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See attached list

Dear Consultee

Periodic Review 2008 (PR08): The treatment of risk and uncertainty

Introduction

1. The periodic review 2008 (PR08) will determine Network Rail's outputs, net revenue requirement and access charges for Control Period 4 (CP4) (expected to be 1 April 2009 to 31 March 2014) based on the requirements of the Secretary of State and Scottish Ministers' high level output specifications (HLOSs) and statements of funds available (SoFAs) and the requirements of other customers and funders of the railway.
2. Our overarching objective for PR08 is to ensure an outcome that secures value for money for customers and funders, by determining the level of Network Rail's access charges and outputs in a way that balances the interests of all parties. The timetable for PR08 is set out in Annex A of our July 2006 consultation document on the incentive framework¹.
3. We have consulted on the high-level issues surrounding both the financial framework for Network Rail² and the incentive framework³, with a view to

¹ This is available at (<http://www.rail-reg.gov.uk/upload/pdf/298.pdf>).

² *Periodic review 2008, Initial assessment of Network Rail's CP4 revenue requirement and consultation on the financial framework*, Office of Rail Regulation, London, December 2005. This can be accessed on our website at <http://www.rail-reg.gov.uk/upload/pdf/264.pdf>.

³ *Periodic review 2008, Enhancing incentives for continuous improvements in performance, a consultation paper*, Office of Rail Regulation, London, July 2006. This can be accessed on our website at <http://www.rail-reg.gov.uk/upload/pdf/298.pdf>

concluding on the high-level principles in our February 2007 Advice to Ministers and Framework for Setting Access Charges document⁴.

4. In order to provide ministers with as complete advice as possible in February 2007 on the likely parameters of Network Rail's required net revenue allowance, we also intend to conclude on a number of technical issues regarding the incentive framework, and Network Rail's financial framework. As set out in our July 2006 consultation on the incentive framework, we intend to consult on these by letter.⁵
5. This is one of two letters we are publishing today in relation to the financial and incentives frameworks. We are consulting with you on the high-level principles that we should adopt with regard to risk and uncertainty. In particular, we set out the key types of risk that Network Rail faces, and the options for allocating those risks efficiently between the company, its lenders, customers and funders.
6. This letter does not cover all the specific risks that Network Rail faces, for example tax and pensions. These detailed issues will be addressed later in the review. It is important that our conclusions on these other issues are consistent with our high-level principles and in particular the amount of surplus that we allow Network Rail to cover risk and our approach to the use of re-openers.
7. Once we have concluded on the principles, further work will be required to determine the detailed design and specification of the appropriate mechanisms
8. Other letters we are publishing today deal with our approach to determining an allowance for amortisation in the price control and the Issues and Options with regard to Network Rail's Initial Strategic Business Plan. All three letters are available in the ORR library and on our website (www.rail-reg.gov.uk).

Your views

9. We would welcome your views on any of the issues raised in this letter and, in particular, on:
 - the principles to be used in deciding how risks should be dealt with;
 - what risks Network Rail should bear and what risks customers and funders should bear;

⁴ A full timetable for the periodic review process is provided in Annex A of our July consultation document on the incentive framework (<http://www.rail-reg.gov.uk/upload/pdf/298.pdf>).

⁵ The July 2006 paper said we would publish a letter on inflation. This letter covers the inflation issues we originally planned to raise in a separate letter.

- the use of access charges review re-opener provisions;
 - the treatment of non-controllable costs;
 - how inflation should be treated;
 - the type of price control;
 - the length of the control period; and
 - the options for allocating interest rate risk.
10. Your responses should be sent to us by Friday 22 December 2006 in electronic format (or, if not possible, in hard-copy format) to:

Carl Hetherington
Head of Regulatory Finance
Office of Rail Regulation
1, Kemble Street
London WC2B 4AN
Tel: 020 7282 2110

Email: Carl.Hetherington@orr.gsi.gov.uk.

11. You should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise we would expect to make it available in our library and on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, that can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

Issue and objectives

12. All businesses face risk and uncertainty with regards the effect of exogenous events on their costs and revenues. Regulated businesses such as Network Rail are no exception. However, the regulatory framework has a significant effect on how these risks are allocated between the company, customers and funders.
13. The way in which risk and uncertainty are treated affects a number of issues, including the:

- incentives on Network Rail to behave efficiently and innovatively, as both creditors and managers will generally aim to minimise the effect of risk and the likelihood of it materialising;
 - rate of return that the company requires to accommodate fluctuations in cash flow;
 - balance sheet buffer, i.e. the difference between the regulatory asset base and net debt; and
 - price at which Network Rail is able to raise risk capital as creditors will require a premium to accept greater risk.
14. Ensuring that the risks are borne by the appropriate party is crucial if value for money is to be obtained by Network Rail's customers and funders.
15. Our objectives in designing the approach include the need to:
- allocate appropriate risks to Network Rail where it is best placed to manage them and provide appropriate compensation and, where appropriate, have regard to cash flow implications;
 - incentivise Network Rail to secure continuous improvements in cost efficiency and value for money;
 - enable Network Rail to take appropriate risks in seeking innovative approaches to delivering material and sustained year-on-year improvements in performance and safety;
 - enable Network Rail to accommodate fluctuations in cash flow; and
 - enable Network Rail to raise risk capital at an appropriate cost (see the July 2006 paper on incentives for more details).
16. In deciding how to allocate risk, the main principle to be used is that, as far as possible, risk should be borne by the party best able to manage it. Exposing Network Rail to risks it is unable to manage efficiently is unlikely to provide value for money because it will increase the company's cost of capital.

