PR23 draft determination:

Policy position – financial framework

15 June 2023

Contents

About this document

This financial framework policy document is one of four policy positions documents of our draft determination for the 2023 periodic review (PR23).

PR23 will determine what the infrastructure manager for the national rail network, Network Rail, is expected to deliver with respect to its operation, support, maintenance and renewal (OSMR) of the network during control period 7 (CP7), which will run from 1 April 2024 to 31 March 2029, and how the available funding should be best used to support this.

This strongly influences:

- the service that passengers and freight customers receive and, together with taxpayers, ultimately pay for; and
- the charges that Network Rail's passenger, freight and charter train operator customers pay to access its track and stations during CP7.

Our draft determination sets out:

- our review of Network Rail's strategic business plan (SBP); and
- decisions on its proposed outcome delivery and its planned expenditure to secure the condition and reliability of the network;
- changes to access charges and the incentives framework; and
- relevant policies on managing change and the financial framework.

In addition to **this document**, we have also published as part of our draft determination:

Document type	Details
Executive summaries of our determination	Our key proposals from our draft determination for: • England & Wales • Scotland

Overviews of our determinations	What Network Rail will need to deliver and how funding will be allocated in: • England & Wales • Scotland
Consolidated decisions	A summary of our draft decisions across Great Britain
Introduction	An overview of PR23 and background to our draft determination
Settlement documents	Detailed draft decisions for each of: • Scotland • Eastern region • North West & Central region • Southern region • Wales & Western region • System Operator
Supporting documents	Technical assessments of: • Health and safety • Outcomes • Sustainable and efficient costs • National Functions • Other income
Policy positions	How we intend to regulate Network Rail during CP7 in relation to: • **Financial framework** • Access charges • Schedules 4 & 8 incentives regimes • Managing change

Responding to the consultation on our draft determination

We are consulting on our draft determination and welcome comments from stakeholders on any of our documents which form the draft determination on or before 31 August 2023.

Responses should be submitted in electronic form to our inbox: PR23@ORR.gov.uk. We request stakeholders provide their response using this proforma.

We intend to publish all responses on our website alongside our final determination in October 2023. Annex A to our proforma document sets out how we will treat any information provided to us, including that which is marked confidential.

Next steps

After taking account of stakeholder responses, we expect to issue our final determination on Network Rail's delivery and funding for CP7 by 31 October 2023.

We expect to issue our Review Notices by December 2023 and, subject to Network Rail's acceptance, issue Notices of Agreement and Review Implementation Notices. These will give effect to the decisions made during PR23 in time for CP7 to commence from 1 April 2024 and for Network Rail to develop its plans for delivery.

Executive summary

Introduction

This supplementary document to our draft determination for the 2023 periodic review (PR23) sets out our intended approach for the financial framework of the infrastructure manager of the mainline railway, Network Rail, for Control Period 7 (CP7), the five-year period starting 1 April 2024. We describe the policy choices we have made and explain why we consider that most features of the existing financial framework should be retained. It follows the consultation on financial framework matters that we published in December 2022 and takes account of the responses we received. We are grateful to all those who responded to the consultation.

PR23 is the process through which we determine what Network Rail should deliver in respect of its role in operating, maintaining and renewing its network in CP7 and how the funding available should best be used to support this. This feeds through into:

- the service that passengers and freight customers receive and, together with taxpayers, ultimately pay for; and
- the charges that Network Rail's customers, including passenger, freight and charter train operators, will pay for access to its track and stations during CP7.

The full set of documents that form the draft determination is available here. After taking account of consultation responses, we will publish our PR23 final determination in October 2023.

Policy matters set out in this document

Choices around the financial framework for CP7 matter because, taken together, they affect the:

- success of our regulatory settlements;
- total costs borne by train operators, rail users, and taxpayers, now and in the future;
- management of financial and other risks and the early identification of problems;
- quality of network development decisions, with consequences for output, achievement and service levels;

- effective renewal of rail infrastructure and its impact on asset performance and safety; and
- potential for new sources of financing and funding.

The chapters of this document set out the matters that we are deciding on. These are:

(1) Network Rail's cost of capital and cost of debt

A cost of capital and cost of debt are not necessary components of our PR23 determination of revenue requirements for CP7. However, these values and our approach to them are relevant for some contractual purposes. Removing these could be problematic for Network Rail. Retaining them also has other possible benefits. We include proposed values for Network Rail's cost of capital and cost of debt values for Network Rail for CP7 (3.88% pre-tax cost of capital, 2.33% cost of debt).

(2) Setting and updating regulatory asset base balances

We do not intend to use Network Rail's regulatory asset base (RAB) in the calculation of the company's revenue requirements for CP7. However, the RAB underpins the fixed asset valuation in Network Rail's statutory financial statements. Removing it could be problematic for Network Rail. Retaining it also has other possible benefits. We propose to retain our current approach for the setting and updating of RAB balances for CP7.

(3) Our policy on rebates of unused funds to governments

Rebates of government grants by Network Rail back to governments should only be made in exceptional circumstances and should not create risks to the financial sustainability of Network Rail's business. Our approval is required before a rebate is paid. Other options are available for the return of funding to governments.

(4) Network grant arrangements and dilution provisions

We will continue to seek provisional confirmation of the profile and level of network grant payments from funders before our final determination, as in PR18. We will then seek written confirmation of finalised network grant documentation (including payment amounts) by December 2023. This is a change to the proposal in our December consultation, reflecting views from industry on the timetable that we set out there.

Additionally, we intend to strengthen Network Rail's protection against an unexpected shortfall in grant funding, by reducing the delay between a grant dilution event occurring and an increase in fixed track access charges (FTAC) payments to meet any shortfall. We will consult on this specific amendment to grant dilution provisions in Schedule 7 of operators' track access contracts as part of our forthcoming consultation on changes to model contracts.

(5) Re-opener provisions to vary the terms of our regulatory determination

Re-opener provisions are a formal process to amend the periodic review in extreme circumstances. We intend to retain the current re-opener provisions[1] because they provide an important mechanism that allows us to work with funders, Network Rail, and industry stakeholders to change the terms of our determination if material unforeseen circumstances arise.

(6) Management of financial risk

This section of the document explains Network Rail's intended approach for managing financial risks during CP7. Like any company, Network Rail needs appropriate provisions in place to manage the risks it faces, such as inflation, cost shocks and adverse events.

(7) Governments' budgetary processes

This section explains our understanding of DfT's (Department for Transport) and Transport Scotland's budgetary processes in relation to Network Rail's funding under their own budgetary regimes, including providing for limited flexibility to move underspend and overspend between years and between budgetary categories.

