeseen circumstances. These protections are set out in our determination. It is not the intention, however, that the allowed revenues are sufficient to absorb all significant external cost shocks. In such circumstances, the determination may need to be reopened, by means of an interim review.
4. As set out in our determination and as reflected in Schedule 7 of franchise operators’ track access contracts, there are a number of circumstances in which an interim review may be triggered:
 - (a) **Material change in circumstances re-opener.** Where there has been a material change in the circumstances:
 - (i) of Network Rail; and/or
 - (ii) in relevant financial markets or any part of such markets.
 - (b) **Network Rail is unable to finance itself efficiently:** Network Rail will be able to request a re-opener at the point at which it is unable, or expects to be unable, within the next 18 months, to finance itself efficiently.

- (c) **Quantified re-opener.** Where Network Rail requests a review on the basis that its externally verified forward looking average AICR ratio projection in any Review Period is less than or equal to 1.4x. The forward looking AICR is defined as:

Network Rail's projected total income in the Review Period;

less

Network Rail's projected total expenditure (excluding Network Rail's projected renewals and projected enhancements expenditure) in the Review Period;

less

projected corporation tax payable by Network Rail in the Review Period;

less

the regulatory amortisation assumption made by ORR for the Review Period;

divided by

the projected net interest payable by Network Rail on its financial indebtedness in the Review Period (as financial indebtedness is defined in Network Rail's network licence).

The Review Period will either be the following three years or the remaining part of CP4 in the control period, whichever is the shorter. We had previously said that Network Rail should project into CP5 in order to maintain the forward three year average AICR ratio projection. However, having discussed the merits of this with Network Rail, we believe that there would not be significant value in the company making projections into CP5 simply based on an assumption that all key financial ratios are compatible with a solid investment grade credit rating.

- (d) **Scotland re-opener.** Where Network Rail projects its forward three-year average total net expenditure in Scotland to be more than 15% greater than that assumed in the regulatory determination. This would trigger the interim review process for Scotland only. As above, when there is less than three years remaining in CP4, the calculation will be solely for the remaining part of CP4.

5. We would need to determine whether the terms of the relevant re-opener provision have been met and, if so, would then consider whether there is a compelling case for an interim review in the light of our section 4 duties (Railways Act 1993).

6. The process under Schedule 4A of the Railways Act 1993 would require the Secretary of State and/or Scottish Ministers (as applicable) to provide a new HLOS and SOFA. The outcome of an interim review may be a change in Network Rail's regulatory requirements and/or allowed revenues. However, it may also be a reaffirmation of the existing regulatory requirements and allowed revenues.

Triggering an interim review

7. There will be a two-stage process for triggering an interim review.

Stage 1: Process commencement

8. We have made some changes since our draft procedural document to the process to determine whether an interim review should be initiated reflecting our PR08 determination. In particular, we have made it clear that the re-opener associated with Network Rail being unable to finance itself efficiently and the quantified re-opener would only be triggered at Network Rail's request. We will of course be monitoring the company's financial position as we explain below.

9. Should Network Rail believe that it has satisfied the conditions of one or more of the re-opener provisions, it will be able to apply to us to request a triggering of the interim review process. It will need to apply to us in writing to do this, setting out:

- (a) The re-opener provision(s) under which it is requesting the interim review;
- (b) A detailed explanation of the reasons why it believes it has satisfied the terms of the re-opener, including evidence on the extent to which its efficient costs have been or are expected to be impacted. Network Rail should set out the cost and revenue requirement implications for delivering the HLOSs and also options for reducing outputs to continue to operate within the latest determination. We would expect Network Rail's submission to include relevant financial projections that have been externally verified; and
- (c) The actions (if any) it has taken to mitigate any change in efficient costs.

10. At this stage we would also consider whether we should, having regard to Network Rail's financial circumstances, be conducting the interim review on an expedited basis. We could do this by serving a Review Initiation Notice on a conditional basis which would enable DfT and/or Transport Scotland to prepare their HLOSs and SOFAs at the same time as we conducted our assessment to determine whether the terms of the re-openers have been met (see below). We are able to include conditions in any Review Initiation Notice which need to be satisfied if we are to proceed with an access charges review. We would propose to make the notice conditional on us concluding at the end of our stage 2 assessment process that the trigger for an interim review had been satisfied.

