

FRAMEWORK FOR SETTING ACCESS CHARGES

We set out our decisions and emerging views on the framework for setting access charges, including incentives, the financial framework, structure of charges and freight charging.

FINANCIAL FRAMEWORK

We support Network Rail's intention that the government guarantee of Network Rail's debt (the financial indemnity) should be restricted from CP4. The incentives on the company will be improved, for example through restoring the monitoring role of creditors. This will enable us to make higher assumptions for Network Rail's efficiency improvement. We intend to provide Network Rail with an allowed return that reflects its risk-adjusted cost of capital and establish a framework that ensures that any surpluses are used appropriately.

INCENTIVES FRAMEWORK

We want to reinforce the incentives on Network Rail to perform well in each of its wide-ranging roles and to forge partnerships with train operating companies and other parties to improve whole industry outcomes. We consider that Network Rail should be provided with a volume incentive in CP4, to meet higher (or lower) than anticipated demand in the most effective way. We consider there is merit in creating a mechanism that allows Network Rail and other industry parties flexibility in the delivery of the HLOSs. We also see merit in creating an efficiency benefit sharing mechanism, whereby train operators could share in Network Rail's efficiency outperformance. We will be developing the incentive framework further during PR08.

FREIGHT CHARGES

We have brought forward decisions on key aspects of the review of freight charges and established caps for the maximum level of charges in CP4. The specific charges and associated price lists will be determined later in PR08. We have identified a range for possible freight variable usage charges in CP4 and set a cap at the upper end of the range. The lower end of our range is significantly lower than current levels for these charges and we consider there is a strong possibility that final charges will be below current levels. We will implement a new charge to recover fixed costs of freight only lines, which will be levied on trains carrying coal for the electricity supply industry and spent nuclear fuel.

KEY ISSUES AND CHALLENGES TO NETWORK RAIL AND THE INDUSTRY FOR PR08 AND CP4

Capacity challenge: Network Rail/industry must deliver the required capacity in an affordable way.

SoFAs / HLOSs: For the first time in a periodic review government must set out explicitly the funding it has for the railway and what it wants to be achieved.

Safety: Continuous safety improvement is possible and necessary – through improved processes, competence, culture and asset management.

Asset management: Network Rail has established good foundations but further improvement is necessary.

Value for money: Continuous improvement in efficiency is essential and achievable without compromising safety or performance. The SBP should reflect how the whole industry can deliver the HLOSs. Examination of demand

management should be included as an option for addressing the capacity challenge

Incentives: Incentives, including the structure of access charges, are important for delivering better industry outcomes. Limiting the government guarantee of Network Rail's debt is a key milestone in the company's progress towards financial independence.

Balanced scorecard: Network Rail, working with the industry, must also:

- build on improvements in performance and deliver this consistently across the network;
- develop and implement an efficient possessions strategy to deliver a 7-day railway; and
- ensure that rail maintains and improves its comparative environmental advantages.

The Office of Rail Regulation (ORR), established in July 2004 under the Railways and Transport Safety Act 2003, is an independent statutory body led by a board, with responsibility for the safety and economic regulation of the national rail network and other aspects of rail services. It is also the safety regulator for other railways, including underground railways, heritage railways and trams.

PERIODIC REVIEW 2008

FEBRUARY 2007 UPDATE



ADVICE TO MINISTERS & FRAMEWORK FOR SETTING ACCESS CHARGES

On 28 February 2007 we published 'Advice to Ministers and framework for setting access charges', a key document in the 2008 periodic review (PR08). PR08 will determine Network Rail's regulated outputs, revenue requirement and access charges for control period 4 (CP4) which is expected to run from 1 April 2009 to 31 March 2014. We intend to conclude the review when we publish our final determinations in October 2008. The final levels of individual access charges and associated price lists will be approved by us in December 2008 following calculation by Network Rail.

Our February document together with the notice starting the formal phase of PR08 provides advice to the Secretary of State for Transport and Scottish Ministers to assist them in their input to PR08. The document:

- sets out our assessment of Network Rail's initial strategic business plan (ISBP) for CP4;
- provides an assessment of Network Rail's possible CP4 required revenues; and
- summarises the guidance that we have provided to Network Rail on the compilation of its strategic business plan (SBP).