(8) Performance innovation fund and other matters

Our December consultation also sought comments on whether a dedicated performance innovation fund should be used in CP7, and how such a fund should be managed. This matter is covered in our [PR23 draft determination: supporting document on sustainable and efficient costs](), which also forms part of our draft determination.

Some of the matters that we are deciding on are linked to our Managing Change Policy where we recognise that there may be circumstances where Network Rail needs to make changes to the level of funding for regions (and System Operator and National Functions) or to the outputs that it is required to deliver. For example, there may be legislation changes, or the organisation may decide to restructure. We have set out our policy conclusions on these, see [here]().

There are a few matters that relate to the financial framework which we consider do not require a decision from us, namely, the treatment of Network Rail's historic debt and

[1] For CP6, we included provisions in track access contracts for there to be a re-opener if there is a material change in Network Rail's circumstances, or (for Scotland only) if expenditure in Scotland is forecast to be more than 15% higher than our determination over a forward-looking three-year period.

related financing costs, and British Transport Police costs. These are outside of the scope of PR23 as they are a separate funding matter for the Department for Transport.

Summary of responses to our December consultation

We received nine responses to our December consultation on the financial framework for CP7. These are available here. Key points from respondents are summarised below, with these matters covered in detail in the relevant chapters of this document.

- **Network Rail**: Network Rail largely supported our proposed approach of maintaining existing regulatory mechanisms. Network Rail expressed concern that the change for implementing FTAC / network grant may introduce additional administrative burden within a tight periodic review timescale. It noted that its England & Wales strategic business plan does not assume that funds will be available for a performance innovation fund.

- **Department for Transport (DfT)**: DfT broadly agreed with our consultation questions, noting that the financial framework was designed ahead of CP6 and shortly after Network Rail had become a fully public sector body. The rationale for these arrangements still applies, and the experience of CP6 has shown these arrangements are broadly appropriate and robust. In the interests of certainty and stability, DfT's strong preference is only to change either where necessary, or there are clear benefits and to apply lessons learned from CP6 to ensure a robust and transparent financial framework.

- **Transport Scotland:** Transport Scotland broadly agreed with our consultation questions, noting that Scottish ministers consider that our financial framework must be coherent, simple and transparent, and that it must respect the integrity of the devolved settlement for Scotland's railway. The framework should allow financial alignment and associated arrangements developed between Transport Scotland and Network Rail, ScotRail Trains Limited and other partners.

- **Transport for London (TfL)**: TfL expressed concern about our proposed approach for setting Network Rail's cost of debt due to its potential financial impact on the Crossrail supplementary access charge. TfL also did not agree with our proposed approach for setting FTACs if network grant is not agreed prior to our final determination.

- **Rail Partners**: Rail Partners broadly agreed with our consultation questions, though it considers that the structure of a risk fund to manage financial risks needs some thought. Rail Partners supports a performance innovation fund, but that the level of the fund needs to increase.

- **Northern Trains Limited (NTL)**: NTL would prefer network grant documentation in place before the final determination as this will allow FTACs to be set for the control period. NTL supports the use of a dedicated performance innovation fund, the functioning of which could improve on CP6.

- **East West Rail (EWR):** EWR noted that whilst the financial framework for CP7 may seem, at first sight, somewhat esoteric, it is in fact a vital building block to a well-functioning railway. EWR commented that Network Rail will need ways to manage inflation and execution risk without passing these through to stakeholders through unduly reduced levels of performance or making unsustainable reductions in renewal spend. EWR did not consider that a dedicated performance innovation fund in CP7 is likely to deliver good value for money given other funding pressures.

- **Southeastern Trains Limited (SETL):** SETL broadly agreed with most aspects of our consultation. However, it did not support our proposed approach for re-opener provisions in track access contracts, instead suggesting that the provision should only apply if most train operators believe that there is a financial or commercial case for it to be applied. SETL questioned the incentive effect of the proposed FTAC/network grant arrangement and the governance arrangements around a ringfenced risk fund. It also noted a disconnect between the suggested government budgetary flexibility and that which applies to train operators. In addition to supporting a performance innovation fund, SETL suggested that a separate carbon innovation fund should be established.

- **Railway Safety and Standards Board (RSSB)**: The RSSB responded to our questions around the use of a performance innovation fund. RSSB's view is that such a fund is very much needed to support service performance and that its governance could be streamlined to allow projects to transition quicker to deployment.

Responding to our consultation on the draft determination

We welcome comments on this document and other documents that form part of our draft determination by 31 August 2023. Full details on how to respond are available here. This includes how we will treat any information provided to us, including that which is marked as confidential. Subject to this, we expect to publish responses alongside our final determination in October 2023. We have provided a pro-forma should you wish to use this when responding. If you choose not to use the pro-forma, we would be grateful if you would make clear in your response that you are commenting on this supplementary document. This will assist our process for reviewing comments.

1. Cost of capital and cost of debt

1.1 As set out in our financial framework consultation, we do not consider that a weighted cost of capital (WACC) or cost of debt are necessary components to determine revenue requirements, track access charges, or network grant levels for CP7. However, these values are relevant for reasons explained below.

1.2 We received responses from Network Rail, DfT, Transport Scotland, TfL and Rail Partners. Respondents broadly agreed with our consultation questions about whether we should largely retain the approach that we adopted for CP6, making changes only where necessary.

- Transport Scotland questioned the value of being able to calculate what Network Rail's revenue requirements would be based on an allowed return on the asset base using a hypothetical cost of capital. We are not intending to set allowed revenues in this way as part of PR23, however, the ability to reinstate such an approach if there are changes to the ownership model for parts of the GB rail network is useful.
- TfL expressed concern about our proposed approach for setting Network Rail's cost of debt due to its potential financial impact on the Crossrail supplementary access charge. TfL instead considers that we should look at historic cost of debt used for borrowing rather than contemporaneous benchmarks.
- Rail Partners asked that we consult on the methodology and assumptions that we will use to calculate the cost of capital. This document does this as part of our draft determination consultation, details of how to respond to the consultation are provided above.
- SETL asked that we provide full visibility of the UKRN's (UK Regulators Network) work, which we have done below.

Decision

1.3 We will specify cost of capital and cost of debt values for Network Rail in CP7 as part of our final determination. We include draft values below.

