Bill Emery
Chief Executive
Telephone 020 7282 2006
Fax 020 7282 2043
E-mail bill.emery@orr.gsi.gov.uk

OFFICE OF **RAIL REGULATION**

20 December 2007

Dr Mike Mitchell
Director General, Rail & National Networks
Department for Transport - Rail & National Networks
5/24 Great Minster House
76 Marsham Street
London
SW1P 4DR

Dear Mike

Periodic review 2008 - likely affordability of your high level output specification

1. We have now reached a stage in our appraisal of the industry's strategic business plan where we can give you an initial view on the likely affordability of your high level output specification given the public funds that you are making available for the railway sector in the next control period.

2. **I am pleased to be able to tell you that we consider there is a high likelihood that your output specification can be accommodated within the funds you have committed to the railways for the period 2009-14.**

3. Our view is based on a number of important assumptions that I summarise below. We are happy to take your staff through our work to date and explain in more detail these assumptions.

4. Of course our review work on the strategic business plan continues and the situation could change. We will update you if our further work changes materially the position set out in this letter. As you know, we will not come to a firm conclusion on these issues until our draft determination, currently planned for early June next year. Despite the reassurance you can take from our initial work you might find it prudent to develop a contingency plan. This would involve you identifying what are the lowest priority outputs in your specification and/or any scope for increasing the funding from the public purse, so that if the affordability situation deteriorates you are in a position to respond quickly to our formal notice.

Our approach to this initial assessment

5. At this stage of our review of the strategic business plan we have calculated high and low estimates that we believe will encompass the most likely costs of maintaining and operating the railway and delivering the improvements set out in your high level output specification. We have translated these into a possible revenue requirement range for Network Rail. We have taken your estimates of the costs you are likely to incur in supporting the franchised train operators.

6. We have paid particular attention to the high estimates so that there is a very low likelihood that our draft determinations in June will be above these estimates.

Our appraisal of the strategic business plan

7. We have now carried out our initial assessment of all the information provided by Network Rail in the strategic business plan, including the detailed supporting information. The plan is a clear and substantial improvement on the earlier initial strategic business plan Network Rail submitted to us in June 2006. The plan, together with the update of parts of it we will require from Network Rail in early April, will provide us with an adequate basis for our determinations next year. That said, from our preliminary work, we consider the current plan significantly overstates the revenue Network Rail will require in the next control period.

8. Our focus at this stage is on what Network Rail needs to do to deliver its component of your output specification. The main differences between Network Rail's view and our high estimate are:

- reduced **maintenance and renewals** work and associated expenditure where we consider it is not required to deliver the specification,
- greater **efficiency savings** on operating, maintenance and renewals expenditure,
- removal of **enhancements** not required to deliver the output specification, offset in part by some higher costs on some of the specific projects where a prudent view suggests that risks are higher than in the plan proposed by Network Rail, and an allowance for depot costs,
- a lower level of **amortisation** based on assumptions on the efficient level of long run renewals,

- a lower **return on the regulatory asset base** reflecting the lower assumed expenditure on renewals and enhancements.

9. For our low estimate we have assumed, compared to our high estimates, lower expenditure needs and higher scope for efficiency savings. These in turn lead to lower amortisation charges which together with a lower net investment but a higher rate of return produce lower overall returns on the regulatory asset base.

10. We have assumed that **all capital investment is added to the regulatory asset base** and remunerated through amortisation charges and the return on the asset base year by year. This follows standard regulatory practice and is what Network Rail assumed in the strategic business plan. We note that you had assumed that part of the enhancement capital investments would be funded on what is often called a 'pay as you go' basis (that is a pound of capital investment is funded by a pound of income in the same year). You will be aware that this difference in assumptions does have a material effect on the revenue requirements.

11. As I noted at the beginning we have taken account of your estimates of the costs you are likely to incur in supporting the franchised train operators. These include a range for lease charges based on the rolling stock numbers that you and Network Rail have supplied us with together with a range for depot costs.

12. Overall, with our high estimates, we consider the reasonable upper limit for Network Rail's revenue requirement to deliver your output specification for 2009-14 is £22.8bn. Our low estimates and associated financial assumptions are some £3bn less. These numbers compare with the £24.6bn estimate in the strategic business plan.[1] Against your public funding commitments of £13.3bn our range is £10.2bn to £13.5bn. [2]

Likely affordability of your high level output specification

13. Based on our work to date and using the assumptions I have summarised above, at the high estimates the public funds available are not quite adequate for the control period. However the deficit is relatively small and we believe there is a low likelihood that our conclusions will be at the high end of the range. We have identified that there could be surpluses and deficits for individual years. Since the annual deficits are relatively small we believe it is appropriate to assume that your output specification can still be secured either

---

[1] The definition of revenue requirement used corresponds with the one you used in preparing your SoFA. Specifically it excluded other income received from third parties e.g. property income

[2] All these figures are in 2006-07 prices

through some re-phasing of activities within period or short term financing wholly within Network Rail's control.

14. There are no affordability issues with our low estimates. However our low estimates are both very challenging and have not provided for a number of what could be very worthwhile initiatives identified by the industry and Network Rail. Part of our work in the next few months will be to test these initiatives more thoroughly to see if some of them are economically justified and affordable and could be included in our regulatory requirements for the next control period.

15. I am copying this letter to Iain Coucher at Network Rail, George Muir at the Association of Train Operating Companies, Graham Smith at the Rail Freight Operators Association and Ola Solaja at HM Treasury. I am also placing a copy on our website so that all interested parties are kept informed as we pass this important milestone on our periodic review.

Yours sincerely

Bill Emery

Bill Emery