Department
for Transport

Will Godfrey,
Director of Economics, Finance and Markets

cc: Gordon Cole

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DEPUTY DIRECTOR, RAIL STRATEGY

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7 March 2023

Dear Will,

I would like to take the opportunity to thank the ORR for the work to date on the regulatory framework for CP7. In particular, the Department is grateful for the work on the Holding to Account framework (policy and technical consultation) which we believe will provide a strong basis from which to set the full regulatory framework.

I and my colleagues in the Department look forward to further engagement ahead of the determination stage of Periodic Review 2023. As we (Government, NR, ORR, the rail industry, customers and broader stakeholders across England and Wales) crystallise the thinking I am confident we can collectively offer a strong and effective regulatory framework that holds Network Rail to account across CP7 to deliver the obligations in the CP7 High Level Output Specification (HLOS), across all parts of its business. This will ensure NR provides a reliable service for the benefit of passengers and freight customers, and value for money for taxpayers.

In doing so, it will be important to continue to ensure appropriate flexibility to support the creation of Great British Railways, so that we achieve the maximum benefits from this transformational change.

<u>Overview of the Department for Transport's Response</u>
Subject to some points of detail set out below, I am broadly content to agree with the questions set in the ORR consultation (with the exception of the question set in paragraph 4.10, and as explained in paragraph 3 below).

As you are aware, the current (CP6) financial framework was designed ahead of CP6 and shortly after NR had become a fully public sector body. The rationale for the arrangements for CP6 therefore still applies, and the experience of CP6 has shown these arrangements to broadly appropriate and robust.

In the interests of certainty and stability my, and the Department's, strong preference is only to change either where necessary or there are clear benefits; or to apply lessons learned from CP6 to ensure a robust and transparent financial framework.
I have set out these points in more detail below.

I look forward to continued, excellent, constructive engagement on the Periodic Review and ensuring we can deliver effectively for passengers and taxpayers.

Yours sincerely,

[redacted]

Department for

Response to Financial Framework Consultation Cost of Capital, Debt

and Regulated Asset Base

1. As a consequence of bringing Network Rail into the public sector the importance of cost of capital, debt and the regulated asset base within the Periodic Review process is broadly limited to certain legacy arrangements; particularly where these relate to third parties. However, DfT strongly encourages ORR to ensure that work in this is undertaken in a strictly proportional way. DfT therefore broadly agrees with ORR's points on Cost of Capital and Debt (paragraph 1.5) and the Regulated Asset Base (paragraph 2.9) and (in response to the questions set in paragraphs 1.5 And 2.9) DfT agree to the associated proposals in sections 1 and 2.

Rebate, Network grant and Re-opener provisions

2. As ORR notes, the provisions described in sections 3, 4 and 5 are intended for more exceptional circumstances. Ensuring stability and certainty is of critical importance to support effective planning, help ensure delivery (including by the supply chain) and secure efficiency over the upcoming Control Period. DfT agrees with ORR that retaining current arrangements is a sensible and appropriate way forward.
3. Regarding the network grant and dilution provisions (section 4), DfT has two substantive points.
    - First, DfT was unclear as to the rationale for a change from grant to grant-in-aid. DfT would need sufficient justification and an understanding of what additional comfort NR would gain from this change compared to existing arrangements to support such a change.
    - Secondly, DfT agrees it is to the benefit of the whole industry for certainty to be provided ahead of the start of the control period and best endeavours must be made to ensure this is the case. Whilst DfT expect that it should be an absolute last resort, DfT agree that a "backstop" provision for ensuring continued funding of Network Rail across the Control Period boundaries has considerable merit. However, DfT has some concerns there is a risk that the current proposal may simply transfer the uncertainty from NR to TOCs. We would welcome the opportunity to test the proposal further and explore other options to ensure continuity of funding across the Control Period transition, particularly ensuring no undue burdens on train operators.

Risk Framework

4. The approach to risk for CP6 has been successful and resilient to a significant level of shocks so far in this control period (CP6). DfT is keen that the successes of risk management from CP6 are built on, and lessons learned as we move into CP7. While the broad principles of the CP6 risk framework carry-over, DfT recognises that the delivery environment is substantially different (in terms of context; the projects; and overall mix of projects to be delivered). As a consequence, the nature of the funding held as risk in CP7 may need to differ from that held as risk in CP6. DfT welcome

further discussion with ORR and NR on the details of the risk framework arrangements.