Reason for decision

1.4 We consider that cost of capital and cost of debt values are relevant for the following purposes:

- calculating facility charges payable by third parties who have promoted enhancements financed by the governments through Network Rail;
- providing a benchmark discount rate/internal rate of return for internal projects (and other economic decisions) by Network Rail in CP7;
- the cost of debt that we determine also affects the Crossrail supplemental access charge (CSAC) income that Network Rail will receive in CP7; and
- calculating what Network Rail's revenue requirements might be under a full building blocks approach to the periodic review (i.e. determining the allowed return on the asset base using a hypothetical cost of capital Network Rail might face if it were financed in the private sector by a mix of debt and equity).

1.5 We note TfL's view that we should look at the historic cost of debt used for borrowing rather than contemporaneous benchmarks for setting a cost of debt value. The relevant contract is the 'track access option in connection with the Crossrail project' that was agreed between Network Rail and DfT, which was updated in 2014. This contract states that the rate of return means, in any year, the rate determined by ORR in its then most recent periodic determination for Network Rail as ORR's assessment of the regulatory cost of debt for an efficient rail infrastructure management company.

1.6 It seems clear to us that the intention of the track access option was for the rate of return in the calculation of the CSAC to be ORR's assessment of Network Rail's regulatory cost of debt for an efficient rail infrastructure company at each periodic review, rather than a specific cost of debt that may be associated with the Crossrail works. This is consistent with the approach that we adopted at PR18 for setting a cost of debt for CP6. We note that Network Rail did not issue debt specifically in relation to its Crossrail enabling work, so in practice, an historic cost of debt for this work is not readily available. We do not propose to make any change to the approach that we adopted for CP6.

Determining values for the cost of capital and cost of debt

1.7 UKRN recently published guidance for economic regulators on the approach that should be adopted for calculating cost of capital parameters including cost of debt. ORR was a member of the UKRN taskforce that developed the guidance, and we have followed the guidance in our approach set out below.

Cost of capital

1.8 When corporation tax is not separately modelled as an allowed revenue item, price controls work off a pre-tax weighted average cost of capital (WACC):

Real pre-tax weighted average cost of capital = (pre-tax cost of debt x gearing) + (cost of equity grossed up for corporation tax x 1-gearing)

1.9 When the corporation tax is separately modelled as an allowed revenue item, the formula above is calculated without 'grossing up' the cost of equity by the amount required to recover corporation tax and is known as the 'vanilla' WACC. The gearing value is commonly a notional percentage, representing the proportion of finance provided by borrowing.

1.10 For CP6, we specified a real pre-tax WACC that Network Rail might face if it was financed in the private sector by a mix of debt and equity of 4.15%. Network Rail has proposed a range for CP7 from 2.11% to 3.98%, with a point estimate of 3.68%. Presented as a real vanilla WACC, the range is from 1.83% to 3.35%, with a point estimate of 3.12%.

1.11 UKRN publishes an annual update report on cost of capital decisions taken by economic regulators. UKRN's most recent report was published in July 2022 and is available here. Recently published regulatory determinations of cost of capital values from this report are shown in Table 1.1, together with Ofwat's final methodology for PR24 and Network Rail's proposed values for CP7.

Table 1.1 Comparison of recent regulatory values for cost of capital

Date	Dec-19	Dec-20	Mar-21	Mar-21	Mar-21	Dec-22	Mar-23
Sector	Water	Gas & Elec.	Water	Telecoms Open R.	Telecoms Other	Water	Network Rail's proposal
Cost of debt	2.14%	1.82%	2.18%	1.5%	1.6%	2.60%	2.33%
Cost of equity	4.19%	4.30%	4.73%	5.8%	7.1%	4.14%	4.44%
Notional gearing	60%	60%	60%	45%	45%	55%	62.5%
Total market return	6.50%	6.50%	6.81%	6.7%	6.7%	6.00-6.92%	5.23%
Corporation tax	17%	n/a	19%	19%	19%	n/a	25%
WACC (vanilla)	2.92%	n/a[2]	3.12%	3.8%	4.6%	3.23%	3.12%

Sources: UKRN annual cost of capital report 2022, Ofwat final methodology for PR24 and Network Rail PR23 submission to ORR. Values are presented as real (CPI).

1.12 We have reviewed Network Rail's proposed values for its WACC components for CP7. There are two matters where we have taken a different view to Network Rail:

(a) *Total Market Return*

The Total Market Return (TMR) represents the expected real return required by the market for being invested in a well-diversified portfolio. TMR is used in the calculation of cost of equity.

Noting that Network Rail's submission preceded the publication of UKRN's guidance, in our view, Network Rail's proposed value for the TMR does not follow UKRN guidance for using a mid-point estimate for calculating the cost of equity.

Given that total market return is not sector-specific and should be relatively stable over time, we consider that it is helpful to consider the values determined by other regulators. These values were published in UKRN's most recent cost of capital annual report. These values are summarised in Table 1.1. We also note the TMR value determined by CMA (Competition and Markets Authority) in its 2021 final determination for electricity

[2] Varies by subsector and CMA appeal, see UKRN report for details.

distributors (6.50%, CPI-real)[3], and Ofwat's recently published final methodology for PR24 which stated an early view of 6.00% to 6.92% (see Table 2.1 of Ofwat's report).

Based on these considerations, we consider that a TMR of 6.50% (CPI, real) should be used in the calculation of Network Rail's cost of equity.

(b) *Risk-free rate*

The risk-free rate (RFR) is the theoretical rate of return on an investment with zero systematic risk. It is used in the calculation of the cost of equity.

In our view, Network Rail's proposed value for the RFR of 2.6% does not follow the UKRN guidance for using recent yields on index-linked gilts with a maturity which matches the assumed investment horizon for their sector.

We note Network Rail's view that its approach is appropriate due to the current volatility in capital markets. However, consistent with the UKRN methodology, we consider that the observable yields on appropriately long-dated gilts provides the best view of the market's expected return on long-term gilts as a proxy for the RFR[4].

Ofwat's recent (PR24 final methodology) used a value of 0.47% for 20-year (RPI) index-linked gilts based on September 2022 Bank of England data and an RPI-CPI wedge (see Table 2.1 of that report).

To calculate a RFR for the calculation of Network Rail's cost of equity, we have used the Bank of England's latest 20-year data and applied the same RPI-CPI wedge as used in Ofwat's analysis. On this basis the RFR would be 0.98%[5].

1.13 We note that there has been a general trend to reduce the level of notional gearing in regulatory determinations due to concerns around over-gearing. Network Rail's gearing (62.5%) appears high compared to Ofgem and Ofwat's values (60% and 55% respectively). However, we do not consider that there are good reasons why

[3] See paragraph 5.292 of the CMA determination.

