



OFFICE *of*  
RAIL REGULATION

**ORR's approach to regulation in Scotland:  
Conclusions**

**December 2005**



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# Executive Summary

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1. In July 2004, the Department for Transport (DfT) published The Future of Rail White Paper. A major change introduced by this White Paper is the transfer of responsibility for rail strategy and funding in Scotland to Scottish Ministers.
2. The implementation of the White Paper and the subsequent Railways Act 2005 (the 2005 Act) require a number of significant changes to the way that we regulate the railways both in Scotland and in Great Britain as a whole. In particular, the Act requires us to have regard to any general guidance given to us by Scottish Ministers about railways services in Scotland.
3. In addition, the Secretary of State for Transport and Scottish Ministers will now provide us with separate high-level output specifications (HLOSs) and a statement of the public funds available (SOFAs) for the delivery of those outputs in England & Wales and Scotland respectively. In practice, this means that at future access charge reviews we will establish Network Rail's outputs and corresponding revenue requirement separately for Scotland and for England & Wales. In addition, a number of further modifications to the regulatory framework will be necessary in the light of the new arrangements.

## Changes to the regulatory framework

4. In June this year, we consulted on the changes that would be required to the framework that we employ for regulating Network Rail, in order to facilitate the new approach set out in the White Paper and the 2005 Act. Following this consultation process, our conclusions in this document confirm our approach to:
  - regulating the railways in Scotland, focusing, in particular, on how we will conduct future access charges reviews and how we will work with Scottish Ministers to secure their reasonable requirements for the railway in Scotland;
  - introducing a greater level of transparency and accountability to the price control arrangements for the remainder of control period 3 (CP3) which runs from April 2004 until March 2009. This will ensure a greater level of

monitoring and enforceability of outputs for England & Wales and Scotland separately;

- further separating Network Rail's price control in the future under the risk-bearing arrangements that will be developed and put in place from CP4 (which will run from April 2009 until March 2014) onwards. Under risk-bearing, the funding requirements for the Scottish Executive and the DfT will be based entirely on Network Rail's performance within Scotland and England & Wales respectively; and
- disaggregating Network Rail's regulatory asset base (RAB). In future, Network Rail's regulatory accounts will report separately on adjustments and accruals to the element of the RAB allocated to Scotland and the element of the RAB allocated to England & Wales.

# 1. Introduction

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## Context

- 1.1 In July 2004, the Department for Transport (DfT) published The Future of Rail White Paper<sup>1</sup>. A major change introduced by this White Paper, is the transfer of responsibility for rail strategy and funding in Scotland to Scottish Ministers.
- 1.2 Although the details are different, there will also be increased roles for the National Assembly for Wales, Transport for London and the English PTEs. There has now been legislation, in the form of the Railways Act 2005 (the 2005 Act), to provide the basis for implementing those changes which required legislation.
- 1.3 In June 2005, we published a consultation document<sup>2</sup> setting out our proposed approach to implementing the changes required to key aspects of the regulatory framework in response to these new arrangements. It considered the proposals set out in the White Paper in the context of all the various bodies to which power is being devolved. Progress in developing the proposals has been most advanced in relation to devolving new powers to Scottish Ministers and this document, therefore, focuses on the issues only in relation to Scotland.

## Purpose of this document

- 1.4 The purpose of this document is to:
- set out our overall philosophy and approach to regulation in Scotland in the light of the new arrangements introduced by the White Paper and the 2005 Act;
  - confirm the arrangements for working with Scottish Ministers and the Scottish Executive in the future; and

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<sup>1</sup> The Future of Rail, Cm 6233, Department for Transport, July 2004.

<sup>2</sup> Disaggregating Network Rail's expenditure and revenue allowance and the future price control framework: a consultation, Office of Rail Regulation, June 2005. <http://www.rail-reg.gov.uk/upload/pdf/238.pdf>.

- confirm our position on the economic issues related to devolution. These were discussed in detail in our June consultation document and include:
  - our proposed approach to introducing greater transparency and accountability to the price control arrangements for the remainder of control period 3 (CP3); and
  - the further separation of Network Rail's price control under the risk-bearing arrangements proposed for CP4.

## Structure of this document

1.5 This document is structured as follows.

- Chapter 2 sets out an overview of how the 2005 Act will influence the way we regulate the railways in Scotland, focusing, in particular, on how we will conduct future access charges reviews and how we will work with Scottish Ministers to secure their reasonable requirements for the railway in Scotland.
- Chapter 3 confirms our approach to introducing a greater level of transparency and accountability to the price control arrangements for the remainder of CP3. This chapter also outlines broadly how the framework will be developed further, in the future, to ensure that the price control structure properly meets the requirements of customers and funders of the railway from CP4 onwards.
- Annex A lists the respondents to the June consultation document.
- Annex B confirms our approach to disaggregating Network Rail's expenditure and revenue requirement separately for Scotland and England & Wales for the remainder of CP3. This includes our approach to separating Network Rail's regulatory asset base (RAB).
- Annex C sets out details of the disaggregated outputs which Network Rail will be required to deliver in Scotland and England & Wales over the remainder of CP3.



## Responding to this document

- 1.6 Although this publication is not a consultation document, comments on the content are welcome and can be sent to or discussed with:

Robert Toal  
Senior Economist  
Office of Rail Regulation  
1 Waterhouse Square  
138-142 Holborn  
London EC1N 2TQ

E-mail: [robert.toal@orr.gsi.gov.uk](mailto:robert.toal@orr.gsi.gov.uk)

Tel: 020 7282 2055



## 2. Approach to regulation in Scotland

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### Background

2.1 Under the provisions of the 2005 Act, Scottish Ministers will from April 2006 both specify and fund the railway outputs they wish to be delivered in Scotland. This change will have important implications for the way that we regulate Network Rail both in Scotland and in the rest of Great Britain. To that extent, we have previously outlined how the new arrangements for devolution will impact on economic regulation including in:

- (a) our September 2004 consultation document *Implementing The Future of Rail: ORR's Role and Proposed Work Programme*<sup>3</sup>, which discussed the initial proposals and highlighted the importance of clarifying the relationships between devolved funders and other stakeholders;
- (b) our April 2005 *Corporate Strategy*<sup>4</sup>, which explained how we will facilitate the new developments by working with the Secretary of State and the Scottish Ministers;
- (c) our June 2005 consultation *Disaggregating Network Rail's expenditure and revenue allowance and the future price control framework*<sup>5</sup>, which set out the principles that we intend to adopt, focusing in particular on the economic issues around how Network Rail's price control may be separated in the future; and
- (d) our August 2005 *Periodic review 2008 – first consultation document*<sup>6</sup> which sets out the context for the next review and its proposed objectives, as well as outlining our role in relation to the high level

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<sup>3</sup> *Implementing The Future of Rail: ORR's Role and Proposed Work Programme*, Office of Rail Regulation, September 2004, available at: <http://www.rail-reg.gov.uk/upload/pdf/211.pdf>.