5. Although DfT is broadly satisfied that there was satisfactory discharge of the risk funding over CP6, DfT is keen to ensure greater transparency and independent scrutiny of the risk funding arrangements throughout the Control Period than that of CP6. In practice, this should mean stronger and more active governance from the regulator, ORR; and continued oversight from Government (DfT and HMT) of the NR risk fund, its deployment, and the overall level of risk that NR holds. We would welcome further engagement with the ORR and NR on this issue.

Financial Flexibility

6. DfT agrees with ORR's characterisation of the current Government budgetary process, as set out in section 7 of the consultation document.

7. DfT thinks it is useful to re-state that the objective of the financial flexibilities was to provide a robust mechanism to allow Network Rail to manage changes in circumstances (i.e. movements in opex, capex and income) during the five-year control period so that Network Rail could make effective and efficient asset management decisions to support delivery for passengers, freight customers and taxpayers.

8. This recognises that Network Rail resource expenditure and income can differ from control totals. For example, this can be due to changes in the income Network Rail receives from train operators (e.g. from changes in traffic) or from its retail estate at stations. Resource expenditure can differ as a result of bad weather that tends to occur towards the later stages of the financial year (i.e. in winter). Bad weather increases maintenance costs and can drive higher compensation payments to operators. These issues are difficult to plan for without leaving significant provisions within resource budgets that would be lost if unspent at year-end.

9. While our aim is to provide financial flexibilities with these objectives in mind, Government is not able to confirm the specifics of the flexibilities it is able to afford to Network Rail or the Department so far in advance of the Control Period. It is however reasonable to proceed with the assumption that similar objectives are likely to be sought from financial flexibilities for CP7; and that, in turn, similar financial flexibilities (to those of CP6) are likely to be employed in order to achieve those objectives.

10. DfT would expect GBR to inherit these flexibilities on day one for day-to-running of the railway. Any alteration to these flexibilities required for the operation of GBR would be agreed separately as part of the GBR and reform processes and stood-up as part of the GBR financial arrangements.

Performance Innovation Fund

11. The Department for Transport supports the continuation of a dedicated collaborative innovation fund, which addresses co-ordination issues. DfT recognises that there are difficult decisions to be made on funding levels. However, given collaborative

innovation can deliver benefits across the rail industry, as well as ensure value for money for taxpayers more broadly, we are therefore keen to see a specific fund of this type over the next control period – alongside broader Research, Development and Innovation activity. Indeed, we consider that such a fund could be a part of fulfilling the requirements set out in the HLOS to ensure "*Network Rail's plans [are] fully joined up and to form a coherent whole together with those of other parties in the sector, particularly the Rail Safety and Standards Board, to ensure an aligned approach which delivers the greatest possible benefits from the available resources. He also expects the plans to reflect broad engagement with academic and industry partners*."

12. DfT considers that any such fund should be managed with clear and transparent oversight (in collaboration with suitable partners with an expertise in relation to R&D, such the RSSB) and with clear and transparent objectives derived from the HLOS as set out above, for example:

    - Collaboration and broad engagement across the industry (including TOCs, RSSB and academia);
    - Cross system approaches;
    - Clear reporting, monitoring and evaluation to ensure innovation benefits are delivered;
    - Opportunities for integrating with other funding sources and strategies of other parties;
    - Securing commitment from industry partners;
    - Rolling out innovations to deliver efficiency and effectiveness gains over the life of the Control Period.

We welcome further engagement with NR, ORR and broader stakeholders on how we can ensure that we provide a framework to maximise the opportunities to bring the industry together to innovate and improve over the next control period to improve the passenger and freight customer experience and build skills, increase productivity and support innovation within the UK rail industry.

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London
E14 4QZ

[redacted]

23 February 2023

Sent via email to pr23@orr.gov.uk

Dear colleague,

PR23 – Consultation on the financial framework for CP7

Thank you for giving East West Railway Company (EWR) the opportunity to respond to questions posed by ORR in its PR23 Financial Framework for CP7 consultation.

