

John Thomas Director of Competition and Regulatory
Economics

Telephone 020 7282 2025

Fax 020 7282 2044

E-mail john.thomas@orr.gsi.gov.uk

17 July 2008



Dear Consultee

Procedural approach to conducting an interim review in CP4

1. Our June Periodic Review 2008 draft determinations¹ set out the circumstances in which the regulatory settlement that we will determine for Network Rail for CP4 (2009-10 – 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. The procedural document will sit alongside our October 2008 final determinations.
2. The attached paper constitutes a draft of the procedural document for consultation. We have proposed certain refinements to the process that was set out in the draft determinations. We have made these refinements where we have identified ways in which we might expedite the process if we considered that this was appropriate because of Network Rail's financial position.
3. We would welcome your views on any of the issues raised in this document and, in particular, on:
 - a. The clarity of the process set out; and

¹ These are available on our website at <http://www.rail-reg.gov.uk/upload/pdf/368.pdf>.

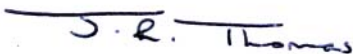
- b. The timings set out for each stage in the process and particularly whether we have struck the right balance between conducting as prompt a process as possible and giving interested persons an adequate time to consider issues.

4. Responses should be sent in electronic format (or, if not possible, in hard-copy format) by **Thursday 4 September 2008** to:

Carl Hetherington
Head of Regulatory Finance
Office of Rail Regulation
One Kemble Street
London WC2B 4AN
E-mail: Carl.Hetherington@orr.gsi.gov.uk

5. We will make your response available in our library, publish it on our website and may quote from it. If you wish all or part of your response to remain confidential to us then please indicate this clearly. We may also publish the names of respondents unless a respondent indicates that they wish their name to be withheld.
6. A copy of this document can be found on the ORR website (www.rail-reg.gov.uk).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'J. R. Thomas'.

John Thomas

List of consultees

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 draft determinations 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 Chapter 14 of our draft determinations², to which it cross-refers.
2. This document sets out the procedure that we are minded to follow in the circumstances that we or Network Rail believe 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 draft determinations provide 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 are set out in our draft determinations. It is not the intention, however, that the allowed revenues are sufficient to absorb 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 draft determinations, there are three 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.

² Modifications to the final version of this document will need to be made to ensure that it is aligned with our Final Determinations. For ease of reference in this document we refer to draft determinations and this will need to be updated to refer to our final determinations.

- (b) **Quantified re-opener.** Where Network Rail's audited forward three-year average AICR ratio projection is less than or equal to 1.35x. The AICR is defined as:

Network Rail's forecast total income in the next three years;

less

Network Rail's forecast total expenditure (excluding Network Rail's renewals and enhancements expenditure) in the next three years;

less

forecast corporation tax to be paid by Network Rail in the next three years;

less

the regulatory amortisation assumption made by ORR for the next three years;

divided by

the forecast net interest to be paid by Network Rail on its net debt in the next three years (as that expression is defined in the 2009 Final Determinations).

- (c) **Scotland re-opener.** Where Network Rail projects its forward three-year average total net expenditure in Scotland (as defined in the regulatory accounts) to be more than 15% greater than that assumed in the regulatory determination. This would trigger the interim review process for Scotland only.

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.

7. Importantly, if during the process set out below Network Rail's financial position should deteriorate to the extent that, in its view, it needs to defer ring-fenced fund (RFF) expenditure, the company would have full discretion to do this. (See below.) If we were to conclude that we should initiate an interim review it is assumed that the DfT/TS would consider whether any deferred RFF projects might be restored in the relevant HLOS.

Triggering an interim review

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

Stage 1: Process commencement

9. The process to determine whether an interim review should be initiated can be triggered either by us or by Network Rail.

10. We will trigger this process should we believe it is likely that the conditions of one or more of the re-opener provisions set out above may have been satisfied. At this point, 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) An explanation of our reasons.

11. 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 impacted. Network Rail should set out the cost and revenue requirement implications for delivering the HLOSs. 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.

12. 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.

Stage 2: Assessment

13. 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.

14. 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.

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

- (a) *Material change in circumstance re-opener.* We will 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 a change in financial market conditions.
- (b) *Quantified re-opener.* We will assess the robustness of the assumptions underpinning Network Rail's AICR projections. Network Rail will need to ensure, in any case, that the projections it provides to us and publishes on its website 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.

16. 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.

17. 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 period might be a hearing.

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 to continue to finance its activities efficiently.

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.

Undertaking an interim review

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

22. 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.

23. 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).

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

25. 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.

26. 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.

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

28. 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.

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

30. 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. 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.

31. 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.

Deferring RFF projects

32. The RFF provides a mechanism for deferring outputs to generate more net cash flow in the event that unplanned expenditure is sufficiently large to threaten Network Rail's ability to finance its business efficiently.

33. Once we or Network Rail have initiated the interim review process (i.e. stage 1 of the initiation process), Network Rail is free to defer RFF expenditure as it sees fit to relieve financial pressures.

RFF deferral advance notification procedure

34. Unless the deterioration in Network Rail's financial situation is so rapid as to prevent it, if Network Rail wishes to defer RFF expenditure it will need to notify us in writing that it wishes to do so.

35. Government will then be given one calendar month to specify which outputs it would want to be deferred. They could, of course, be reinstated through the interim review process.

36. Importantly, if government does not do this within the time provided or if Network Rail's financial position deteriorates sufficiently before government has had chance to respond, Network Rail will have full discretion as to which outputs to defer.

RFF deferral post deferral notification procedure

37. Where the deterioration in Network Rail's financial situation is so rapid as to necessitate a deferral in RFF expenditure ahead of carrying out the above, Network Rail will need to:

- (a) notify us in writing immediately that it has or intends to defer RFF expenditure and explain which outputs will be affected; and
- (b) explain why it was unable to comply with the RFF deferral advance notification procedure set out above.

38. Should Network Rail not comply with the RFF deferral advance notification procedure and be unable to explain satisfactorily to us the reason for this, we would consider whether the company was in breach of its licence.

39. Should Network Rail need to defer RFF projects, the split between England & Wales projects deferred and Scotland projects deferred would reflect the sources of overspend compared to our determinations in each geographic area. Should the overspend be attributable entirely to one geographical area, say England & Wales, then only England & Wales RFF projects would be deferred in the first instance. However, if the overspend were sufficiently large, all RFF projects, including Scottish projects, would be at risk. Network Rail retains the right to defer all RFF expenditure if necessary, regardless of the area where the overspend is incurred. Any discrepancy between geographic area of overspend and the deferral of RFF outputs will need to be made good at the next periodic review.

Sequence of events

40. 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