[4] In the UKRN methodology the stability comes from a stable TMR with the RFR varying within that stable TMR envelope, see the UKRN guidance for further details.

[5] Using the Bank of England's latest available data (28 March 2023), the yield on 20-year index linked gilts was 0.44% at the end of March 2023, compared to -0.05% in September, which was used in Ofwat's analysis. Appling the 0.54% 20-year RPI-CPI wedge used by Ofwat (see Table 3.3 in PR24 final methodology) gives an RFR of 0.98%. The Bank of England data is available at Yield curves | Bank of England.

an efficiently financed rail infrastructure manager would adopt a different level of gearing than Network Rail has suggested for CP7. We have therefore used a notional gearing of 62.5% in our determination of cost of capital values.

1.14 Based on the above, our view is that the real (CPI) pre-tax WACC for Network Rail would be 3.88% in CP7. The parameters that we have used to calculate Network Rail's WACC are set out in Table 1.2.

Table 1.2 Parameters used to calculate Network Rail's cost of capital

Parameter	Network Rail's proposed value	Our determined value
Cost of debt	2.33%	2.33%
Cost of equity	4.44%	4.69%
Notional gearing	62.5%	62.5%
Total market return	5.23%	6.50%
Risk free rate	2.6%	0.98%
Equity beta	0.70	0.70
Corporation tax	25.0%	25.0%
WACC (pre-tax, real, CPI)	**3.68%**	**3.88%**
WACC (post-tax, real, CPI)	**2.76%**	**2.91%**
WACC (vanilla, real, CPI)	**3.12%**	**3.27%**

Source: ORR own analysis

1.15 We expect UKRN to publish an updated annual cost of capital report this summer. We will review the information in that report and assess any material changes to capital markets ahead of our PR23 final determination and adjust our value if appropriate.

Cost of debt

1.16 Network Rail has forecast a real (CPI) pre-tax cost of debt of 2.33% for CP7. For reference, for CP6, we specified a real (RPI) pre-tax cost of debt of 1.45%, which equated to a real (CPI) pre-tax cost of debt of 2.45%.

1.17 Network Rail's estimate drew on analysis of forecast interest rates on government borrowing, the company's existing debt (a combination of nominal and index-linked bonds) and the proportion of existing debt versus required new debt in CP7 (42%). Network Rail also reviewed other external market-based measures including the yield to maturity for recent bond issuances by comparable companies and yields on Standard and Poor's investment grade corporate bond index. Network Rail calculated an average cost of new debt of 3.77% and an average cost of existing debt of 1.27%.

1.18 We note that Network Rail's forecast cost of debt is slightly higher than the values published in UKRN's most recent annual cost of capital report, though it is lower than Ofwat's PR24 value. We consider that Network Rail has used appropriate up to date information which takes account of the increased yield on corporate bonds following the Bank of England's decisions to increase interest rates over the past few months.

1.19 Based on the above, our view is that the real (CPI) pre-tax cost of debt for Network Rail should be 2.33%. We expect UKRN to publish an updated annual cost of capital report this summer. We will review the cost of debt information in that report ahead of our PR23 final determination and adjust our value if appropriate.

2. Setting and updating regulatory asset base balances for CP7

2.1 Network Rail's regulatory asset base (RAB) was not used in the calculation of its revenue requirements for CP6, and we do not intend to use the RAB for this purpose for CP7. However, there are benefits in maintaining RAB values for each of Network Rail's geographical regions together with total values for England & Wales, and for Scotland for the reasons explained below.

2.2 For reference, the value of Network Rail's regulatory asset base was £76.3 billion on 31 March 2022[6]. We decided not to establish a RAB value for any of Network Rail's central functions other than its System Operator (SO) in CP6 because they have few tangible assets of their own.

2.3 We received responses from Network Rail, DfT, Transport Scotland, SETL and Rail Partners. Respondents broadly agreed with our consultation questions about whether we should largely retain the approach that we adopted for CP6, making changes only where necessary.

- Network Rail highlighted the usefulness of having a RAB valuation to support its Core Valley Lines divestment in CP6.
- Transport Scotland supported the use of a RAB in respect of asset valuation, but questioned the additional resource required in respect of some of the other benefits of maintaining a RAB.
- Rail Partners noted that an additional reason for keeping the RAB updated is in case of any future changes to Network Rail's status which would require once again a conventional approach to calculating the revenue requirement and access charges.
- SETL questioned whether CPI is appropriate to be used as a default inflator for all asset categories. SETL also queried how disposals were treated including any gain/loss from a disposal.

[6] Network Rail's valuation using the depreciated replacement cost (DRC) approach is around £370 billion, see Note 5 of the DfT's annual report and Accounts 2021–22.

Decision

2.4 We intend to retain our CP6 approach for the setting and updating of regulatory asset base balances for CP7. In particular:

RAB balances for geographical regions and SO

2.5 We will determine a provisional opening RAB balance for each geographical region and SO together with an indicative forecast value for each year of CP7.

Updating RAB balances during CP7

2.6 We will use the following steps to update RAB balances in CP7:

- Inflate the value at the start of each year using CPI indexation.
- Add capital expenditure (renewals and non-grant funded enhancements[7]) during the year.
- Deduct renewals funding included in our revenue determination, at the end of the year, as a proxy for amortisation.

2.7 Under this approach, in real terms, RAB values going forward should remain broadly in line with their opening values during CP7 because additions and deductions each year should broadly be in line with each other.

2.8 We will include detailed provisions setting out how RAB values will be rolled forward from year to year in regulatory accounting guidelines that we will update and publish for CP7.

Reason for decision

2.9 We consider that RAB values are relevant for the following purposes, in order to:

- provide a valuation of Network Rail's assets (which are important national infrastructure);
- enhance understanding of the long-term financing of the network;
- facilitate comparability with other regulated network businesses; and

[7] Because non grant-funded schemes require separate funding, as opposed to those which have been funded through government grants. We note that excluding grant funded enhancements understates the full asset value of the network.

- support the valuation of assets for disposal or transfer purposes, such as the Core Valley Lines disposal in Wales in CP6.

2.10 Transport Scotland questioned the additional resource required in respect of some of the other benefits of maintaining a RAB beyond its usefulness for asset valuation. We do not consider that any additional resources are required in respect of the other benefits of maintaining a RAB mentioned in our consultation.