About EWR

EWR is creating a new direct connection between Oxford and Cambridge, and beyond. Serving communities across the area, it will bring faster journey times and lower transport costs as well as easing pressure on local roads. It is an ambitious project that proposes bringing back into use a section of railway that was closed to passengers in the 1960s, refurbishing existing railway lines between Bletchley and Bedford, and building brand new railway infrastructure between Bedford and Cambridge. The first stage is to reopen the line between Bicester Gavray Junction and Bletchley. This is known as Connection Stage 1 (CS1), to provide two services per hour between Oxford and Milton Keynes Central calling at Oxford Parkway, Bicester Village, Winslow & Bletchley High Level stations. The train service is due to be introduced onto the network in July 2024 for testing, becoming established in the December 2024 timetable.

General observations about ORR's consultation

EWR considers that many of the issues covered by this consultation are somewhat specialist and technical in nature, pertaining to the detailed machinations of NR's regulatory framework. Therefore, EWR has only provided responses to a handful of ORR's questions. However, before responding to those specific questions we make the following observations.

NR provides the bulk of Great Britain's railway infrastructure. Passengers, communities and many businesses rely on it being well funded, safe and well managed. For example, rail freight operators businesses are wholly reliant on NR providing reliable provision of services across more or less the whole GB network.

Whilst the financial framework for CP7 may seem, at first sight, somewhat esoteric it is in fact a vital building block to a well-functioning railway. NR will face all sorts of financial risks during CP7 – most notably inflation and execution risk. Therefore, NR will need to have ways of managing risks that crystallise without passing these through to stakeholders through unduly reduced levels of performance or making unsustainable reductions in renewal spend.

ORR's questions

1.5 Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?

We do not have any comments relating to this question.

2.9 Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

We do not have any comments relating to this question.

3.6 Do you agree with our proposal to retain the current rebate mechanism for CP7?
We do not have any comments relating to this question.

4.10 Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

We do not have any comments relating to this question.

5.4 Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

Yes, although we do not consider that the re-opener provision should be relied upon as a way of dealing with anything other than extreme levels of risks materialising. We consider that the use of a re-opener for a control period would likely be extremely time consuming and distracting of all railway stakeholders if it were to be used. Therefore, we consider that it should be reserved for only the most extreme levels of outturn situations.

6.5 Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

There seem to us to be two main ways in which NR could manage risks that crystallise during CP7.

The first would be to explicitly provide NR, through the PR23 Financial Determination, with a significant financial risk buffer that could be ’drawn down’ if and when an adverse risk crystallises.

The second approach would be to allow NR to flex some of its PR23 outputs in the event that a risk crystallises. For example, reducing the spend on renewals during CP7.

If ORR (and DfT as NR’s principle funder) is unwilling (or unable) to provide NR with a significant financial risk-buffer for CP7, it seems to us that a pre-determined method of flexing NR’s CP7 outputs is the only other way in which NR could absorb adverse outcomes. We consider that it would be in all stakeholders interests to understand these financial trade-offs upfront through the PR23 Final Determination. Absent such an approach, we are concerned that outputs could be reduced in an ad hoc and potentially unsustainable manner during CP7. We also consider that such trade-offs should be possible in a mechanistic way (as determined up front by PR23) without the need for case-by-case approval from ORR. We consider that if ORR was required to opine in every such situation it would be likely to slow down the process and introduce too much bureaucracy and uncertainty for all stakeholders.

Therefore, we tend to agree with NR’s proposal for CP7. However, we think that NR’s proposal is not quite as described in ORR’s consultation. We believe that it is better described as ***- retaining a broadly similar approach in principle to CP7 as is in place for CP6, with some funding identified for asset management activities that would not be started, re-scoped or potentially stopped if risk arose (these could be called “contingent asset management activities”).***

7.16 Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

We do not have any comments relating to this question.

8.5 Do you have any views on the use of the performance innovation fund in CP6?

ORR's aims for the CP6 Performance Innovation Fund (PIF) were laudable. However, in practice the results delivered by it seem patchy. We, therefore, query the value for money of the CP6 spend through the PIF.

EWR considers that railway stakeholders should be able to work together, where appropriate, to deliver innovative solutions to joint issues without the need for a PIF type mechanism. We note that some progress has been made in this regard through performance overlays – for example between NR and Merseyrail and between NR and TfL.