The document also set out our decisions or our emerging views on several key aspects of our framework for setting access charges.

PR08 will establish Network Rail's programme for the operation, maintenance, renewal and enhancement of Britain's rail network for CP4, but the effects of that programme will extend well beyond then. Our decisions must therefore be based on a clear and appropriate longer term vision and strategy for the railway that reflects the expectations of both rail users and funders. Our overarching objective for the review is to ensure an outcome that

secures value for money for users and taxpayers in a way that balances the interests of all parties. Other specific objectives include promoting continuous improvement in health and safety, further to the company's existing obligations under safety legislation. We will be determining separate outputs, revenue requirements and access charges for Network Rail in England & Wales and in Scotland, in line with the new devolved funding responsibilities.

ACCESS CHARGES

At a periodic review, we determine the amount of revenue that we consider Network Rail needs to run the railway over the subsequent control period. It recovers this through a combination of access charges paid by train operators for use of the infrastructure (including stations) and, possibly, grants paid by government in lieu of access charges.

KEY DATES

August 2005

First periodic review document

December 2005

Initial assessment of Network Rail's revenue requirement for CP4

July 2006

Network Rail publishes its ISBP

February 2007

Advice to Ministers & framework for setting access charges

July 2007

Secretary of State and Scottish Ministers each publish their HLOS & SoFA

October 2007

Network Rail submits its SBP, including indicative access charges

December 2007

Initial assessment of whether HLOSs & SoFAs match

February 2008

Our assessment of the SBP

June 2008

Draft determinations

October 2008

Final determinations

December 2008

Final levels for access charges

April 2009

Control period 4 begins

PR08 PROCESS

The Railways Act 2005 set out a new framework for determining priorities for public funding of the railways. The Secretary of State and Scottish Ministers are required to provide us with information on what outputs they want the railway to deliver and the public funding available to deliver these. They will each do this by publishing their 'high-level output specification' (HLOS) and statement of the public funds available (SoFA). If, after detailed analysis, we consider the funding to be insufficient to deliver the outputs, and there are no revisions by the Secretary of State or

Scottish Ministers, we must decide which outputs the railway should provide given the funding available.

Our review initiation notice requires the Secretary of State and Scottish Ministers each to provide their HLOS and SoFA by the end of July 2007. These will form key inputs to our work to determine Network Rail's regulated outputs, revenue requirement and access charges for CP4. In undertaking PR08 we will also take into account the reasonable requirements of all of Network Rail's customers and other

fundors, including non franchised passenger and freight operators.

Network Rail needs to work with its industry partners to develop its SBP. The PR08 timetable is demanding. We are engaging with Network Rail, DfT, Transport Scotland and the industry to ensure that PR08 is progressed as planned. We will consult on all of the key issues and decisions.

INITIAL STRATEGIC BUSINESS PLAN

Network Rail published its ISBP in July 2006. This sets out the company's two defined 'strategies' for CP4. The Baseline strategy delivers a non-degrading network that will provide for minimal growth, while the Base Case strategy delivers a network with significant enhancements to address some of the challenges presented by substantial passenger and freight growth.

We have reviewed and challenged the ISBP. It reflects a significant step forward in Network Rail's planning capability, not least through the development of its asset policies and an infrastructure cost model (ICM). However, there is a great

deal more for Network Rail to do in order that it can submit to us a robust, substantiated plan in October 2007.