2.11 SETL questioned whether it is appropriate to use CPI as a default inflator for all asset categories. We agree that different assets within the overall asset base may have different underlying asset price trends, although in the long run the value of a complex infrastructure asset like the rail network is likely to be highly correlated with general price inflation. Moreover, the indexation approach to the RAB is primarily designed to compensate investors for the real terms value of past investments. This is consistent with the approach of other UK economic regulators and historic precedent. Therefore, we consider that using general inflation, as measured by CPI, is the most appropriate inflator to apply to RAB balances.

2.12 SETL also questioned how disposals are treated for the RAB including any gain/loss from a disposal. We are not proposing any change to our CP6 RAB approach, which is set out in our regulatory accounting guidelines. A relevant example was the divestment of the Core Valley Lines in CP6 where the whole value of the RAB for the Core Valley Lines was deducted, meaning that there was no gain or loss for RAB purposes. This was documented in our annual efficiency and finance assessment of Network Rail.

3. Rebates

3.1 Our policy on rebate payments by Network Rail to governments in CP6 has been that rebate payments should only be made in exceptional circumstances, and that they should not create risks to the financial sustainability of Network Rail's business.

3.2 The current rebate mechanism is set out in the CP6 track access contracts for franchised passenger operators. It provides for Network Rail to rebate income that it does not require to discharge its obligations under its network licence and any contracts to which it is a party. ORR's approval is required before a rebate is paid. In broad terms, the rebate to franchised passenger operators flows through to the governments under the commercial terms of franchise arrangements. We note that other options exist in network grant letters for Network Rail to return funding to governments.

3.3 We received responses from Network Rail, DfT, Transport Scotland, Rail Partners and SETL. Except for SETL, respondents broadly agreed with our consultation questions. Whilst Transport Scotland saw no need for changes, it noted concern about the time taken for decisions to be made and wanted this to be further discussed during the next control period.

3.4 Network Rail considered that rebates to governments should take place in exceptional circumstances, or where there is a very significant outperformance. It noted that under current funding arrangements, it can choose to draw down lower levels of grant funding than originally set out at the start of the control period if the funding is not required. As such, it would be unlikely that the rebate mechanism in track access contracts would be used given the additional administrative complexity involved.

3.5 Rail Partners stated that it is important to maintain the rebate mechanism as it can help to ensure that Network Rail does not overcharge for its services and maintains records that can be used for future comparison purposes and can assist with accountability.

3.6 SETL considered that a rebate mechanism should be retained but that the requirement for Network Rail to be confident that surplus funds will not be required should be removed. SETL considered that this is overly cautious and means that rebates are only ever likely towards the end of the control period, or even not likely at all. SETL proposed that any surplus should be monitored on an ongoing basis and joint governance put in place to identify and agree more timely release of surplus funds. However, SETL agreed that any release should not create risks to the financial sustainability of Network Rail's business.

Decision

3.7 We intend to retain a rebate policy to keep the CP6 rebate mechanism in place for Network Rail to potentially make rebate payments during CP7. As in CP6, payments should only be made in circumstances where Network Rail is confident that surplus funds will not be required in CP7 and should not create risks to the financial sustainability of its business.

Reason for decision

3.8 We consider that there have been no significant changes that justify a change to our CP6 rebate mechanism. We note that other mechanisms exist for governments to reduce their network grant funding to Network Rail. Retaining the existing rebate provisions in track access contracts does not appear to raise any material issues as it does not preclude Network Rail returning funds to government through other channels.

3.9 In response to SETL's suggestion that our approach may be unduly cautious, and its proposal that any surplus should be monitored on an ongoing basis, we actively monitor Network Rail's financial performance, and report on it through our annual efficiency and finance assessments. We intend to continue with this approach throughout CP7. As such, we consider that suitable monitoring arrangements will be in place to form an early view about the viability of rebates where appropriate. However, in practice, we would expect Network Rail to use other mechanisms to return excess network grant funding to governments.

3.10 As requested by Transport Scotland, during CP7, we will review with them the time taken for decisions to be made regarding rebate decisions.

4. Network grant arrangements and dilution provisions

4.1 Network Rail recovers a proportion of its fixed costs through direct network grants from funders. This is in lieu of fixed track access charges (FTACs) paid by passenger operators on concession-style agreements. In CP6, the network grant represented around 62% of operating and capital expenditure (excluding enhancements), and the DfT's SOFA for England & Wales (see here) would imply a similar proportion for CP7[8].

4.2 For CP6, there has been a deed of grant between DfT and Network Rail, and a grant agreement between Transport Scotland and Network Rail, which set out the dates and amounts for network grant payments.

4.3 The existing track access contracts held by passenger operators on concession-style agreements also contain network grant dilution provisions[9]. These provide that, in the unlikely event that a network grant payment is not made *during* the control period, operators are obliged to pay a share of the shortfall to Network Rail, three months after the 'dilution date'. This reflects that the network grants offset an amount of income that would otherwise be recovered through higher FTACs.

4.4 As part of PR23, we have considered the process and timings for confirming the terms of network grant arrangements for CP7. In PR18, we received written confirmation from Network Rail and funders of the dates, amounts and conditions for network grant payments after our final determination (in the first quarter of 2019)[10]. This meant that the PR18 settlement, and the level of FTACs set out in price lists, was based on an assumed level of grant funding that had not been formally confirmed at that point.

4.5 We said in our December consultation that, for CP7, we will seek written confirmation of the dates, amounts and conditions for network grant payments (in signed network grant documentation) *before* our final determination. If network grant documentation is not in place by then, we proposed that:

[8] Calculated including EC4T and industry costs and rates.

[9] These are set out in Part 3A of Schedule 7 of operators' contracts.

[10] In the case of Scotland, this was in late March, i.e. very close to the start of CP6.

(a) We would assume for the purposes of our final determination that there will be no grant funding for CP7, and the Schedule of Fixed Charges would be set to recover Network Rail's *total* net revenue requirement.

(b) However, we would also include a variation clause in passenger operators' track access contracts whereby FTAC amounts would be adjusted downwards to reflect the amount of network grant which we agree should be paid to Network Rail, if this is confirmed before the start of CP7.

4.6 The purpose of this proposed change was to improve the overall governance and assurance around Network Rail's funding certainty for CP7, while still allowing flexibility for funders and Network Rail to agree network grant documentation after the final determination and make grant payments.

4.7 Responses to this proposal were mixed. Respondents generally supported our desire to agree the terms and amounts of network grant funding at an early stage – though Network Rail queried whether it would be possible to agree the schedule of grant payments before ORR has determined outputs and funding as part of our final determination.