8.6 Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

Given that NR's funding for CP7 seems likely to be highly constrained, we do not consider that a hypothecated PIF would be likely to deliver good value for money. Therefore, we do not consider that there should be a PIF in CP7.

8.7 Do you have any comments on how such a fund should be managed?

If ORR did conclude that there should be a PIF in CP7, we consider that NR would continue to be best placed to manage it, with oversight (where appropriate) from ORR.

Next Steps

EWR has been working closely with NR and ORR during PR23 on the topics covered by this consultation which we welcome. EWR would welcome the opportunity of discussing our feedback with ORR as part of this ongoing dialogue.

We are content for ORR to publish our response in full.

Yours sincerely,

[redacted]
Contracts Executive, East West Railway Company

Network Rail's response to ORR's consultation on the CP7 financial framework

24 February 2023

Executive summary

We welcome the opportunity to respond to the Office of Rail and Road's (ORR) consultation on the CP7 financial framework, published on 19 December 2022. Our views on each of the consultation questions are set out in this response, but we provide a summary of our key points here:

- We agree with ORR's proposal to maintain existing regulatory mechanisms such as RAB balances, rebate mechanisms and re-openers.
- We understand why ORR is seeking to incentivise Government to confirm network grant payments ahead of the final determination, but the proposed mechanism is likely to add additional administrative burden to the already tight timescales for the periodic review and so we would welcome further discussion about how early agreement of grant payments could be achieved without changes to track access contracts.
- Our proposed approach to managing financial risk and uncertainty in CP7 seeks to retain the benefits of our CP6 approach, whilst adapting it to reflect the funding constraints that we face. Our risk approaches for England & Wales and Scotland have some differences to reflect the funds available for CP7 from each of the respective governments.
- CP6 budgetary controls have been critical in allowing us to respond to changes in circumstances, which impact our inherently uncertain income and costs during the five-year control period. We continue to discuss with Government the budgetary controls that will be in place for CP7.
- Our England & Wales strategic business plan does not include a performance innovation fund (PIF), given funding constraints. However, aligned to Scottish Minister's high level outputs specification, we have included performance improvement funding in Scotland's Railway's plan.

Introduction

We recognise that ORR's consultation comes at a time of significant change and uncertainty for the rail industry, as is the case for the wider 2023 periodic review. The periodic review itself may be affected by industry reform and uncertainty of inflation forecast, future passenger demand and industrial relations issues, which may impact how ORR's conclusions are put into practice during CP7. The flexibility of ORR's overall regulatory frameworks, including the financial framework, will be of significant importance during the control period to react to the changes that may take place.

Following the publication of DfT's Plan for Rail, Government with the support of industry, including the Great British Railways Transition Team (GBRTT), is developing implementation plans that will bring track and train together under GBR, creating an integrated plan that incorporates CP7 infrastructure manager plans. ORR's consultation recognises that Network Rail's financial framework is expected to be absorbed into GBR during CP7 and will evolve.

We have discussed this response with GBRTT and they support the views set out here, but as discussions on the overall regulatory framework for GBRTT are ongoing, including the financial framework, this should not be considered GBRTT's formal response to proposals for regulation under rail reform.

We have set out our response to the questions you raised in your consultation document. We have aligned the structure of our response to the sections in the consultation document.

We note that you are not consulting on the length of control period, indexation approach and treatment of costs outside of the scope of PR23, such as historic debt and related financing costs.

1. Cost of capital and cost of debt

Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?

The assessment of the WACC is taking place at a time of significant volatility and uncertainty in financial markets. It is difficult to predict how markets will move over CP7, noting uncertainty over future interest rates, asset values, government expenditure and general price inflation.

Unlike other regulated infrastructure managers, the WACC does not drive a significant element of our funding requirement as we do not have a typical financial structure / economic regulatory model. But, the WACC is important for the reasons ORR notes in its consultation, particularly for calculating some facility charges that recover the cost of past works on the network for stakeholders, and for accounting valuation purposes.

We agree that ORR should draw on work done by UKRN's Cost of Capital Working Group, but note that each of the WACC determinations carried out by other regulators reflects the information available at the time. For example, we note the UKRN report that ORR provided as part of the consultation is from December 2020, which reflected a very different set of circumstances to the ones we face today. It also appears that the latest available WACC report on UKRN's website is dated July 2022, which pre-dates the recent economic events that have since seen increases in market rates, and therefore, would be expected to have a significant impact on cost of capital estimates.