11. If we decide to trigger the process, we will notify Network Rail in writing that we are triggering the process, setting out:

- (a) The re-opener provision(s) that we consider may have been satisfied; and
- (b) A detailed explanation of our reasons.

Stage 2: Assessment

12. Stage 2 will involve an assessment by us of whether the terms of the re-opener(s) concerned have been met and hence whether we should conduct an interim review. We will complete this assessment in no more than two calendar months of notifying Network Rail that we are triggering the review process / receiving Network Rail's notification that they are triggering the process.

13. We expect that this will involve considerable engagement with Network Rail and may require Network Rail to provide us with specified information to tight timescales to enable us to complete our assessment within the timescale. We therefore expect Network Rail to make the necessary people and information available.

14. The precise details of what the assessment will involve depend on the re-opener(s) concerned.

- (a) *Material change in circumstance re-opener.* The regulatory framework, including the re-opener process, is intended to provide a number of protections to Network Rail in the event of unforeseen circumstances. Before initiating a re-opener as a result of a material change of circumstances we would therefore have regard to Network Rail's view as to whether it felt it needed an interim review of charges and outputs. We would then examine the evidence for whether there has been a material change in circumstances. There are clearly a number of events that might constitute a material change in circumstance, which for example could include a substantial, sustained and unanticipated rise in input prices or interest costs that an efficient Network Rail would face.
- (b) *Quantified re-opener and Network Rail unable to finance itself efficiently re-opener.* We will assess the robustness of the assumptions underpinning Network Rail's projections and the evidence to support the company's view that it would be unable to finance itself efficiently without an interim review. Network Rail will need to ensure, in any case, that the projections it provides to us are externally verified. We would want to understand from Network Rail the assumptions underlying the projections.
- (c) *Scotland re-opener.* We will assess the robustness of Network Rail's net expenditure projections for Scotland. Network Rail will need to ensure, in any case,

that the projections it provides to us are externally verified. We would want to understand from Network Rail the assumptions underlying the projections.

15. Where we believe that the terms of one or more of the re-opener provisions have been met, we will then consider whether there is a compelling case for an interim review against our section 4 duties. We would expect to have particular regard to the following duties:

- (a) to act in a manner which we consider will not render it unduly difficult for Network Rail to finance its activities;
- (b) to promote efficiency and economy on the part of persons providing railway services; and
- (c) to protect the interests of users of railway services.

16. It will be necessary for us to take into account the views of interested persons, such as the affected funders, during stage 2. In view of the need to conclude stage 2 within two calendar months, consultees would only have relatively short timescales in which to set out their view. Where appropriate, we would therefore consider whether the best way to understand the views of interested persons might be a hearing.

17. One consultee was concerned that the time available for consultation with interested parties during stage 2 is short. We recognise this but believe that it is important to strike an appropriate balance between giving stakeholders a reasonable time to respond and conducting the whole process as expeditiously as possible.

18. Where we are satisfied that the terms have been met, we will initiate an interim review. If the issue is confined to a single geographic region (i.e. to England & Wales only or to Scotland only), then we will ensure that the outcome of the review impacts only on the appropriate train operators and funders.

19. Where we are not satisfied that the terms of the re-opener have been met, there will be no interim review. Network Rail will need to deliver the existing regulatory outputs within its existing settlement, deferring RFF expenditure if it deems it necessary.

20. Importantly, should there be further changes in Network Rail's financial position it would be able to apply to us again. We would also keep the situation under review as part of our ongoing monitoring of Network Rail's financial position.

21. It is important to note that our regular monitoring of Network Rail should provide early warning of impending difficulties. For instance, we assess Network Rail's performance against the regulatory assumptions on an annual basis. The expenditure analysis included

in our annual assessment currently provides our assessment of Network Rail's performance for OM&R, but will be expanded to cover enhancement expenditure.

Undertaking an interim review

22. If the terms of a re-opener are satisfied, we will undertake an interim review of Network Rail's allowed revenues and regulatory outputs.

23. Immediately following the conclusion of stage 2 of the initiation process, we will issue a review initiation notice, commencing the formal phase of the review. Alternatively we will, if we have already served a conditional review initiation notice, confirm that the relevant condition has been satisfied. This will require DfT and/or Transport Scotland, as necessary, to restate their HLOS(s) and SOFA(s). The notice would also state the period to be covered by the new regulatory settlement.