4.8 However, respondents raised some concerns with the proposed approach to setting FTAC amounts if grant documentation is not in place. Several respondents said this approach could increase uncertainty for train operators (and other devolved rail authorities) over the level of FTAC they would be required to pay in CP7. Network Rail also said this would create an additional administrative burden, particularly with the anticipated creation of Great British Railways during CP7.

Decision

4.9 We will continue to seek **provisional** confirmation of the profile and level of network grant payments from funders before our final determination and a near final draft of the grant documentation. If this is adequate, Network Rail's Schedule of Fixed Charges will be set to be consistent with this. Written confirmation of finalised network grant documentation (including payment amounts) would then be submitted to ORR by 7 December 2023. If we have not received the signed grant documentation by this date, we will publish a letter to Network Rail requiring it set out contingency arrangements.

4.10 Additionally, as part of our forthcoming consultation on changes to model contracts, we will consult on amending the existing network grant dilution provisions in Schedule 7 of operators' track access contracts, to shorten the delay between a dilution event occurring and an increase in FTAC payments. This will strengthen Network Rail's protection against an unexpected shortfall in grant funding, compared to the provisional amounts confirmed in our final determination.

Reason for decision

4.11 Since publishing our December consultation, we have held further discussions with funders and Network Rail about network grant arrangements. Our view remains that the terms and amounts of network grant can be agreed before or alongside the final determination. At this point, Network Rail's funding settlement should be largely stable, and FTACs can be adjusted to satisfy any minor changes in its net revenue requirement that arise.

4.12 However, in practice, we understand that these arrangements are unlikely to be confirmed by this point. In this context, our proposal could increase uncertainty for train operators over the level of FTAC they would pay in CP7 (which would likely be different to what is set out in the published Schedule of Fixed Charges). It would also require us to develop and consult on new contractual wording in track access contracts, which, as noted by Network Rail, may only be in place for a single control period.

4.13 We do not therefore intend to take forward this proposal. This means that our final determination – and the level of FTACs set out in Network Rail's final price lists – would continue to be based on a provisional level of grant funding, as in PR18.

4.14 While we would not expect final network grant arrangements to differ from the provisionally agreed amounts, this approach continues to leave a risk that further changes to grant arrangements would occur after our final determination. This could trigger the use of grant dilution provisions early in CP7, to ensure that Network Rail's funding requirement is met.

4.15 In light of this, we have reconsidered the grant dilution provisions in operators' track access contracts to ensure they are sufficiently robust. Under the current provisions, operators are required to pay a share of any shortfall in network grant payments three months after the date that a payment is missed[11]. This means that Network Rail is still financially exposed to a funding shortfall for an interim period – particularly now that it cannot borrow easily. We consider this could be mitigated by reducing the maximum length of time between a dilution event being triggered and an additional FTAC payment from operators from three months to one month. We consider this is the minimum practicable time needed to implement a grant

[11] This payment is defined in track access contracts as the 'Compensation Amount'.

dilution event, taking into account of the seriousness of a situation where this event is needed[12].

4.16 We will consult on this change to the timing of grant dilution payments as part of our forthcoming consultation on changes to model contracts. This would be a simpler way of strengthening Network Rail's funding certainty than the change to track access contracts that was proposed in our December consultation.

4.17 Finally, as set out above, we will then seek written confirmation of finalised network grant documentation (including payment amounts) by 7 December 2023. If grant letters have not been signed and submitted to ORR by this date, we will write to Network Rail asking it to set out its contingency arrangements, for how it will deal with a shortfall in grant funding from the 1 April 2024, to ensure there is sufficient certainty over Network Rail's ability to deliver the PR23 determination. This would also serve to provide advance notice to industry that a grant dilution even may be triggered.

4.18 We note that this revised approach is contingent on receiving provisional confirmation of the level and profile of network grant payments before our final determination. If there remains significant uncertainty about the terms of grant arrangements at 31 August 2023, we may consider alternative options. This could, for instance, include setting the Schedule of Fixed Charges based on a level of grant funding that is determined by ORR; or reverting to the approach proposed in our December consultation, i.e. assuming there will be no grant funding for CP7. This would limit Network Rail's exposure to the risk of subsequent changes in network grant arrangements, after our final determination.

[12] We recognise that operators would likely be unable to fund a grant dilution payment out of normal working capital, so this would likely trigger a requirement for additional funding to be provided by commissioning authorities outside of normal business planning cycles. Given that a dilution payment is a contractual requirement under Schedule 7, we consider this would be achievable, particularly in this situation where Network Rail would not have sufficient funding for trains to run.

5. Re-opener provisions

5.1 Track access contracts currently contain a provision relating to “Access charges reviews capable of coming into operation before 1 April 2024”. This is commonly referred to as a re-opener provision and refers to the ability to amend the revenue requirements that Network Rail can recover through access charges and network grants in extreme circumstances. A re-opener is a formal process to vary the terms of our regulatory determination.

5.2 The provision in CP6 track access contracts is for there to be a re-opener of our regulatory determination in two scenarios:

(a) a material change in the circumstances of Network Rail or in relevant financial markets. Under this provision we would consider whether there were compelling reasons to initiate an access charges review, having regard to our duties under section 4 of the Act. This re-opener applies to events in England & Wales, and in Scotland; and

(b) if expenditure in Scotland is forecast to be more than 15 percent higher than our determination over a forward-looking three-year period. This provision applies to Scotland only.

5.3 We received responses from Network Rail, DfT, Transport Scotland, Rail Partners and SETL. Except for SETL, respondents broadly agreed with our consultation questions. Network Rail noted that the existing provisions provide some flexibility if the circumstances that it faces during CP7 are materially different from those assumed during PR23. Rail Partners supported the principle of reopener provisions if it caused only a potential change in FTAC but not to other charges levied on open access operators. Rail Partners noted that ORR should consider reviewing lessons learnt from other industries because of COVID-19 and high inflation, recognising that reality might deviate so far from regulatory assumptions used to set the revenue requirement that a re-opener would be required. Transport Scotland considers that the re-opener provision could be an appropriate mechanism to respond to the significant uncertainty posed by high rates of inflation in the UK economy and welcomed ORR’s views on this point.

5.4 SETL considered that the existing provisions do not consider wider industry or train operator related scenarios, noting that even the significant impact of COVID-19 during CP6 did not require a re-opener. SETL believes that there should be scope for a re-opener if most train operators believe that there is a case for a re-opener due to underlying financial and commercial circumstances.