As part of our SBP, we have developed our own analysis of the WACC for CP7, which draws on recent market data and forecasts of our own debt costs. We welcome a discussion with ORR on this analysis in advance of concluding on this issue.

2. Setting and updating regulatory asset base balances for CP7

Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

Since Network Rail's reclassification in 2014 and the change in our funding arrangements, so that we no longer borrow from the markets to finance capital investment, the RAB has limited practical importance to our financial framework. However, it is still relevant for our financial reporting, and was used in CP6 to price transactions such as the Core Valley Lines disposal in Wales. ORR's proposal to maintain the existing approach to calculating balances, therefore, appears reasonable.

3. Rebates

Do you agree with our proposal to retain the current rebate mechanism within track access contracts for franchised operators for CP7?

We think that rebates to Government should take place in exceptional circumstances, or where there is a very significant outperformance against our forecasts. Under current funding arrangements with Government, Network Rail can choose to draw down lower levels of grant funding than originally set out at the start of the control period, if funding is not required. Therefore, the likelihood of using the rebate mechanism in track access contracts to return funds to Government is very unlikely, given the additional administrative complexity that it would involve. However, retaining existing rebate provisions in track access contracts does not appear to raise any material issues as it does not preclude Network Rail returning funds to government through other channels.

The dynamics of rebates are likely to change significantly under GBR, as GBR-contracted train operators are not expected to have direct financial flows with Government. Therefore, fixed track access charges would not provide the same opportunity to return rebates to Government as they do currently.

4. Network grant arrangements and dilution provisions

Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

We agree that there are benefits of the existing track access provisions that provide a mechanism for Network Rail to receive agreed funding through access charges in the event that we do not receive network grant payments from Government during the control period. The existing mechanisms also ensure that CP6 grants are recognised within CP6, and that they are not expected to be deferred into CP7, which provides clarity to support the recognition of grant payments in our financial statements.

We also recognise the importance of creating certainty about funding available to Network Rail before the start of CP7, and we understand that ORR wants to create clear governance processes around the agreement of grant funding. This is because in PR18, grant funding was agreed late in the periodic review process, which caused issues with finalising access charges price lists for CP6.

ORR's proposal to include provisions in track access contracts in relation to network grants would provide clear incentives to conclude grant discussions in advance of the final determination. However, it is not clear that it would be possible to agree the schedule of grant payments before ORR has determined CP7 outputs and funding, as there could be knock-on impacts of ORR's decisions on the overall phasing of funding and also on the level of fixed track access charges.

The main concerns that we have with ORR's proposal are the administrative burden this approach could create, and how it could affect train operators that pay FTAC, but are not contracted by DfT or TS, such as TfL and Merseyrail. If no network grant was agreed before the start of CP7, charges to these operators would be significantly higher than CP6 and is likely to cause significant budgetary issues. Recognising these concerns, we would welcome further discussion with ORR about its proposals.

We also note that whilst network grants are a significant source of income for Network Rail, we also receive other grant funding from Government, such as for enhancements, financing costs, corporation tax costs and BT Police costs. Therefore, the certainty that the proposed track access contract provisions could provide would only relate to part (albeit a significant part) of the income that Network Rail would expect to receive during the next five years.

As with other proposals in ORR's consultation, the creation of GBR is likely to change the dynamics of these financial flows. This raises the question of whether the effort required to make the changes proposed by ORR would justify the benefits, particularly as in the future, GBR would look to resolve the problem itself because GBR-contracted train operators would no longer have direct financial flows from DfT.

5. Re-opener provisions

Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

Existing re-opener provisions in track access contracts provide the option to re-open the price control if there is a material change in circumstances for Great Britain, and also a specific re-opener for Scotland. The existing provisions provide some flexibility in the event that the circumstances we face during the control period are materially different from those assumed during PR23.

In reality, if we faced a significant increase in costs during CP7 (e.g. due to significantly higher inflation than forecast), we would discuss the implications with DfT, Transport Scotland and ORR as part of ongoing performance reporting. Changes to outputs and/or funding would most likely be agreed without changes to access charges, and therefore, without using the provisions in track access contracts.

