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29 September 2006

**TO ALL MANAGING DIRECTORS OF TRAIN OPERATING
COMPANIES AND FREIGHT OPERATING COMPANIES**

Network Rail Initial Strategic Business Plan 2009-14: Issues and Options

1. I am writing to you to encourage your involvement in developing plans for the rail industry during the next regulatory Control Period CP4 (expected to run from 1 April 2009 to 31 March 2014) and to seek your views on some key issues which arise from consideration of Network Rail's Initial Strategic Business Plan (ISBP)¹.
2. In July 2006 Network Rail published its ISBP for CP4 and beyond. We are now reviewing it in detail and we will publish our assessment in February 2007.
3. The 2008 Periodic Review (PR08) will set Network Rail access charges and outputs for CP4. Under the new processes introduced by the 2005 Railways Act it will be for the Secretary of State and Scottish Ministers to decide on their high-level output specifications (HLOSs) and make statements of the funds available (SoFAs). These will apply to the publicly sponsored railway as a whole, taking infrastructure and train services together. They are likely to be published in July 2007. DfT and Transport Scotland are working with Network Rail, train operators and other industry stakeholders to inform this.
4. We are committed to facilitating this by providing advice to inform these decisions. We therefore need an understanding of the whole industry costs and benefits of alternative strategies.
5. We also need to look beyond the HLOSs and SoFAs to the strategic business plan which Network Rail must produce in October 2007. We strongly encourage you and other interested parties to engage directly with Network Rail as it refines and amends its plan over the next twelve months. This plan, and the route strategies in particular,

¹ Network Rail's ISBP is available on Network Rail's website at <http://www.networkrail.co.uk>.

need to contribute to meeting the needs of users and funders in ways which are efficient and effective from a whole-industry perspective. This is not something that Network Rail can be expected to achieve alone. It is seeking input from a wide range of stakeholders, which should enable the October 2007 strategic business plan to command a considerable degree of industry-wide support.

6. To inform our advice to ministers and to help us set out the requirements for Network Rail's October 2007 strategic business plan we are now seeking your views on a number of aspects of the ISBP, set out in the note attached to this letter.
7. To expand on some of these issues and to gain an early insight into your and other interested parties' perspectives we are holding a rail industry seminar on 11 October 2006. I will be chairing the seminar and Iain Coucher will be presenting key elements of the ISBP and providing an update on the subsequent work.
8. Please can you send your views on the issues we have raised in electronic format (or if not possible, in hard-copy format) by Friday 22 December 2006 to:

Sylvia Ford
Office of Rail Regulation
1, Kemble Street
London WC2B 4AN
Tel: 020 7282 2070
Email: Sylvia.Ford@orr.gsi.gov.uk

9. You should indicate clearly if you wish all or part of your response to remain confidential to ORR. Otherwise we would expect to make it available in our library and on our website and potentially to quote from it. Where your response is made in confidence please can you provide a statement summarising it, excluding the confidential information, that can be treated as a non-confidential response. We may also publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.
10. We are copying this letter to other interested parties who may wish to send us their views. A copy of this letter will also be sent to John Armitt at Network Rail.
11. Copies of this letter can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely



Bill Emery

Chief Executive

Network Rail Initial Strategic Business Plan: Issues and Options

Background

1. Network Rail's ISBP contains two distinct scenarios:
 - (a) A 'Baseline' intended to illustrate the future activities and funding required to deliver a non-degrading railway infrastructure. This scenario includes only committed enhancements, and goes no further than that in tackling issues raised by changes in demand and the economic environment.
 - (b) A 'Base Case' that presents Network Rail's preferred approach to developing the network in the light of projected growth in passenger numbers and freight volumes, as well as the requirements of Government where these are already understood.
2. Network Rail will submit shortly an additional scenario illustrating the impact of undertaking further targeted investment that it considers might be appropriate to address specific areas of safety risk, delivering benefits on a whole-industry or wider basis going beyond the requirements of existing legislation. ORR, with the Rail Safety and Standards Board, has itself developed a number of such options and is asking Network Rail also to consider these.
3. The ISBP is an initial plan. A great deal of good work has gone into its production, including developing the first version of a comprehensive Infrastructure Cost Model which adds clarity and detail to the planning process. But Network Rail is aware that there is a substantial amount of work to be done to ensure that the October 2007 submission is complete and robust.
4. We are now engaged in detailed evaluation of the ISBP. Issues we are examining with Network Rail include:
 - (a) the need for Network Rail to demonstrate that the engineering policies underlying the scenarios represent an efficient approach to asset management and that alternatives – including radical alternatives where appropriate – have been explored;
 - (b) the robustness of the relationships between activity and outputs (e.g. asset condition measures and performance) and between traffic levels and cost causation, and the scope for trade-offs between expenditure on maintenance and renewal;
 - (c) the need for Network Rail to substantiate its estimates of the achievable level of future cost efficiencies;
 - (d) the need to improve the robustness of cost disaggregation, with particular emphasis on identification of planned expenditure and income for Scotland separately from that for England and Wales, and identification of the incremental costs incurred by freight operations;