Decision

5.5 We intend to retain the re-opener provision in track access contracts, updated to refer to 'before 1 April 2029'. The bar for a re-opener is high, requiring a material change in the circumstances of Network Rail or in relevant financial markets. We are retaining the Scotland specific provision for a re-opener if expenditure in Scotland is forecast to be more than 15% higher than our determination over a forward-looking three-year period.

Reason for decision

5.6 Noting SETL's view that most train operators should support a re-opener for it to be used, we consider that the current provision provides an important mechanism that allows us to work with the governments, Network Rail, and industry stakeholders to change the terms of our determination of track access charges if material unforeseen circumstances were to arise during CP7. We do not consider that it would be appropriate to be only able to implement a re-opener if it was supported by most train operators.

5.7 In response to Transport Scotland's view that the re-opener provision could be an appropriate mechanism to respond to the significant uncertainty posed by high rates of inflation in the UK economy, we agree that a re-opener may be appropriate if such uncertainty represents a material change to Network Rail's circumstances and could not be absorbed within existing funding or planned expenditure (including any risk-funding).

6. Management of financial risks

6.1 This chapter covers our approach for Network Rail's management of financial risk and uncertainty in CP7. It does not examine the amount that Network Rail has put aside as a group risk fund for CP7 and the renewals that is proposing to de-prioritise as this matter is covered in our PR23 draft determination: supporting document on sustainable and efficient costs. It also does not address uncertainty related to British Transport Police costs, external financing, enhancements, and corporation tax costs, as we expect these to be funded outside of the PR23 settlement.

6.2 Like any company, Network Rail needs appropriate provisions in place to manage the risks it faces, such as inflation, cost shocks and adverse events. Our approach for Network Rail's management of financial risks in CP6 included flexibility provided by setting outputs on a P80 basis[13] and Network Rail not having to commit all its expenditure into asset management plans at the start of the control period. In addition to using risk funds to cover unanticipated costs, particularly relating to COVID-19 and inflationary pressures, Network Rail also drew down on its risk funds to implement the recommendations of reports by Lord Mair and Dame Slingo (in relation to the tragic Carmont accident), improve track worker safety, support work on rail reform, and other matters.

6.3 Network Rail expects to face many of the same type of financial risks in CP7 as in CP6, with some expected to be more significant (for example, general economic uncertainty), some less (the impact of COVID-19) and some new risks including the transition to Great British Railways. If these risks are not managed effectively, there is the potential for seriously adverse impacts on the deliverability of renewals and other activities.

6.4 We received responses from Network Rail, DfT, Transport Scotland, Rail Partners and SETL.

Network Rail

6.5 Network Rail responded that its proposed approach for managing financial risk in CP7 seeks to retain as many of the benefits of the CP6 approach as possible, which includes: the flexibility provided by holding back funding in 'resource' budgets (i.e. budgets not allocated to capital projects); the ability to set outputs on a risk adjusted basis; and recognising that asset management plans will adapt as

[13] Meaning that there is an 80% chance of the outputs being delivered within the available funding.

circumstances change through the control period. It noted that the extent of risk that the company will face in CP7 is difficult to quantify as Network Rail cannot foresee all the risks that will materialise in the control period, but that risk exists irrespective of any risk management approach that it takes.

6.6 Network Rail stated that its intended approaches to manage financial risks in England & Wales, and in Scotland have some differences to reflect the funds available for CP7 from each of the respective governments. For England & Wales, Network Rail considers that its SoFA funding is significantly lower than that needed to maintain a steady state railway. Therefore, it is not able to hold back the same scale of funding from renewals as in CP6 (circa £3 billion). Instead, the SBP (strategic business plan) proposed to:

- Hold a provision outside of region and function budgets of £0.5 billion across the five years as a backstop for overall financial risk for England & Wales.
- Identify around 5% of the value of each regions' plan that would be deferred or de-scoped if risk materialised in CP7 – around £1.5 billion for the four England & Wales regions. This is different from CP6 where Network Rail held risk funding in regions that was not aligned to specific activity in the plan.
- Identify output forecasts consistent with its risk-adjusted plan and assess the impact on outputs if risk does not materialise.
- Hold a proportion of funding that would otherwise be allocated to renewals as 'resource' budget (or RDEL).
- Separately identify the impact of higher than forecast inflation on its net costs (i.e. costs less income) to support discussions with the UK Government about how it should manage a situation with materially higher inflation than assumed in the SoFA.

6.7 In Scotland, Network Rail's interim SBP suggested risk funding for CP7 of £206 million. However, it is continuing to work through the value of the provision which it has attributed to the delayed timing of Transport Scotland's HLOS (High Level Output Statement) and SoFA. A key difference from Network Rail's SBP for England & Wales is that it has not yet identified any further activity in its Scotland plan that would be deferred or de-scoped if risk materialised. However, we note that the funding available in the SoFA is greater than the net expenditure projected in the interim SBP for Scotland by £221 million. As we explain in our PR23 draft determination: executive summary document for Scotland, Network Rail did not have sufficient time between the publication of the SoFA and the submission date to consider how this funding should be best used. It considers that some of this funding should be used for additional risk funding. We agree and consider £101 million should be added to risk funding.

DfT

6.8 Although DfT was broadly satisfied that there was satisfactory discharge of the risk funding over CP6, it is keen to ensure greater transparency and independent scrutiny of the risk funding arrangements throughout CP7 than in CP6. In practice, this should mean stronger and more active governance from ORR and continued oversight from Government (DfT and HMT) of the deployment of Network Rail's risk fund, and the overall level of risk that Network Rail holds.

Transport Scotland

6.9 Transport Scotland considers that the level of risk funding should be proportionate to the level of risk that it would be reasonable for Network Rail to be expected to manage. It noted that it would be helpful to consider this in terms of defining a framework under which risks can be more easily shared to enable funding authorities to have a greater influence on significant strategic decisions required in light of risks arising.

Rail Partners

6.10 Rail Partners broadly agreed with our consultation questions, though it considers that the structure of a risk fund to manage financial risks needs some thought. Rail Partners suggested that there could be a dedicated inflationary risk fund, which Network Rail would have to show that inflation was responsible, before it can draw on, helping to incentivise it to be efficient.

SETL

6.11 Whilst recognising that flexibility will be required when setting initial plans, SETL was concerned that train operators are being asked to contribute to a risk fund where it has no certainty around its use. SETL questioned what governance arrangements will be in place around these provisions from an ORR and train operator perspective. SETL's view was that for a ringfenced risk fund, any surplus should be separately monitored and rebated to train operators on an annual basis.