<sup>4</sup> *Corporate Strategy*, Office of Rail Regulation, April 2005, available at: <http://www.rail-reg.gov.uk/upload/pdf/233.pdf>.

<sup>5</sup> *Disaggregating Network Rail's expenditure and revenue allowance and the future price control framework: a consultation*, Office of Rail Regulation, June 2005 available at: <http://www.rail-reg.gov.uk/upload/pdf/238.pdf>.

<sup>6</sup> *Periodic Review 2008 – first consultation document*, Office of Rail Regulation, August 2005, available at: <http://www.rail-reg.gov.uk/upload/pdf/245.pdf>.

output specifications that will be produced by the DfT and the Scottish Executive.

- 2.2 The next section of this chapter builds on the issues discussed in these documents and confirms our overall philosophy and approach to regulation in the light of the new arrangements. In addition to highlighting the differences in approach to regulation in Scotland brought about by the 2005 Act, this chapter also clarifies the aspects of regulation that are not expected to change under the new legislative framework.

## **Our overall philosophy and approach**

### *Section 4 duties*

- 2.3 We carry out our functions in the light of the public interest duties set out in section 4 of the Railways Act 1993 (as amended). This now includes explicit reference to the role of Scottish Ministers, in particular that we must have regard to any general guidance given to us by the Scottish Ministers about railway services wholly or partly in Scotland, or about other matters in Scotland that relate to railways.
- 2.4 In having regard to such guidance we are required to give appropriate weight to the extent to which the guidance relates to matters in respect of which expenditure is to be or has been incurred by Scottish Ministers. An important principle of the new arrangements is that Scottish Ministers will, in the future, have an equivalent role in Scotland to that of the Secretary of State in England and Wales in the conduct of access charges reviews.

### *Setting Network Rail's outputs and revenue requirement*

- 2.5 A primary focus of our activities will be setting Network Rail's outputs and corresponding revenue requirement, at an access charges review, in the light of the statement of what Scottish Ministers want to be delivered by the railway and their statement of funds available. We have already started work on the next review, which will amend access charges from 1 April 2009. Our August consultation document (see footnote 6 above) was the first in a series of planned ORR consultation documents, which will ensure that the Periodic Review 2008 (PR2008) is conducted in a rigorous, open and consultative manner.

- 2.6 We have subsequently published a further document setting out our initial assessment of a possible range for Network Rail's CP4 revenue requirement<sup>7</sup>. This initial assessment provides a basis for the next stages of PR2008 and includes separate breakdowns of the possible revenue requirements for Scotland and England & Wales. We have also begun discussions with the Scottish Executive about the development of the Scottish HLOS for the next control period.
- 2.7 The overall approach to undertaking reviews of access charges will continue to be based upon the standard building block methodology used at the Access Charges Review 2003 (ACR2003). In future, Scottish Ministers will have the option of specifying and funding a higher (or lower) level of outputs in Scotland, which we will then be required to price and include in the calculation of Network Rail's revenue requirement for Scotland.
- 2.8 From the start of the next control period (i.e. April 2009) a key principle underpinning the price control framework is that the funding requirements for the Scottish Executive and the DfT and will be based entirely on Network Rail's financial performance within Scotland and England & Wales respectively. This means that any out-performance in either area will be ring-fenced and used solely for the benefit of customers and funders in that area. Similarly, customers and funders in each area will separately bear the cost and output risks associated with under-performance by Network Rail.
- 2.9 We would expect Network Rail to take reasonable steps to ensure that it can deliver the outputs required in Scotland and in England & Wales. However, if there were conflicts (e.g. because of shortage of specialist resources), we would expect Network Rail to prioritise resources based on the best GB-wide public-interest outcome.
- 2.10 We are currently developing the regulatory framework to facilitate these changes, which form part of our wider review of the regulatory framework for the PR2008. Our conclusions are explained in more detail in Chapter 3 of this document.

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<sup>7</sup> *Periodic Review 2008 Initial assessment of Network Rail's CP4 revenue requirement and consultation on the financial framework* December 2005, Office of Rail Regulation, available at: <http://www.rail-reg.gov.uk/upload/pdf/264.pdf>

## Other ORR responsibilities

- 2.11 Although our responsibilities with respect to undertaking access charge reviews will change as we will be undertaking separate access charges reviews for Scotland and England & Wales, it is also important to recognise that the GB railway is an integrated network (e.g. in terms of timetabling, standards and operation) and the regulatory regime operates at the GB wide level. Our jurisdiction and key elements of industry relationships will also remain at the GB level.
- 2.12 In practice, this means that while some aspects of regulation will change in the light of the devolution of powers to Scottish Ministers, other functions that we carry out will remain unchanged. The impact on the key areas of regulation is discussed below.

### *Licensing*

- 2.13 Under the Railways Act 1993 (as amended) and the Railway (Licensing of Railway Undertakings) Regulations 2005, the operators of trains, stations, networks and light maintenance depots must be authorised by an appropriate licence or exemption. Although licences are not normally limited to a particular geographic area, some changes to their detailed wording will be required to reflect, for example, the Scottish Ministers' new role as a franchising authority. The 2005 Act provides a mechanism for these changes to be made. Otherwise, our licensing responsibilities will not be directly affected by the new arrangements.