However, retaining existing re-opener provisions in track access contracts would provide an additional channel to respond to changes in circumstances during CP7, without any obvious downsides. Therefore, we support ORR's proposal.

6. Management of financial risks

Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

ORR's consultation summarises our current CP6 approach to managing financial risk, and also identifies that the level of funding available in CP7 means that holding risk funding in our plans is more difficult. Our CP7 approach to managing financial risk seeks to retain as many of the benefits of the CP6 approach as possible, which includes: the flexibility provided by holding back funding in 'resource' budgets; the ability to set outputs on a risk adjusted basis (with P80 being adopted in CP6); and recognising that asset management plans will adapt as circumstances change through the control period.

We expect to face many of the same risks in CP7 as we did in CP6 with some expected to be more financially significant (e.g. inflation is expected to be a significant risk in CP7, given the high and volatile level of inflation we are currently experiencing) and some new risks (e.g. delivering workforce reform) and some not to re-occur (e.g. Covid costs and associated property income shortfall). The extent of risk that we will face in CP7 is difficult to quantify as we cannot foresee all the risks that will materialise in the control period. But risk exists irrespective of any risk management approach we take.

Network Rail's funding settlement is expected to be managed more holistically by GBR in due course but the approach set out, below, focuses solely on the risks facing Network Rail. We are continuing to keep in touch with GBRTT to understand the progress being made in its work with DfT to develop the overall GBR financial management framework.

Our SBP sets out how we plan to manage financial risk and uncertainty in CP7, which has been discussed with ORR, Government and GBRTT. Our approaches in England & Wales and Scotland have some differences to reflect the funds available for CP7 from each of the respective governments.

For England & Wales, our CP7 SoFA funding is broadly equivalent to CP6 levels. However, this funding is significantly lower than the funding we would need to maintain a steady state railway, and also includes funding for the programme to fit trains with digital signalling equipment, which accounts for up to £1bn of funding over CP7. Therefore, we are not in a position to hold back the same scale of funding from renewals as we have done in CP6 (c.£3bn). Instead, we plan to:

- Hold a provision outside of region and function budgets of £500m across the five years as a backstop for overall financial risk for England & Wales
- Identify c.5% of the value of each regions' plan that would be deferred or de-scoped if risk materialised in CP7 – this totals c.£1.5bn for the four England & Wales regions. This is different from CP6 where we held risk funding in regions that wasn't aligned to specific activity in the plan.
- Identify output forecasts consistent with our risk-adjusted plan (i.e. excluding the £2.0bn associated with risk. This is consistent with our CP6 approach. We will also identify our assessment of the impact on outputs, reflecting the uncertainty of precise forecasting, if risk does not materialise and we do not need the funding for risk.
- To provide flexibility within our CP7 budget to manage risk, and consistent with our CP6 approach, we will hold a proportion of funding that would otherwise be allocated to renewals as 'resource' budget (or RDEL).
- We will also separately identify the impact of higher than forecast inflation on our net costs (i.e. costs less income) to set out the scale of risk that we face in CP7. We will use this information to support discussions with Government about how we would manage a situation with materially higher inflation than assumed in the SoFA.

In Scotland, we plan to hold a provision in CP7 plans for risk, but given the timing of the Transport Scotland's HLOS and SoFA, we are continuing to work through the value of risk provisions we will hold for CP7. The holding position on risk funding will be set out in Scotland's Railway's interim SBP. Business planning activity ahead of the publication of Transport Scotland's SoFA developed a 'minimum viable product' for our SBP, and so a key difference from England & Wales is that Scotland's Railway has not identified any further activity in the plan that would be deferred or de-scoped if risk materialised. Scotland's Railway's CP7 outputs are based on a plan that assumes we will require the risk funding for risk that materialises in the control period.

Our risk approaches in England & Wales and Scotland aim to provide some ability to manage uncertainty during CP7, which will lead to changes in plans during the control period, as circumstances change and new information arises. We understand that ORR is planning to consult on its managing change policy for CP7 before the draft determination. As we set out in our September 2022 response to ORR's overall framework consultation, we understand that transparency of changes we make to our plans is important to enable ORR and Government to continue to monitor us effectively against an up-to-date view of funding and outcomes across regions and functions. We look forward to engaging with ORR further on this area of policy.

