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Steve Russell,
Chairman of Remuneration Committee
Network Rail
Kings Place
90 York Way
London N1 9AG

Dear Steve

Executive directors' remuneration and the Management Incentive Plan

1. I am writing, further to our recent meeting and the discussions we and our teams have had over the last few weeks, in respect of your executive directors' remuneration and the Management Incentive Plan (MIP).
2. We recognise the need for Network Rail to review the MIP and put in place appropriate remuneration arrangements for your executive directors in the light of the adjournment of your members meeting earlier this year which would have voted on the MIP that you had developed last year. We recognise and support the need for Network Rail to establish remuneration packages for its executive directors to ensure it can attract, retain and reward high calibre talent, to ensure that the users and funders of the railway get real value for money for the substantial amounts money committed to the company.
3. I said in my letter to you of 5 December 2011 that it is for Network Rail's board and its Remuneration Committee to decide on the remuneration of the company's executive directors and staff. Our role is to ensure that Network Rail operates with the framework established by the licence.
4. As you know, Condition 16 of Network Rail's licence sets out the company's obligations in relation to a MIP covering the remuneration of its executive directors. The condition sets out a number of principles which the MIP must meet, including the objectives we established in March 2011. The arrangements you are intending to put in place now, even if, as you see them, they are only 'stop-gap' measures for the remainder of CP4 pending



development of a full, new MIP for CP5, need to be considered under Condition 16. We therefore need to be satisfied that your current proposals comply with all the requirements of the licence.

5. Over the last few weeks, through the various meetings and letters you have sent us you have outlined the changes you propose to make (subject to engagement with your members and the vote at your AGM on 11 July) to the executive remuneration arrangements.

6. In terms of the proposals we do not yet consider that what we have seen from you so far complies with your licence obligations, including our objectives. Though I recognise that there are other documents that you plan to send us, the point of my writing now is to explain what we consider you need to do to meet these obligations, so that you have a chance to consider these ahead of your AGM. For the avoidance of doubt, I will also comment where we consider your proposals are compliant.

Increase executive director base pay

7. You propose to increase executive directors' base pay by 3%. You will need to be able to demonstrate the value for money of these proposals taking account of the recent shift in the executive remuneration landscape and against the background of the public sector financial environment. You will be aware of recent debate around executive remuneration at TfL, HS2 and Crossrail and there will inevitably be read-across which you will need to bear in mind.

Revised Annual Incentive Plan (AIP)

8. You propose significant changes to this, both in terms of the 'hurdles' approach and in the specific 'performance measures'. From the information you have provided to us it is not yet clear how the revised AIP will work: we need to see more detail on how the taper approach works (e.g. minimum/trigger/maximum points for each performance measure). Notwithstanding this, it is not clear to us why you have decided to change the approach developed last year based on the hurdle approach – which we accepted as being compliant with our objectives. It is very important that it is clear that the AIP will reward success and that success reflects proven, long term sustainable delivery against your CP4 targets and trajectories (recognising that progress year-to-year is not necessarily a linear path). Before we could say that the revised approach is compliant we would need to see

more information on the AIP design and for you to explain clearly and comprehensively how it complies with our objectives.

Defer old LTIP scheme payments until the end of CP4

9. This is a straightforward and sensible approach given the importance of the FVA calculation and our role in approving the number at the end of CP4. We would like to reiterate the point we made in our discussions last year that we would expect any LTIP payments to reflect levels of FVA created as a result of management effort.

Replace the GainShare Plan with a revised LTIP

10. We consider your proposals are compliant with our objectives, subject to the level of the FVA trigger being appropriate and, as such, ensuring that the revised LTIP strongly incentivises significant outperformance of our PR08 efficiency assumptions. We expect this revised LTIP to still be based on the 'two pots' approach to defining FVA. We look forward to discussing the FVA trigger point with you as soon as possible.

Retain the retention bonuses

11. Whilst we would prefer to see clearer arrangements for base pay and bonuses we can understand the logic for the retention payments. You will need to set out how you consider your proposals comply with our objectives. As discussed, we are keen that their payment should be linked to performance, and your members will need to be consulted.

Member and funder engagement

12. It is of critical importance that you follow a full and open process of consultation with your members and all your principal funders (including DfT and Transport Scotland). We accept that this process will be staged, but urge you to set out for us as soon as possible how you plan to conduct it. Key element in the success of any such process will be your value for money case, which we would again urge you to share with us as soon as possible. Only by bringing your stakeholders with you – informally as well as formally – will you secure full acceptance of and support for your proposals.

13. As you know, we are holding our annual meeting with your members on 27 June. As part of that meeting we will update them on our work on the MIP.

MIP statement

14. You have said you will send us further information that we need:

- (a) setting out how you believe your proposals comply with our objectives;
- (b) the full (potential) remuneration implications for each of the executive directors;
- (c) how the level of any award would be decided on;
- (d) the vfm case for the package; and
- (e) the process Network Rail intends to follow in discussing and agreeing the proposed package with their members.

15. We understand that you do not intend to update the MIP statement. As you know, under Condition 16.4 and 16.8 you are required to provide us with a MIP. We recognise that the various information that you have and intend to provide to us constitutes the MIP and, provided what you give us is complete and meets the requirements set out above, we are content to accept it in that form for the purposes of your licence obligation. However, you are also obliged to send us and publish a MIP statement that fulfils the requirements of Condition 16.7. We consider that having all the relevant information in one place will be helpful to your members and funders and other interested parties and should help your case for achieving agreement by them without any confusion. We therefore take the view that you should publish an updated MIP statement to satisfy your licence obligations

16. I am copying this letter to Steve Gooding and Nick Bisson at DfT, David Middleton at Transport Scotland. As flagged by Cathryn Ross to Richard Doyle, I am also copying this letter to your members, and will draw on it in our discussion with them on MIP at our forthcoming meeting. I am also publishing it on our website.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'R Price', is located below the 'Yours sincerely' text.

RICHARD PRICE
Chief Executive