### *The access regime*

- 2.14 Under the Railways Act 1993 (as amended), we are responsible for determining the fair and efficient allocation of the capacity of railway facilities (track, stations and light maintenance depots). We will continue to apply common criteria and procedures for the exercise of our functions in relation to the access regime. Updated editions of our *Criteria and Procedures* documents for the approval of passenger<sup>8</sup> and freight<sup>9</sup> track access contracts,

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<sup>8</sup> *Criteria and Procedures for the approval of passenger track access contracts: fourth edition* – a consultation document, ORR, November 2005, available at: <http://www.rail-reg.gov.uk/server/show/nav.00100b002001005001>.

<sup>9</sup> *Criteria and Procedures for the approval of freight track access contracts: third edition* – a consultation document, ORR, November 2005, available at: <http://www.rail-reg.gov.uk/upload/pdf/258.pdf>.

on which we are currently consulting the industry, recognise the devolved responsibilities for rail in Scotland.

### *The Network Code*

- 2.15 This common set of contractual provisions is contained in every track access agreement<sup>10</sup> and will continue to be applicable to train operators operating in or to Scotland. This ensures that common processes for issues such as timetable change, management of disruption or vehicle and network change will continue to be managed at a total industry level, retaining consistency of application for key processes.
- 2.16 The Network Code is currently under review, and in our conclusions on the reform of the Network Code, published in November 2005<sup>11</sup>, we have concluded that considerable benefits can be gained by the industry in allowing certain classes of funders (including the Scottish Executive) and suppliers, specific rights to be consulted and involved in discussions about vehicle and network changes to ensure that their long-term interests are protected. We have, therefore, proposed that third parties should have access to general facilitation agreements.

### *Safety*

- 2.17 The *Future of Rail* White Paper announced the Government's intention to give us responsibility for both safety and economic regulation of railways in Great Britain as a whole. From early 2006, we will take on responsibility for health and safety in relation to the full range of railway operators including metro systems, heritage railways and trams. We will develop new ways of working and review and revise existing practices in order to comply with the legislation and meet the policy objectives of the White Paper.

### *Competition Act powers*

- 2.18 ORR is the competent competition authority, concurrently with the Office of Fair Trading (OFT), with the responsibility for investigating and examining possible breaches of the prohibitions contained in the Competition Act in

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<sup>10</sup> Except for certain pre-privatisation contracts such as the arrangements for Heathrow Express and London Underground.

<sup>11</sup> Network Code reform phase 2: update and emerging conclusions; available at: <http://www.rail-reg.gov.uk/upload/pdf/262.pdf>.

relation to the supply of services relating to railways. We will continue to apply these powers in Scotland as we have done on a GB-wide basis.

### *Investment policy*

- 2.19 Our policy framework<sup>12</sup> to facilitate investment sets out clearly what Network Rail should do to facilitate and deliver investment, terms (including principles for risk allocation) for carrying out investments, and specific proposals in relation to investments sponsored by third parties (i.e. bodies other than the DfT/Scottish Executive and Network Rail, such as regional and local authorities, train operators and private developers).
- 2.20 The policy framework is designed to apply to all investments in the network in Great Britain, including Scotland. However, we recognise that for specific categories of scheme (such as minor schemes promoted by Network Rail through the Network Rail Discretionary Fund (NRDF)) the Scottish Executive may wish to put in place arrangements differing from those established by the DfT. There are also some investment schemes which will continue to be sponsored by the DfT on a GB-wide basis e.g. the ERTMS.

## **Our relationship with the Scottish Executive and Scottish Ministers**

- 2.21 As a result of the changes introduced by the White Paper and by the 2005 Act, we have been reviewing our working relationship with the Scottish Executive<sup>13</sup>. We have considered carefully how we can build upon and develop our current working arrangements. The objective is to ensure that the respective roles and responsibilities are well defined and understood so that we can work together to secure the reasonable requirements of funders and customers of the railway in Scotland, as well as the rest of Great Britain.
- 2.22 Following the merger of ORR and HSE Rail, which is expected to take place during 2006, we will have staff and offices in Scotland. We will appoint a member of staff based in Scotland to fulfil a wider representational role for ORR including acting as a focal point for key stakeholders and advising on

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<sup>12</sup> More details on the investment framework can be found in our October 2005 publication Policy Framework for Investment: conclusions; available at <http://www.rail-reg.gov.uk/upload/pdf/255.pdf>.

<sup>13</sup> Following the announcement of the proposals in the White Paper, a working group (the Scotland Working Group) was established comprising the DfT, the Scottish Executive, ORR and Network Rail to coordinate and implement the new arrangements for Scotland.



emerging issues in Scotland. One of our Directors will have specific responsibility for relationships with stakeholders in Scotland.

- 2.23 In addition, we have established an internal working group, drawing on staff from a variety of disciplines throughout the office to co-ordinate policy development and delivery on Scottish issues. We will also establish regular high-level liaison arrangements with the Scottish Executive and with other key stakeholders, which will include participation from our Chairman and Chief Executive. Likewise, our Heads of the Railway Inspectorate and Safety Policy will establish a regular liaison with counterparts at the Scottish Executive supported by more frequent working level meetings as appropriate. These arrangements will ensure that we keep our Board informed of key policy issues in Scotland, and that we are able to respond appropriately to emerging issues on rail regulation as it affects Scotland.



## **3. Network Rail's price control framework**

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### **Introduction**

- 3.1 Network Rail's current price control framework was established at ACR2003 on a GB-wide basis. This means that the assumptions we made about the expenditure that the company would need to incur to operate, maintain and renew the network were determined at the GB-level and were not ring-fenced to any geographical area. Similarly, the outputs determined at ACR2003 were generally set at the GB level (although network capability is to be maintained at a route level).
- 3.2 Currently, our monitoring of Network Rail is focused at the GB level although some information is collected and monitored at various levels of geographical disaggregation. In our June consultation document, we explained that it would be necessary to make modifications to the price control framework to ensure that the structure was fit for purpose in the light of the devolution proposals.
- 3.3 The first part of this chapter sets out our conclusions on how the price control framework should be modified for the remainder of the current control period. The second part of the chapter explains how the framework will be developed further for CP4.