- (e) whether there is a sustainable lower-cost option than represented by the Baseline (during CP4 this delivers further improvements in overall asset condition including a 10% reduction in broken rails and track defects and 23% reduction in points, track circuit and signalling failures);
 - (f) since key decisions have still to be taken about the future of the European Railway Train Management System (ERTMS) programme, what impact would these decisions have on the level and nature of CP4 signalling renewals? and
 - (g) whether any of the expenditure included in the scenarios for CP4 represents deferred activity that will already have been funded during CP3.
5. This note considers the key issues under three headings: growth and how it is addressed, issues related to asset management and issues related to the efficient delivery of outputs. Appendix A contains a summary of the financial information for the two scenarios and comparisons with our earlier December 2005 initial assessment and the CP3 determination.

Growth and how it is addressed

6. Network Rail has made projections for rail demand (both passenger and freight). The Base Case shows forecast growth of 2.7% pa in passenger miles, and 0.8% per annum in passenger train miles (this would lead to higher average load factors unless train lengths are increased). This would represent a slower rate of demand growth than has been seen over the last five years. Freight growth in the Base Case is forecast to be 1.9% per annum (tonne-miles), also slightly below recent trends.
7. The Baseline scenario has lower projections reflecting Network Rail's assessment of how capacity constraints would serve to limit growth. Network Rail has suggested that no material increase in passenger train miles or freight train tonne-miles could be accommodated after the end of CP3 in this scenario.
8. Enhancement projects in the Baseline only include those that are committed and amount to approximately £1 billion over CP4³. Enhancements included in the Base Case reflect Network Rail's view of the best way to meet growth and amount to £8 billion over CP4. A number of projects in the Base Case are at an early stage of development and include a substantial provision for contingency. Base Case projects do not include the introduction of ERTMS (except for development work), CrossRail or any new high-speed line.
9. We would welcome your views on the following questions:
- (a) Is there scope to deliver more from the existing network, for both passenger and freight customers, than shown in the Baseline plan - for example through radical approaches to demand management, capacity management and timetabling?**

³ For some enhancement projects in the Baseline (mainly relating to the West Coast Route Modernisation) DfT has yet to confirm the scope as being appropriate for this plan.

- (b) Do you have views on the unconstrained passenger and freight forecasts used by Network Rail in the Base Case? What do you consider are the main sources of uncertainty?
- (c) Do you think that the growth in average load factors implied in the Base Case can be accommodated without increased overcrowding? What would be the main pressure points?
- (d) Do you support the proposed enhancement projects in the Base Case? Would there be other more cost effective ways of delivering the increases in capacity?
- (e) We will be challenging Network Rail on the assumptions they have used on enhancement costs. **We would also welcome your views on whether the estimated costs of the enhancement projects are reasonable and on ways in which they might be reduced.**