24. Generally, we would expect that the new settlement would run until the end of the current control period (i.e. end March 2014). However, we may specify an alternative period, for example a new five-year period, where we believe that this would be more appropriate. DfT and Transport Scotland can also set out their opinion on this issue when they provide their restated HLOS(s) and SOFA(s).

25. Governments may choose to leave its HLOSs and SOFAs unchanged or to update one or both.

26. Even where we were not conducting the interim review on an expedited basis (see paragraph 12) we would consider whether we should rely on Schedule 4A paragraph 1C (5), in which case Government would need to provide us with their updated HLOSs and SOFAs within four weeks of receipt of the review initiation notice.

27. Immediately following the receipt of the HLOSs and SOFAs, we would begin a thorough review of the efficient cost of delivering the HLOSs. If one or both of the HLOSs have been restated, we would ask Network Rail to provide a further submission with its cost forecasts of delivering the restated HLOSs. If the HLOSs cannot be delivered within the SOFAs we would inform DfT and/or Transport Scotland that this is the case following the process set out in Schedule 4A.

28. We would not generally expect to reassess the regulatory framework unless the particular circumstances of the re-opener suggested that this was appropriate.

29. We would aim to publish the new draft settlement for consultation within 6 calendar months of receiving the updated HLOS(s) and SOFA(s). The consultation period would be

limited to six weeks to ensure that we provide Network Rail with a revised settlement as quickly as possible but also enabling proper consultation. During the period when we considered the revised HLOS(s) and SOFA(s) we would consider the most appropriate way to take into account the views of interested persons which might include:

- (a) focussed consultations on issues for which we would expect response times to be not more than one month;
- (b) workshops;
- (c) bilateral meetings; and
- (d) industry hearings.

30. We would then aim to publish the review notice within one calendar month of the conclusion of the consultation period.

31. The review notice commences the formal implementation phase of the review and includes a number of mandatory timescales. Network Rail would have a period of at least 6 weeks to object to the review notice. If we did not receive such an objection or any objection that was made was subsequently withdrawn, we would then publish a notice of agreement. Access beneficiaries then have a 28 day period during which they can serve a termination notice. After the expiry of this period the review can be formally implemented by service of a review implementation notice.

32. Provided that there is no mismatch between the updated HLOSs and SOFAs and the timescales set out above are achieved, we should be able to determine the new regulatory settlement within 9 months of concluding stage 2 of the initiation process and issuing the review initiation notice. Should the iterative process be required because of a mismatch between the HLOSs and SOFAs, this would affect these timescales. We do not think that we can set out an overall timescale for the iterative process but would expect to set tight timescales for responses by DfT and/or Transport Scotland of not more than one month.

33. One consultee expressed concern that the length of the process, at eleven months, was too long and that the uncertainty could impact on the availability of private sector funding. We have to work within the statutory process and allow for the possibility that there could be a significant amount of analysis and consultation to undertake as part of an interim review. However, wherever possible, we will strive to conduct an interim review in the shortest time practicable in order to minimise the period of uncertainty.

Deferring ring-fenced fund (RFF) expenditure

34. Our PR08 determination made some changes to the way that the RFF works, following concerns by Network Rail and feedback from one of the ratings agencies about our initial proposals. These changes mean that there is no longer necessarily a link between the re-opener provisions and deferral of RFF expenditure. Network Rail does not need to seek an interim review before it decides that it needs to defer RFF expenditure. However, Network Rail will need to comply with the RFF notification process as set out in our PR08 determination if it wishes to defer RFF expenditure.

35. In order to ensure that the RFF will be treated by rating agencies/investors as cashflow available for debt service and as revenue in the company's accounts, we have stated in our PR08 determination that it would be more appropriate to structure it as profit in any given year which would then be reinvested in future years on HLOS outputs at Network Rail's discretion. If Network Rail exhausts its risk buffer in any one year, leading to profits falling short of expected levels and a deterioration in financial ratios, HLOS outputs could be deferred if Network Rail decided this was necessary for it to continue to finance its business within the determination allowances.

36. Chapter 14 of our PR08 determination sets out the rules for the operation of the RFF.

Sequence of events

37. The sequence of events for the interim review process is set out in the diagram below. It assumes that there is no iterative process required as a result of a mismatch between the HLOS and SOFA.

Figure 1: Interim review process – sequence of events with target timescales