### **Disaggregating Network Rail's revenue requirement**

- 3.4 Under the new devolution arrangements, the Scottish Executive will take on responsibility for funding infrastructure in Scotland from 1 April 2006, with funding responsibility in England and Wales being retained by the DfT. This means that a proportion of Network Rail's income will, from that date, be funded directly by the Scottish Executive.
- 3.5 Our June consultation document explained that we would disaggregate Network Rail's revenue requirement for the remainder of CP3, including the RAB, to form separate assumptions on expenditure and revenue for Scotland and England & Wales. This is necessary in order to establish what portion of Network Rail's funding should be provided directly by the Scottish Executive and what portion should continue to be paid by the DfT.

- 3.6 The approach we proposed in our June document followed the standard building block methodology that we employed in the ACR2003. This involved:
- identifying the proportions of expenditure on operations, maintenance, renewals and enhancements in Scotland and England & Wales based on the projections set out in Network Rail's business plan;
  - establishing rules for the allocation of an appropriate share of Network Rail's central costs;
  - disaggregating the RAB between Scotland and England & Wales;
  - calculating an allowance for amortisation of the RAB and the return on the RAB for each region, based on the rules established at the ACR2003;
  - identifying the income that Network Rail is expected to earn through the single till (including access charges, station income and freight) in each area; and
  - combining the results of each step above to determine disaggregated expenditure assumptions and revenue requirements for Scotland and England & Wales.
- 3.7 Respondents to the consultation were broadly supportive of our proposed methodology. Annex B of this document sets out details of the final disaggregated revenue requirements for Scotland and England & Wales.

### **Disaggregating Network Rail's outputs**

- 3.8 In return for the revenue that it receives, Network Rail is required to deliver a given set of outputs. Chapter 9 of the ACR2003 final conclusions document<sup>14</sup> sets out details of the GB-wide baseline outputs (including train delay minutes, limits on the number of broken rails and track geometry) that Network Rail is expected to deliver during the current control period. In the June consultation document, we confirmed that in the interests of transparency and accountability, as well as disaggregating the company's revenue requirement, we would also disaggregate the GB-wide baseline

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<sup>14</sup> *Access Charges Review 2003: Final Conclusions*, Office of Rail Regulation, December 2003, <http://www.rail-reg.gov.uk/upload/pdf/184.pdf>.

outputs to form separate outputs for Scotland and England & Wales for the remainder of CP3.

- 3.9 We commissioned Halcrow to determine an appropriate methodology for separating the GB-wide outputs. Halcrow's report<sup>15</sup> sets out in detail the approach they took to disaggregating the outputs.
- 3.10 In undertaking this work, Halcrow considered a number of factors including:
- the relative size of the network in Scotland compared to England & Wales;
  - the intensity of use in each area;
  - the relative proportions of expenditure planned in each area as set out in Network Rail's Business Plan 2005;
  - Network Rail's current and historic relative performance in each area; and
  - the relative proportions of assets or traffic.
- 3.11 Halcrow's work was discussed in detail and the final output agreed with the members of the Scotland Working Group. The results of Halcrow's work in terms of these disaggregated outputs are set out in Annex C to this document.

#### *Enforcement of outputs in CP3*

- 3.12 In terms of how the disaggregated outputs would be enforced, the June consultation document explained that the existing regulatory mechanisms should provide sufficient flexibility to allow us to monitor and enforce the new arrangements for the remainder of CP3. In particular, Condition 7 of Network Rail's Network Licence requires (inter alia) the company to:

"secure -

- (a) the operation and maintenance of the network;
- (b) the renewal and replacement of the network; and
- (c) the improvement, enhancement and development of the network

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<sup>15</sup> Halcrow's report to the ORR for this work has been published on our website at: <http://www.rail-reg.gov.uk/upload/pdf/halcrow-disaggregating-nr-baseline.pdf>.

in each case in accordance with best practice and in a timely, efficient and economical manner so as to satisfy the reasonable requirements of persons providing services relating to railways and funders in respect of:

- (i) the quality and capability of the network; and
- (ii) the facilitation of railway service performance in respect of services for the carriage of passengers and goods by railway operating on the network.

#### *General duty*

The licence holder shall take such steps as are necessary or expedient so as to achieve the purpose to the greatest extent reasonably practicable having regard to all relevant circumstances including the ability of the licence holder to finance its licensed activities.”

- 3.13 We have considered carefully how this provision affects the enforceability of Network Rail's outputs in Scotland and in England & Wales. We have also taken in to account the responses to the June consultation which are summarised below.

#### *Views of respondents*

- 3.14 In its response, the Scottish Executive sought assurance that the disaggregated outputs for Scotland would be supported by an enforcement regime which is as rigorous and as effective as the existing arrangements which apply to GB as a whole. Likewise, the DfT said that it would expect the England & Wales outputs to be reasonable requirements of Network Rail under Condition 7 of its Network Licence, and enforceable under the same framework as the GB outputs set by the ACR 2003.
- 3.15 Network Rail said that the disaggregated outputs should be 'indicative' in nature and incorporate appropriate tolerances. In Network Rail's view, output measures are subject to statistical variability caused by random fluctuation and the accuracy of data measurement. Network Rail also suggested that we should revisit the issue of tolerances and at the same time consider the impact of statistical volatility at the Scotland and England & Wales levels.
- 3.16 Other respondents did not comment specifically on the issue of the enforceability of outputs.

### *ORR position*

- 3.17 As a matter of policy, we have stated in our enforcement policy statement (which was published in November<sup>16</sup>) that we will focus on using regulatory powers to resolve systemic issues that cannot be dealt with effectively in contractual relationships. Although we did not set tolerances around outputs in the ACR2003, we recognise that performance against some outputs may fluctuate and that there may be some statistical variation. We will consider this when reviewing individual cases.
- 3.18 In monitoring and enforcing compliance with Network Rail's Network Licence, we shall examine Network Rail's efficient operation, maintenance, renewal and development of the network, and review whether it is meeting the reasonable requirements of its customers and funders under Condition 7. We consider that reasonable requirements include the disaggregated outputs established through the Halcrow work and set out in Annex C to this document. In the event that Network Rail is failing to deliver an output which we determine is a reasonable requirement, we will consider whether, in the circumstances of the case, Network Rail is fulfilling the general duty.