Asset management

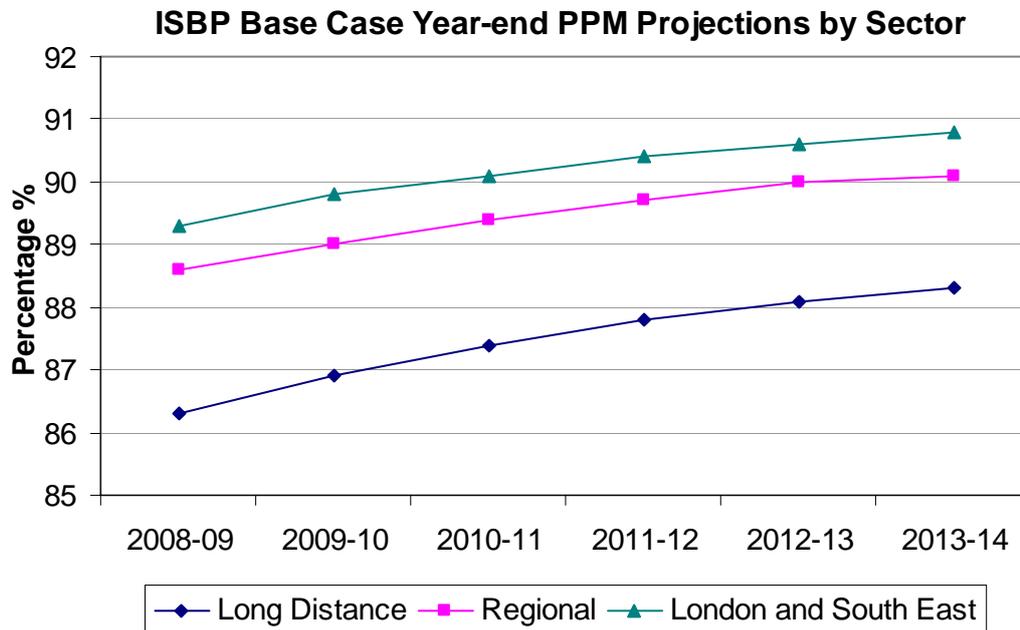
10. The ISBP and the supporting documents provide information on Network Rail's approach to asset management. This is one of the main issues we are discussing with Network Rail. We would welcome your views on the following questions:
 - (a) Do you think that Network Rail's asset management policies and the way they are applied deliver an optimal whole-industry outcome? Are there any different ways of managing their assets that could yield significant improvements in outputs or efficiency? In particular, are there any radical changes that should be considered?
 - (b) Network Rail is still developing its strategy for maintaining, renewing and developing stations, the objectives for which are set out in the ISBP. **How do you think this strategy should be developed in order to provide an appropriate and efficient balance between affordability and the requirements of passengers and station facility owners?**
 - (c) We also consider that PR08 should take the opportunity to identify and assess opportunities for step changes in safety that, whilst going beyond what Network Rail and operators are legally required to deliver, might merit investment when wider industry and public benefits are considered. **We have undertaken work to identify such changes, but would also welcome your suggestions.**
11. The degree to which there is inevitable loss of network availability for engineering work must be quantified, reduced through greater efficiency in the use of possessions, and optimised on a whole-industry basis. This work is the responsibility of the industry possessions review, which is due to report by the end of 2006. The results must inform Network Rail's October 2007 strategic business plan.

Efficiency of delivery and outputs

12. We are inclined to believe that better outputs – both of capacity and performance - should be deliverable for lower costs than shown in the ISBP and we are exploring this with Network Rail.
13. In the Access Charges Review 2003 (ACR2003) Network Rail was targeted to achieve a 31% efficiency improvement in the current control period (equivalent to on average 6.2% per annum). At present it is ahead of target to deliver this.
14. In the ISBP Network Rail assumes that it will achieve the 31% efficiency target in CP3. Its general CP4 efficiency assumption averages 3.8% per annum, but this falls to less than 3% per annum when their view of projected input price inflation is taken into account. They also assume lower figures for certain cost types. These assumptions are towards the bottom of the 2-8% per annum range identified by our consultants in their December 2005 report⁴ and used by us in our December 2005 initial assessment.
15. Network Rail has started a programme of work on efficiency that is intended to provide robust information on the scope for efficiency improvements in CP4. For example it will benchmark itself with international railways and with other organisations such as Metronet and Tubelines, and other utilities for civil engineering work. We are engaging closely with Network Rail on this and are monitoring progress to ensure that results will be available to support the conclusions of PR08. We will also carry out top down benchmarking. All of this work is at an early stage.
16. Our incentives consultation published in July 2006⁵ contained a number of ideas for increasing the incentives on Network Rail to become more efficient. The efficiency assumptions in future plans should be consistent with the assumptions on incentives.
17. Network Rail is responsible for procuring and delivering power supplies for electric train services (“EC4T”) and is reimbursed by train operators through specific EC4T charges. With rapidly increasing electricity costs, and the growing importance of energy efficiency as an environmental issue, it is important that Network Rail work with its industry partners to achieve maximum efficiency in procuring and supplying electricity.
18. Network Rail has not yet been able to provide performance projections for the Baseline. This is because the projected high levels of crowding on some services could be expected to affect performance in ways which are not, as yet, easy to quantify. Network Rail is to provide us with further information on this issue over the next few weeks.
19. Base Case performance projections show a modest improvement from 87.4% (as at period 6, 2006/7) to 90.4% (in 2013/4). Forecasts for individual sets of services are shown in the table below:

⁴ *Assessing Network Rail's Scope for Efficiency gains over CP4 and beyond: a preliminary study – LEK International Ltd and Oxera Consulting Ltd – December 2005.* Note that this work did not take into account the impact of real input price changes.

⁵ *Periodic review 2008, Enhancing incentives for continuous improvements in performance, a consultation paper*, Office of Rail Regulation, London, July 2006. This can be accessed on our website at <http://www.rail-reg.gov.uk/upload/pdf/298.pdf>



20. We would welcome your views on the following questions:

- (a) **Do you think that the efficiency assumptions made by Network Rail are appropriate given the efficiencies Network Rail has achieved already in CP3 and the efficiencies comparable organisations have achieved? What specific opportunities do you think there are for significant efficiency improvements that are not included in the ISBP?**
- (b) **What options should Network Rail explore in relation to improving efficiency in energy usage and in particular minimising the costs of traction electricity e.g. by use of regenerative braking?**
- (c) **Performance as measured by PPM⁶ has improved by 2.[3]% over the past twelve months to 87.4%. In the Base Case PPM improves by 3.0% between now and March 2014. Do you think this projection is reasonable? What additional steps would Network Rail need to take to deliver higher Base Case performance?**

⁶ The Public Performance measure.

Background Financial Information

The tables below show the net revenue requirement and total expenditure included in the two scenarios, and compares them to our December 2005 initial assessment and the Access Charges Review 2003 assumptions⁷.

Table 1: Total expenditure (£m)

	CP4 five-year totals (2005-06 prices)				
	ISBP Baseline	ISBP Base Case	Dec 05 low	Dec 05 high	ACR 2003
Total expenditure (five-year totals)					
Maintenance costs	4.6	4.6	3.7	4.4	5.7
Controllable OPEX	3.7	3.7	3.1	3.8	4.5
Non-controllable OPEX	2.0	2.0	1.3	1.3	1.2
Schedule 4 and 8 costs	0.5	0.6	0.5	0.5	0.5
Renewals costs	10.2	10.5	7.2	10.5	13.0
Enhancements	1.0	7.9	0.7	0.8	2.3
Total expenditure	22.0	29.3	16.5	21.3	27.2

Table 2: Net revenue requirement (£m)

	CP4 five-year totals (2005-06 prices)				
	ISBP Baseline	ISBP Base Case	Dec 05 low	Dec 05 high	ACR 2003
Net revenue requirement (five-year totals)					
Maintenance costs	4.6	4.6	3.7	4.4	5.7
Controllable OPEX	3.7	3.7	3.1	3.8	4.5
Non-controllable OPEX	2.0	2.0	1.3	1.3	1.2
Schedule 4 and 8 costs	0.5	0.6	0.5	0.5	0.5
Amortisation	7.9	8.8	5.1	8.2	7.5
Allowed Return	7.2	8.1	7.3	5.8	7.7
'Other' income	(3.5)	(3.5)	(3.5)	(3.6)	(3.8)
Net revenue requirement	22.4	24.3	17.5	20.4	23.3

Note: To aid comparability the ACR2003 numbers in this table have been adjusted for the December 2005 signalling review but not for the March 2004 revenue deferral: Access Charges Review 2003: Regulator's approval of Network Rail's proposed financing arrangements.

⁷ The previous access charges review covering 2004/05 to 2008/09 (CP3). The December 2005 initial assessment made no provision for traffic growth during CP4