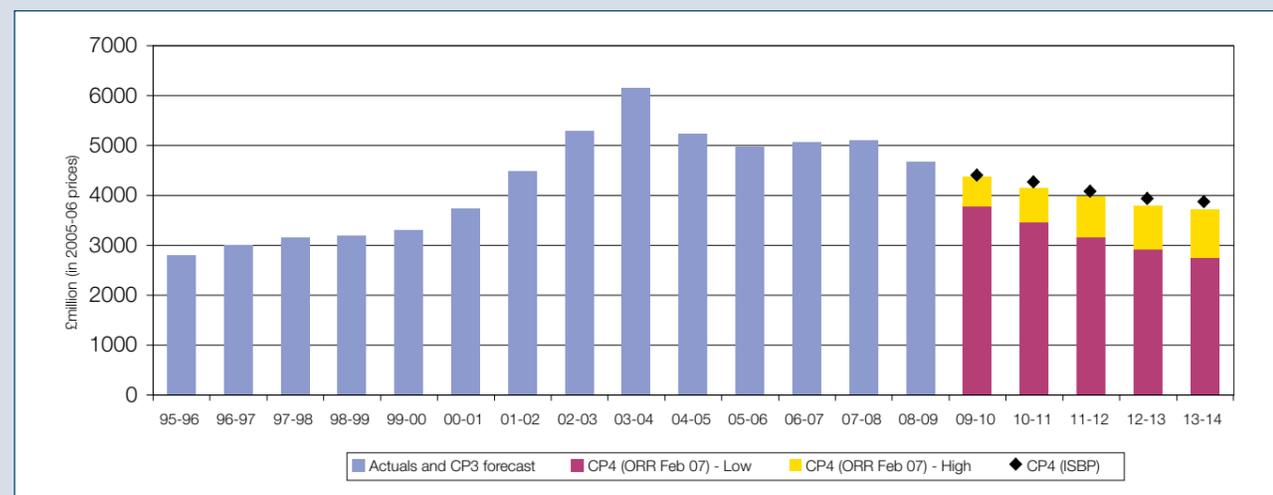
The assessment of Network Rail's proposed expenditure is a key part of the determination of its revenue requirement. We consider that there is scope for Network Rail to deliver improvements in safety, performance and asset management at significantly lower cost than it has assumed in the ISBP (without compromising safety or performance). Across Britain, operating, maintenance and renewal (OM&R) expenditure increased from less than £3bn in 1995-96 to a peak of £6bn in

2003-04 in the wake of the Hatfield accident in October 2000. We consider that it could fall to between £2.8bn and £3.7bn by the end of CP4 in 2013-14, based on the work we have conducted to date on PR08. Network Rail forecasts expenditure at £3.8bn in 2013-14.

In addition to this OM&R expenditure, we consider that incremental expenditure on enhancements in CP4 could lie between £4.0bn and £6.3bn. Network Rail's estimate is £6bn. The final level of this expenditure will be influenced by what level of network capacity and performance the Secretary of State and Scottish Ministers specify in their HLOSs.

OPERATING, MAINTENANCE AND RENEWAL EXPENDITURE IN GREAT BRITAIN

(ACTUAL EXPENDITURE TO 2005-06 AND FORECASTS FROM 2006-07)