Decision

6.12 We will increase our scrutiny of, and transparency around Network Rail's management of financial risks in CP7. This will include enhanced reporting on Network Rail's use of risk funds in our annual efficiency and finance assessments of Network Rail, and other publications where appropriate. This matter also has links to our Managing Change Policy for CP7, which is explained separately in our draft determination.

Reason for decision

6.13 Network Rail intends to retain a broadly similar approach in principle to CP7 as is in place for CP6, with some funding in a risk fund and some funding ringfenced to prioritise asset management activities (these could be called 'contingent asset management activities'). This is effectively an internal management tool, to retain some flexibility within its plans, and to manage its business efficiently and effectively. However, as Network Rail has acknowledged, it is continuing to work through the value of the risk provision for Scotland (which it has attributed to the delayed timing of the Transport Scotland's HLOS and SoFA) and that it has not yet identified any further activity in the plan that would be deferred or de-scoped if risk materialised in Scotland.

6.14 Given Network Rail's nature as a publicly owned operator of national infrastructure, the using up of a larger risk fund fairly quickly in CP6, and the increased complexity of Network Rail's proposed approach for managing financial risks in CP7 (including the material use of contingent asset management activities), we consider that it is important to increase transparency about how Network Rail is managing financial risks during the control period.

6.15 DfT's and SETL's responses expressed similar views that there is a need for greater transparency and independent scrutiny of the use of a risk fund in CP7. Network Rail's response acknowledged this, and the company has stated that it looks forward to engaging with us on this matter. We have addressed SETL's comment on rebating unused funds in the rebate chapter of this document.

6.16 Transport Scotland would like funding authorities to consider how risks can be more easily shared and hence have a greater influence on significant strategic decisions required in light of risks arising. We consider that the approach set out above is consistent with the risks that Network Rail Scotland faces and that it is important that Network Rail Scotland is accountable for the outputs it is being funded to deliver. The network grant arrangements between Network Rail Scotland and Transport Scotland set out how funding is provided. These arrangements need to be consistent with our determination. We can support Transport Scotland and Network Rail Scotland to ensure risks are appropriately funded. For example, our intended approach to increase scrutiny of, and transparency around, Network Rail's management of financial risks in CP7, will help to better support Transport Scotland with such matters.

6.17 In response to Rail Partners’ suggestion of a dedicated inflationary risk fund (which Network Rail would have to show that inflation was responsible for, before it can draw on), we note that the group risk fund that Network Rail has proposed for England & Wales in CP7 is much reduced from that in CP6 and inflation risk is very high. We therefore consider that restricting Network Rail’s access to a proportion of a fund that had been allocated to inflation risk is unduly restrictive on Network Rail’s ability to manage its business efficiently and loses the benefits of being able to manage risk on a portfolio basis (i.e. across its whole activities), which would increase the amount of risk funding required.

7. Governments' budgetary processes

7.1 The reclassification of Network Rail to the public sector occurred during control period 5 (CP5). As such, government budgeting for Network Rail's expenditure operated under the Annually Managed Expenditure (AME) regime for the remainder of CP5. For CP6, Network Rail's budget operated under the Resource Departmental Expenditure Limit (RDEL) and Capital Departmental Expenditure Limit (CDEL) rules that apply to DfT's own budget. Unlike under AME, UK Government departments have limited flexibility to amend RDEL and CDEL.

7.2 This section summarises the flexibilities that we expect to apply for Network Rail within DfT's RDEL and CDEL regimes for CP7 for funding in England & Wales, and the flexibilities that Transport Scotland will apply for the funding for Network Rail Scotland. These remain broadly similar to the flexibilities in CP6.

7.3 We received responses from DfT, Transport Scotland, Network Rail, Rail Partners and SETL.

DfT

7.4 DfT agreed with our characterisation of the UK Government's current budgetary processes. DfT restated that the objective of these financial flexibilities was to provide a robust mechanism to allow Network Rail to manage changes in circumstances during the five-year control period, so that it could make effective and efficient asset management decisions to support delivery for passengers, freight customers and taxpayers. Whilst DfT has not yet confirmed the specifics of the flexibilities for the Control Period, we have assumed that similar financial flexibilities to those of CP6 are likely to be employed to achieve those objectives in CP7.

Transport Scotland

7.5 Scottish Ministers are keen to retain the 10% budget flexibility from CP6 into CP7. Transport Scotland has stated this is dependent on discussions with HM Treasury and is likely to mean greater reliance on Network Rail achieving forecast expenditure if budgetary flexibility is reduced. Transport Scotland also noted that because funding of enhancements was not included in the Scotland SoFA for CP7, it will likely not be possible to balance variations between budgets for network grant and enhancements. The timing of requests is also different for

Scotland because Transport Scotland must first engage with the Scottish Government who can then reflect agreed adjustments as part of the UK budgetary estimates process.

Network Rail

7.6 Network Rail noted that its SBP has been developed on the basis that the budgetary controls in CP7 will be at least as flexible as they are in CP6. Its response stated that removing existing flexibilities would lead to a reduction in financial and management flexibility that would constrain the company's asset management approaches in a way that would lead to less efficient and effective delivery. Network Rail considers this flexibility is very important, particularly for its regional businesses, as restrictions would impact asset management decisions to replace or maintain, and to schedule work in the most efficient way.

7.7 Network Rail stated that its experience of CP6 and understanding of how other DfT arm's length bodies manage their inherent workbank variability has led it to identify some potential improvements to the current financial controls. It is discussing these matters with the UK Government.

Rail Partners

7.8 Rail Partners commented that ORR cannot do much in the design of the financial framework to take account of the impact of governments' budgetary processes. Also, that those budgetary processes ought to ensure that Network Rail is disciplined in its budgeting and cost control.

SETL

7.9 SETL highlighted that there is a disconnect between DfT's approach and how train operators are funded, where they are given annual expenditure targets based on a percentage of the previous year with no ability to defer CDEL etc.

Decision

7.10 Given the nature of Network Rail's business (which comprises a large capital renewals programme as well as the operation and maintenance of the network for a five year period – in return for relatively fixed funding) we see advantages in the flexibilities currently in place, in particular, in relation to supporting stable business planning and management of uncertainties. However, governments' budgetary processes are not a matter for ORR to decide, so this chapter does not set out any proposed decisions for CP7. However, to ensure transparency around the factors that affect Network Rail's financial framework, we will continue to engage with DfT and Transport Scotland about their budgetary processes for CP7, and we will set these out as part of our final determination.