### *Local output commitments*

- 3.19 As well as the regulatory outputs specified by us at access charge reviews, Network Rail also works to contractual targets with each train operating company (TOC) through the local output commitments (LOC) regime. Therefore, Network Rail has a separate LOC target for its contribution to First ScotRail performance.
- 3.20 In contrast, the disaggregated outputs established through the Halcrow work apply to Scotland as a whole and, therefore, the performance targets include the impact of cross-border services and freight traffic. The disaggregated outputs set out in Annex C for train performance are, therefore, complementary to the targets established under the LOC regime.

## **Monitoring in CP3**

- 3.21 Under the new arrangements, it will be necessary to monitor Network Rail's outputs and expenditure in Scotland and England & Wales separately

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<sup>16</sup> Enforcement policy and penalties statement – draft for consultation, November 2005, ORR, available at: <http://www.rail-reg.gov.uk/upload/pdf/259.pdf>.

(alongside the GB level) for the remainder of CP3. This will provide additional information to determine Network Rail's compliance with Condition 7 of its Network Licence in respect of the disaggregated outputs. It will also help to inform the next periodic review process. To that extent, we are currently reviewing and making appropriate modifications to the monitoring framework during 2005-06. The key elements of the monitoring framework are listed below:

- *Network Rail's regulatory accounts* - we are currently working with the Scottish Executive, Network Rail and the DfT to ensure that the regulatory accounting guidelines reflect these new arrangements. In particular, we intend that from 2006-07 Network Rail will prepare fully audited regulatory accounts that will include segmented financial statements for Scotland and England & Wales, as well as at a GB level.
- *Network Rail's Annual Return*<sup>17</sup>: we have recently written to Network Rail to confirm that, in future, we would expect the Annual Return to include separate disaggregated information for Scotland and England & Wales.
- *Network Rail Monitor (Scotland)*: in August 2005, we published the first version of the Network Rail Monitor for Scotland<sup>18</sup>. This is a quarterly report on Network Rail's performance in Scotland, based on a range of financial and operational measures. We will continue to develop the Network Rail Monitor for Scotland and will, in future, also produce a separate Network Rail Monitor for England & Wales.
- *The Network Rail business plan*: this document sets out the company's proposed future activities, outputs and expenditure at a GB-wide level and on its 26 strategic routes. The plan also explains the organisational changes and initiatives that Network Rail is making in order to deliver its proposals. The 2006 Business Plan, which will be produced in March 2006, will include separate disaggregated information for Scotland and England & Wales.

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<sup>17</sup> Network Rail's 2005 Annual Return is available on the company's website at: <http://www.networkrail.co.uk/companyinformation/RegulatoryDocuments/Content/Documents/F-%20Regulatory%20Reports/2005%20annual%20return.pdf>.

<sup>18</sup> Available at: [http://www.rail-reg.gov.uk/upload/pdf/nr\\_monitor-q2-scot.pdf](http://www.rail-reg.gov.uk/upload/pdf/nr_monitor-q2-scot.pdf).



## Financial protections in CP3

3.22 Although we will monitor outputs and expenditure separately for the remainder of CP3, the June consultation document set out our view that all operational risk should continue to be dealt with at a GB-wide level for the remainder of CP3. In practice, this means that:

- the trigger for an interim review of Network Rail's outputs and/or revenue will remain at the GB-wide level (i.e. 15% of cumulative expenditure);
- Network Rail will deal with any revenue shortfalls or cost shocks through the ability to draw on its allowed surplus and financial buffer (e.g. to undertake additional borrowings up to the ceiling of its debt to RAB limit); and
- there will be no restrictions placed on Network Rail's flexibility to transfer operating surpluses between Scotland and England & Wales to offset operating deficits in the other area.

3.23 In their responses to the consultation Network Rail, the Scottish Executive and the DfT all supported the principle that risk should be dealt with at a GB-level for the remainder of CP3. The Scottish Executive also suggested that there should be ring-fencing of Network Rail's operating surpluses within Scotland during CP3. We are currently discussing with Network Rail its criteria for the use of out-performance in CP3 and will publish our final policy statement on the treatment of under-spend and efficiency in January 2006<sup>19</sup>.

## Separating Network Rail's price control framework for CP4

3.24 The June consultation document set out the issues that we will consider in introducing more formal price control separation from the start of CP4. In contrast to the arrangements that we are putting place for the remainder of CP3, the principle of devolution and separate HLOSs and funding means that a greater degree of ring-fencing will be necessary in the future.

3.25 In the June document, we characterised the issue of price control separation in CP4 as risk-sharing versus risk-bearing. It relates to the extent to which the DfT and the Scottish Executive would either share or separately bear the risk

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<sup>19</sup> Our initial consultation in to the treatment of under-spend and efficiency was published in June 2005, available at: <http://www.rail-reg.gov.uk/upload/pdf/237.pdf>.

of unanticipated cost shocks or revenue shortfalls, which result in increases in access charges or reductions in outputs (and therefore possibly funding) or share the benefits of out-performance.

### *Risk-sharing*

- 3.26 In summary, under a risk-sharing model, the risks and associated funding requirements imposed on the DfT and the Scottish Executive would continue to be based on Network Rail's GB-wide financial performance and not related to performance in each area separately. Network Rail would retain any out-performance in an area centrally so that surpluses in one area could be used to cover deficits in the other.
- 3.27 Similarly, under a risk-sharing approach any overspend in an area would be funded centrally by Network Rail (e.g. through its ability to borrow or to draw on operating surpluses). This would, therefore, only lead to an increase in the funding requirement in any area to the extent that it resulted in a legitimate increase in future operating, maintenance and renewal expenditure or had a material impact on Network Rail's GB-wide financial position, resulting in an increase in the company-wide allowed return.
- 3.28 Under the risk-sharing model, under-spend or overspend in either area would not be capped by separate interim review re-opener provisions. Rather, a GB-wide re-opener provision would be retained.

### *Risk-bearing*

- 3.29 In contrast, under a risk-bearing approach, the funding requirements imposed on the Scottish Executive and the DfT would be based on Network Rail's financial performance within Scotland and England & Wales separately. This means that any under-spend in either area would be retained by Network Rail in that area and be used solely for the benefit of customers and funders of the railway in that area.
- 3.30 Likewise, any overspend by Network Rail in either area may have to be funded by any reserves established for each area separately. Under risk-bearing, under-spend or overspend in either area by Network Rail would be capped by implementing separate interim review re-opener provisions in track access contracts to apply to expenditure within each area.