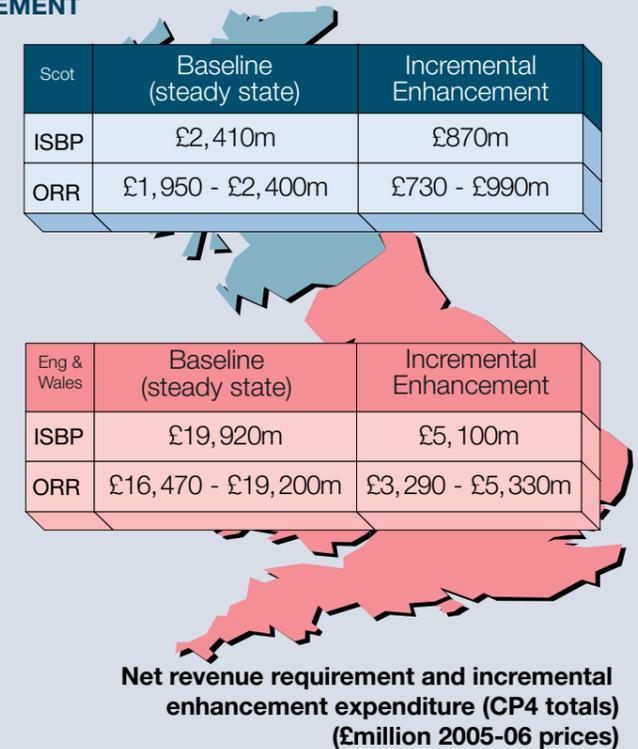


ASSESSMENT OF THE CP4 NET REVENUE REQUIREMENT

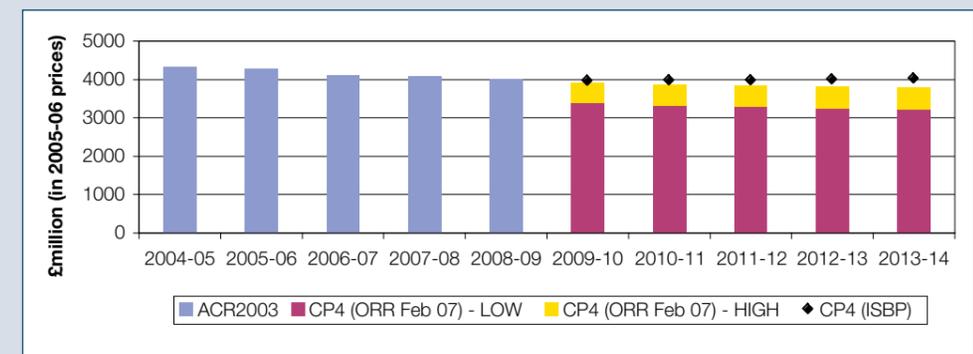
We have assessed the possible range for Network Rail's CP4 net revenue requirement, based on our analysis of the ISBP. It is our assessment, the efficient range of revenue required by Network Rail, including an allowance for the amortisation of enhancement and renewals expenditure and an allowed return on its regulatory asset base.

The net revenue requirement is that paid by franchised passenger track access charges and is net of income that Network Rail receives from other sources (including from property, stations charges and charges paid by non franchised passenger and freight operators). Our assessment informs the development of the HLOSs and SoFAs by the Secretary of State and Scottish Ministers.

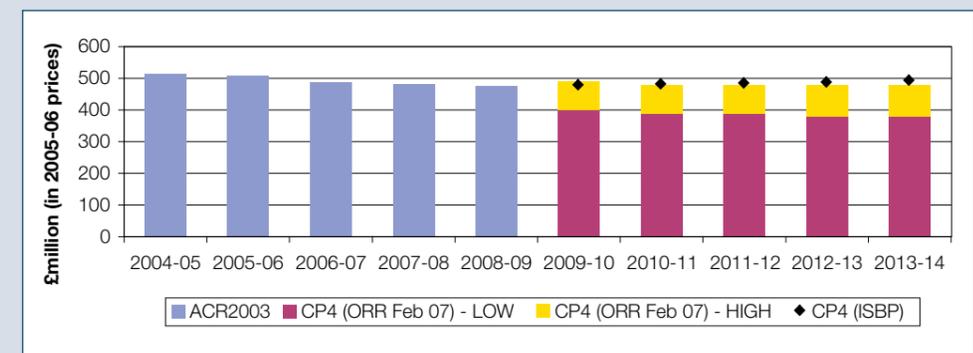
The figure on the right shows our ranges for the net revenue requirement for the Baseline strategy and also for the incremental enhancement expenditure for the Base Case strategy (although the final level of this is dependent on what is required by the HLOSs). The ranges reflect the uncertainty at this stage of PR08.



POSSIBLE RANGE FOR THE BASELINE CP4 NET REVENUE REQUIREMENT - ENGLAND & WALES



POSSIBLE RANGE FOR THE BASELINE CP4 NET REVENUE REQUIREMENT - SCOTLAND



GUIDANCE TO NETWORK RAIL

Network Rail needs to do a significant amount of work to develop its SBP. In particular, we believe Network Rail needs to focus on developing and justifying its asset policies, scope for efficiency improvement, possessions strategy and proposed enhancements. It must also continue to develop its ICM and improve the robustness of the disaggregation of the SBP between England & Wales and Scotland.