Type of risks faced

17. Network Rail faces relatively little risk on the revenue side. Of the revenues Network Rail presently receives from track access charges and direct Government grant, 91% is fixed, i.e. is independent of cost and volume changes. The other 9% is variable with respect to the volume of traffic⁶. All income from grants and charges is protected from general inflation by the indexation of access charges⁷ and grants to the general level of price inflation in the economy⁸.
18. The relative certainty of revenues and the way in which the variable charge is calculated⁹ mean that Network Rail's profits are broadly unaffected by changes in either (i) the number of vehicles running over the network, or (ii) the number of passengers/volume of freight transported. This means that, while Network Rail shares in industry cost risk, it does not share in revenue risk. This issue and potential ways in which Network Rail might be sensitised to changes in whole-industry revenues are discussed further in our July consultation paper on the incentives framework.
19. The majority of exogenous risks faced by Network Rail are on the cost side. Much of the exogenous risk is, at least to some extent, controllable by the company, for example through good planning and procurement or the use of hedging or insurance. However, there is likely always to be an element of risk that is truly uncontrollable, for example changes in law.
20. Exogenous risks relating to cost include:
 - inflation;
 - changes to non-controllable items of expenditure;

⁶ The percentage of Network Rail's income from variable charges could change as a result of the PR08 determination but this will merely reflect the variability of costs with respect to traffic volumes.

⁷ The traction electricity charge is indexed to the average price of electricity to moderately large consumers as published by the Department of Trade and Industry rather than a general price index like RPI. Network Rail is considering the appropriate CP4 approach to profiling the price element of traction electricity charges as part of its charges proposal. For further detail see *periodic review 2008, structure of track access and station long term charges*, Office of Rail Regulation, London, June 2006. This can be accessed on our website at <http://www.rail-reg.gov.uk/server/show/ConWebDoc.8146>.

⁸ Network Rail also receives other income e.g. from stations, depots, property and freight, Some of this income is also subject to RPI adjustment each year e.g. station long term charge income.

⁹ Variable charges are set to reflect the wear and tear costs associated with the running of individual vehicles. Network Rail should therefore be indifferent to changes in traffic volume based on the variable charge alone.

- external events which could not reasonably have been foreseen, such as a prolonged period of extreme weather conditions;
- changes in law, such as new safety or environmental legislation or a change in tax legislation;
- changes in the regulatory environment e.g. changes to the licence;
- interest rate risk, where movements in financial markets affect the company's cost of capital; and
- costs and outputs that are too uncertain at the time of the periodic review for a robust view of the required revenues in relation to those costs/outputs to be made. For example, in Control Period 3 (CP3) we allowed for and conducted an interim review of Network Rail's efficient signalling costs.

21. It is important to note that each of these risks could have either a positive or negative impact on Network Rail's costs and may not be symmetrically distributed, which could affect our approach to the treatment of these risks.
22. Network Rail also faces a variety of management risks and uncertainties, such as the risk that it makes poor investment decisions or fails to drive out inefficiencies as rapidly as expected. However, these are endogenous to Network Rail, being a function of management effectiveness. We therefore think that it is appropriate for Network Rail to bear such risks as it is best placed to manage them and should be incentivised to do so efficiently.

The current framework

23. We currently set a hybrid price/revenue cap for Network Rail for a period of five years. The company's allowed price/revenue trajectory is fixed in advance for the control period based on a number of assumptions and expectations. In isolation, such an approach places all risk and uncertainty with the business and its investors, at least for the term of the control period.
24. However, in line with regulatory best practice, we include a number of mechanisms specifically aimed at sharing risks and uncertainties appropriately between parties. In particular:
- allowed revenues are indexed to a general level of inflation in the UK economy as measured by the Retail Price Index (RPI);

- a volume driver is included so that total access charges rise with the volume of traffic (i.e. through the variable charges);
- the allowance provided for items of expenditure deemed to be non-controllable by Network Rail is not subject to an efficiency adjustment;
- general re-opener provisions exist to enable an interim review to be triggered in the event that:
 - cumulative expenditure on operations, maintenance, renewals and envisaged enhancements deviates from the amount assumed at the 2003 Access Charges Review (ACR2003) by 15% or more; or
 - circumstances lead us to consider there has been a material change in circumstance, and in the light of this, there is a compelling reason to review charges;
- specific re-openers (see Part 7 of Schedule 7 of 7of franchised passenger operators track access contracts¹⁰) also exist for:
 - possessions expenditure;
 - signalling expenditure;
 - West Coast Route Modernisation; and
 - structure of charges through the re-opener relating to improving incentives for the efficient use of the network.
- the efficient cost of additional enhancements required by funders may be logged up and remunerated at the next periodic review; and
- where a change of law occurs, Network Rail may, subject to our approval, levy an additional charge¹¹ on franchised train operators (which would then affect their funders through provisions in the franchise agreements).

¹⁰ The template schedule 7 can be accessed on our website at http://www.rail-reg.gov.uk/upload/doc/sched7_apr04.doc.

¹¹ This charge can be positive or negative as appropriate.