- 3.31 The June document discussed in detail the implications of different models of risk-bearing and risk-sharing and invited views from interested parties on which approach would provide the most appropriate price control framework for Network Rail in CP4.

*Views of respondents*

- 3.32 The Scottish Executive was clear in its response that it prefers a full risk-bearing approach so that from CP4 onwards, risks materialising within Scotland will be wholly managed and funded within Scotland. This would mean that, amongst other things, an interim review re-opener provision would be established at the Scotland level and should Network Rail's costs increase or decrease by more than this level in Scotland, both the Scottish Executive and Network Rail would be able to ask the ORR to undertake a review of access charges in Scotland.
- 3.33 The DfT has said that it also supports full ring-fencing of Network Rail's funds between Scotland and England & Wales. The DfT considers this approach to be consistent with the new arrangements for conducting access charges reviews established by the 2005 Act, including the preparation of separate HLOSs by the Secretary of State and Scottish Ministers. For this reason the DfT has said that a full risk-bearing approach is the appropriate basis.
- 3.34 In contrast, Network Rail has said that, at the highest level, its desire is to support the Scottish Executive and the DfT in their roles of specifying and funding outputs separately. However, it believes that the risk-bearing approach is unlikely to represent the best long-term interests of customers and funders as it considers it would reduce the company's ability to manage the delivery of outputs in the most efficient manner.
- 3.35 Moreover, Network Rail has said that ring-fencing of resources under a risk-bearing approach would mean that it would have less flexibility, and fewer resources to draw upon, to deal with shocks (e.g. asset or weather-related) that can have a big impact at a local level but are smoothed over a larger area.
- 3.36 Of the other respondents to the consultation, First Group expressed support for the risk-bearing model. TfL said that it is preferable for out-performance to be retained for use solely in a particular area and any underperformance absorbed within the relevant 'buffer' for each area. TfL also said that a

constrained model, blending elements of both options may have merit but that it would wish to see this supported by strict criteria for use of surpluses.

### **Proposed price control arrangements for CP4**

- 3.37 Having considered the issues carefully and having regard to the responses to the consultation document, our conclusion is that the risk-bearing approach is necessary in order to be consistent with the principles underlying devolution and the new arrangements for undertaking access charge reviews separately for Scotland and England & Wales.
- 3.38 Network Rail has implied that a risk-bearing approach may increase the cost of running of the network. However, this is difficult to quantify and if, indeed, the costs of a risk-bearing approach are ultimately higher these will be borne by the DfT and the Scottish Executive who have both stated their commitment to this approach. We will ensure through the regulatory framework that there is no additional cost risk to Network Rail from the separation of the price controls.
- 3.39 Under the risk-bearing model proposed for CP4, we will specify clearly the regulatory arrangements underpinning this approach. This means that in addition to the modifications to the monitoring framework described above, the financial protections in the price control framework would also be identified separately including:
- any provision to re-open the price control, in the event that Network Rail's expenditure departs significantly from the assumptions we make at the next periodic review, will be established separately for Scotland and England & Wales;
  - other financial protections which allow Network Rail to manage its risks (e.g. the surplus on the allowed return) may need to be determined separately; and
  - Network Rail will be restricted from transferring operating surpluses or deficits between Scotland and England & Wales.

### **Other aspects of price control separation**

- 3.40 As part of our preparations for PR2008 we will carry out the detailed work on the expenditure assessments, efficiency, activity volumes, outputs, and all

other aspects of the price control framework wholly separately for England & Wales and Scotland.

- 3.41 There will be separate determinations of track access charges, and each of the building blocks used to build up the company's revenue requirement will be dealt with separately. In future, additions and accruals to the Scottish RAB will be based on expenditure and amortisation incurred in Scotland.

### **Other changes to the price control framework through PR2008**

- 3.42 The precise details of the separate price control arrangements will be considered further as part of the PR2008 process. Our initial assessment of Network Rail's revenue requirement in CP4 provides a transparent basis for the next stages of the PR2008 including work on the development of HLOSs and the SOFAs that has recently started, involving the DfT, Scottish Executive, Network Rail and ORR.
- 3.43 As part of the PR2008 we will also be undertaking a fundamental review of the financial and incentive framework for Network Rail. Our December consultation document considers these issues in more detail, setting out our current thinking and options for the key financial building blocks. The financial framework that we determine for Network Rail as part of the PR2008 will form a key input in determining exactly how much revenue the company will be entitled to receive over the next control period in return for the outputs that it will be expected to deliver in Scotland, England & Wales and GB.
- 3.44 Our follow-up document to the consultation on the financial framework, which is likely to be published in the second half of 2006, will set out our emerging conclusions on the appropriate financial framework for Network Rail in CP4, including the impact it will have on the risk-bearing model discussed above.



## **Annex A: Respondents to the June consultation document**

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Angel Trains

Department for Transport (DfT)

First Group

Grant Thornton

Joint response from Merseytravel, Merseyrail Electrics 2002 Limited and Merseyrail Infraco Limited

Network Rail

Scottish Executive

Strathclyde Passenger Transport Executive

Transport for London (TfL)





# Annex B: Disaggregated revenue requirements for Scotland and England & Wales

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## Introduction

1. Under the new arrangements set out in *The Future of Rail* White Paper and the Railways Act 2005, the Scottish Executive will take on responsibility for funding infrastructure in Scotland from 1 April 2006, with funding responsibility in England and Wales being retained by the DfT. This means that a proportion of Network Rail's income will, from that date, be funded by the Scottish Executive, either directly through network grants or indirectly through access charges paid by franchised passenger train operating companies (TOCs) operating in Scotland.
2. In order to facilitate these arrangements, a provisional agreement was reached between the Secretary of State for Transport and Scottish Ministers on 18 January 2005 for a transfer of £302 million per annum for the funding of Network Rail in Scotland<sup>20</sup>. The provisional settlement was calculated using a RAB split which assumed that 10% of the Network Rail RAB applied to Scotland. DfT and the Scottish Executive agreed that all terms of the provisional settlement were to be fixed except for the RAB split, which would be subject to change following determination by us.
3. Our June consultation document set out details of our proposed approach to disaggregating Network Rail's revenue requirement, including the RAB, to form separate indicative determinations for Scotland and England & Wales. The approach we have adopted follows the standard building block methodology that we employed in the ACR2003.
4. Disaggregated revenue requirements for each region based on this approach were set out in Annex C of the June consultation document. Respondents to that document were broadly supportive of our proposed methodology.

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<sup>20</sup> Details of this can be found in a DfT press release at [http://www.dft.gov.uk/pns/displaypn.cgi?pn\\_id=2005\\_0003](http://www.dft.gov.uk/pns/displaypn.cgi?pn_id=2005_0003).

5. Network Rail proposed a number of minor amendments to the allocation metrics for common costs, which were set out in Annex A of the June document. We have considered carefully Network Rail's suggestions and conclude that they do not have a material impact on our proposed methodology to disaggregate the network revenue allowance. We will, therefore, retain those set out in the June document. Those were developed jointly with the Scotland Working Group and were used to underpin the funding transfer between the DfT and Scottish Executive.

## **Disaggregation of the RAB**

6. Chapter 3 of the June consultation document also discussed our proposed approach to disaggregating Network Rail's opening RAB (i.e. at 1 April 2006). The value of the RAB has a significant impact on the overall level of Network Rail's revenue requirement since it affects the allowed return and amortisation building blocks.
7. Our proposed methodology for disaggregating the RAB was a composite approach that considered the effects of both the underlying value of the assets and the level of use that these assets incur. In summary, the approach consisted of three main steps:
  - determining an appropriate measure for the relative proportions of asset values within Scotland and England & Wales;
  - determining the level of asset usage in Scotland and England & Wales; and
  - combining the asset value and usage in each area to determine an appropriate RAB split.
8. Using that methodology, we calculated that the appropriate proportion of the RAB to be allocated to Scotland is 11.17%.
9. All of the respondents to the June consultation were broadly supportive of our proposed methodology. Only TfL raised a detailed point around the metrics used in the approach. Specifically, TfL asked whether we had explored alternative methods for the calculation of asset usage. Our methodology was based on tonne km travelled, and TfL suggested that an alternative method

such as vehicle km may also be valid and could potentially have more merit in terms of networks primarily for passenger use.

10. However, we consider that vehicle km travelled does not adequately reflect the length and weight of trains and, therefore, tonne km travelled represents a more appropriate measure.
11. On the basis of the responses received on the RAB split, we have, therefore, written to the Scottish Executive, the DfT and Network Rail to confirm that the GB RAB will be disaggregated on the basis that 11.17%<sup>21</sup> of the GB total is allocated to Scotland, with the rest allocated to England & Wales<sup>22</sup>.
12. From April 2006 Network Rail's regulatory accounts will report separately on adjustments and accruals to the element of the RAB allocated to Scotland and the element of the RAB allocated to England & Wales. We are currently working with Network Rail, the Scottish Executive and the DfT to ensure that the regulatory accounting guidelines reflect the new arrangements.
13. The DfT and Scottish Executive have confirmed that they will use our split to finalise the funding transfer between the two organisations provisionally agreed in January 2005.

### **Confirmation of expenditure and revenue allowances**

14. Taking the disaggregated expenditure and revenue allowances for each region, together with the RAB split allows us to calculate an indicative revenue requirement separately for Scotland and England & Wales. Annex E of our final conclusions<sup>23</sup> to the ACR2003 sets out details of Network Rail's overall revenue requirement for GB as a whole for the duration of CP3. Annex E also

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<sup>21</sup> Under the funding settlement agreed between the Scottish Executive and the DfT, all of the ACR2003 funded enhancements are attributable to the 'England & Wales' RAB. This includes enhancement expenditure incurred in 2004-05 and 2005-06. Therefore, in practice, the opening RAB split for Scotland will be based on 11.17% of the GB RAB at April 2006 less enhancements expenditure in the first two years of the control period. This expenditure will be added to the England and Wales RAB.

<sup>22</sup> A copy of this letter has been published on the ORR website at: [http://www.rail-reg.gov.uk/upload/pdf/lett\\_rag\\_scot\\_ew.pdf](http://www.rail-reg.gov.uk/upload/pdf/lett_rag_scot_ew.pdf).

<sup>23</sup> Access Charges Review 2003: Final Conclusions, ORR, December 2003, <http://www.rail-reg.gov.uk/upload/pdf/184.pdf>.

sets out details of how this revenue requirement would be funded between access charges, grants and other single till income<sup>24</sup>.

15. We have replicated the Annex E style summary of Network Rail's revenue requirement at a disaggregated level for Scotland and England & Wales based on the principles set out above. The indicative disaggregated revenue requirements are set out below. The key update to this analysis since the June document is that the disaggregated revenue requirements now include enhancement expenditure, which was excluded from the earlier analysis.

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<sup>24</sup> The funding allocation set out in Annex E of the final conclusions was subsequently amended in the light of Network Rail's proposed financing arrangements. Details of the revised funding arrangements are set out in a document published by ORR in March 2004, Access Charges Review 2003: Regulator's Approval of Network Rail's Proposed Financing Arrangements, ORR, March 2004, <http://www.rail-reg.gov.uk/upload/pdf/188.pdf>.

**Table 1: Total Network Rail revenue requirement**

£ million (2004/05 prices)	2006-07	2007-08	2008-09	Total
<b><u>RAB</u></b>				
1 April RAB	23,210	24,341	25,425	
Renewals	2,279	2,294	2,077	
Enhancements	320	263	235	
Amortisation	-1,468	-1,474	-1,477	
31 March RAB	24,341	25,425	26,261	
Average RAB	23,775	24,883	25,843	
<b><u>Revenue requirement</u></b>				
Maintenance	1,096	1,009	928	3,033
Controllable opex	862	819	778	2,459
Non-controllable opex	231	232	232	695
Schedule 4 and 8 costs	97	98	98	293
Return on RAB	1,497	1,566	1,627	4,690
Amortisation	1,468	1,474	1,477	4,419
<b>Gross revenue requirement</b>	<b>5,251</b>	<b>5,198</b>	<b>5,140</b>	<b>15,589</b>
Other single till income	-750	-741	-749	-2,239
<b>Net revenue requirement</b>	<b>4,501</b>	<b>4,456</b>	<b>4,392</b>	<b>13,350</b>
Adjustment for additional borrowing	339	332	325	996
<b>Adjusted revenue requirement</b>	<b>4,841</b>	<b>4,788</b>	<b>4,716</b>	<b>14,345</b>
<i>Funded by:</i>				
Fixed charges	1,857	1,844	2,012	5,713
Variable charges	307	307	312	926
Schedule 4 and 8 income	97	98	98	293
Grants & other funding	2,580	2,539	2,294	7,414
	4,841	4,788	4,716	14,345

**Table 2: England and Wales indicative revenue requirement**

£ million (2004/05 prices)	2006-07	2007-08	2008-09	Total
<b><u>RAB</u></b>				
1 April RAB	20,778	21,839	22,858	
Renewals	2,052	2,075	1,879	
Enhancements	320	263	235	
Amortisation	-1,312	-1,319	-1,324	
31 March RAB	21,839	22,858	23,649	
Average RAB	21,309	22,349	23,254	
<b><u>Revenue requirement</u></b>				
Maintenance	996	915	842	2,752
Controllable opex	778	740	703	2,220
Non-controllable opex	208	209	210	628
Schedule 4 and 8 costs	88	89	89	267
Return on RAB	1,341	1,407	1,464	4,212
Amortisation	1,312	1,319	1,324	3,955
<b>Gross revenue requirement</b>	<b>4,723</b>	<b>4,679</b>	<b>4,631</b>	<b>14,034</b>
Other single till income	-694	-685	-692	-2,072
<b>Net revenue requirement</b>	<b>4,029</b>	<b>3,994</b>	<b>3,939</b>	<b>11,962</b>
Adjustment for additional borrowing	321	304	290	915
Adjusted revenue requirement	4,350	4,298	4,229	12,877
<i>Funded by:</i>				
Fixed charges	1,731	1,720	1,877	5,328
Variable charges	288	288	293	868
Schedule 4 and 8 income	88	89	89	267
Grants & other funding	2,242	2,201	1,970	6,414
	4,350	4,298	4,229	12,877

**Table 3: Scotland indicative revenue requirement**

£ million (2004/05 prices)	2006-07	2007-08	2008-09	Total
<b><u>RAB</u></b>				
1 April RAB	2,431	2,502	2,567	
Renewals	227	219	198	
Enhancements	0	0	0	
Amortisation	-156	-155	-153	
31 March RAB	2,502	2,567	2,612	
Average RAB	2,467	2,534	2,589	
<b><u>Revenue requirement</u></b>				
Maintenance	101	94	86	281
Controllable opex	84	79	75	239
Non-controllable opex	23	22	23	68
Schedule 4 and 8 costs	8	9	9	26
Return on RAB	155	160	163	478
Amortisation	156	155	153	464
<b>Gross revenue requirement</b>	<b>527</b>	<b>518</b>	<b>509</b>	<b>1,555</b>
Other single till income	-55	-56	-56	-167
<b>Net revenue requirement</b>	<b>472</b>	<b>463</b>	<b>453</b>	<b>1,388</b>
Adjustment for additional borrowing	19	28	35	81
Adjusted revenue requirement	491	490	487	1,469
<i>Funded by:</i>				
Fixed charges	125	124	135	385
Variable charges	19	19	19	58
Schedule 4 and 8 income	8	9	9	26
Grants & other funding	338	338	324	1,000
	491	490	487	1,468





## Annex C: Disaggregated Outputs

**Table 4: Disaggregated baseline outputs**

Baseline Output	2006/07		2007/08		2008/09	
	Scotland	England/ Wales	Scotland	England/ Wales	Scotland	England/ Wales
Train Delay Minutes (all operators) in millions of minutes	0.887	9.713	0.820	8.980	0.762	8.338
Passenger Train Delay Minutes per 100 train km	1.74	1.99	1.59	1.82	1.46	1.67
Broken Rails (M1)	30	270	30	270	30	270
Track Geometry Standard Deviations (M3)	See separate table below.					
Condition of Asset – Temporary Speed Restrictions (M4)	108	1091	108	1091	108	1091
Level 2 Exceedences (M5)	0.70	0.93	0.70	0.93	0.70	0.93
Earthwork Failures (M6)	10	37	10	37	10	37
Bridge Condition (M8)	2.0	2.0	2.0	2.0	2.0	2.0
Signalling Failures (M9)	2,948	25,150	2,948	25,150	2,948	25,150
Signalling Condition (M10)	2.5	2.5	2.5	2.5	2.5	2.5
AC Traction Power Incidents Causing Train Delays (M11)	10	97	10	97	10	97
Electrification Condition: AC Traction Feeder Stations and Track Sectioning Points (M13)	1.61	2.18	1.61	2.18	1.61	2.18
Electrification Condition: AC Traction Contact Systems (M15)	1.61	1.83	1.61	1.83	1.61	1.83
Station Condition Index (M17)	2.02	2.29	2.02	2.29	2.02	2.29
Light Maintenance Depot Condition Index (M19)	2.7	2.7	2.7	2.7	2.7	2.7

**Table 5: Disaggregated baseline outputs for track geometry standard deviation data (M3)**

Geometry parameter	35m Top (Vertical)			35m Alignment (Horizontal)			70m Top (Vertical)			70m Alignment (Horizontal)		
	50%	90%	100%	50%	90%	100%	50%	90%	100%	50%	90%	100%
GB target	62.4%	89.2%	97.0%	72.7%	92.9%	96.5%	63.6%	92.3%	95.3%	79.5%	95.8%	97.2%
Scotland target	69.8%	92.4%	97.9%	69.3%	92.9%	96.7%	67.1%	92.4%	95.2%	77.7%	95.8%	97.3%
E/W target	61.2%	88.7%	96.9%	73.2%	92.9%	96.5%	63.1%	92.3%	95.3%	79.8%	95.8%	97.2%