7. Governments' budgetary processes

Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

Government sets Network Rail's budget controls, rather than ORR. In its consultation document, ORR identified the controls that are in place for CP6 and explains that it expects these to stay broadly the same for CP7. We note that the flexibilities ORR describes have not all been available to Network Rail in CP6, such as the ability to roll forward 0.75 % of resource budgets into future years. The budgetary controls that we have in place for CP6 have been critical in allowing us to respond to changes in circumstances, which impact our inherently uncertain income and costs during the five-year control period. Current controls mean that we can make effective and efficient asset management decisions to support delivery for passengers and freight customers.

We continue to discuss with Government the budgetary controls that will be in place for CP7. However, our SBP has been developed on the basis that the budgetary controls in CP7 are at least as flexible as they are in CP6. For example, our CP7 efficiency forecasts are predicated on having continued flexibility to manage budgets effectively.

Removing existing flexibilities would lead to a reduction in financial and management flexibility that would constrain our asset management approaches in a way that would lead to less efficient and effective delivery. This flexibility is very important, particularly in our regional businesses, as restrictions would impact asset management decisions to replace or maintain, and to schedule work in the most efficient way.

Our experience of CP6 and understanding of how other DfT arm's length bodies manage their inherent workbank variability has led us to identify some potential improvements to the current financial controls, which we continue to discuss with Government (e.g. allowing us to accelerate both resource and capital budgets from future years).

8. Performance innovation fund

Do you have any views on the use of the performance innovation fund in CP6?

Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

Do you have any comments on how such a fund should be managed?

Getting passengers and freight where they need to be, on time, must continue to be a top priority for the whole rail industry. Both HLOSs for England & Wales and Scotland make clear the importance of delivering reliable services to passengers and freight users.

Our overall objective is to give passengers and freight users the highest level of train performance possible so we get them where they need to be, on time. But we face increasing challenges in CP7 from ageing assets, climate change and uncertain passenger demand. Because of these additional challenges, we have to make careful choices within the funding available. Our SBP reflects difficult decisions about where to prioritise funding to maximise its benefit.

The majority of the £45m funding from the Performance Innovation Fund in CP6 went towards schemes to improve autumn management (including improved sanding equipment on trains and new technologies such as cryogenic rail head treatment). However, we do not think that the PIF was successful in terms of quick and effective identification and deployment of funds for small train performance innovation initiatives. One of the key challenges has been the time it takes to agree multi-party contracts, which has led to longer lead times for delivering the benefits of schemes. We also think that ring-fencing funding for specific purposes, limits our ability to decide how best to use funding in the control period to maximise value.

Reflecting our CP6 experience, and the constrained level of funding we have available for CP7, our strategic business plan for England & Wales does not include a specific provision for the PIF. We have already made ORR aware that we currently do not intend to establish a network wide PIF for CP7. Our approach for CP7 does not preclude regions from self-funding identified innovation or alternative funding opportunities (e.g. using the 'First of a Kind' funding application process).

Scotland's Railway has included a funding provision in their plan for performance improvements, which reflects Scottish Government's High Level Outputs Specification.

We have also included £165m of research, development and innovation (RD&I) funding in our CP7 plan. Included in our RD&I pipeline for CP7 are schemes that focus on improving the passenger experience (including train performance), which will be delivered through regional innovation. We have also identified freight improvements that we plan to co-fund with RSSB.

The cross-industry framework we have in place to manage our RD&I portfolio has been developed directly with RSSB, to maximise the value of investment. By creating a joint framework we can create one clear railway response to the challenges we face. In doing this we have also gathered feedback from, and continue to engage with, railway industry bodies, groups such as RIA, operators and others to identify specific areas of interest that could further increase value for money through pooling or collaboration.

By attending the train operator innovation group, along with GBRTT, we have worked to identify a number of areas where there is the potential for collaboration to improve train performance beyond specific initiatives already in our plan, and to address multiple industry needs. For example, better accessibility will improve passenger experience, reduce dwell times and enable our station teams to be more flexible. We have also identified a requirement for improved camera usage on trains which have been proven to allow for more effective information transfer and decision making following major incidents that create a quicker route to return to service, for example, determining if an incident needs a police presence.

Such initiatives are good examples of how we can continue to work closely with industry on targeting performance improvements through the RD&I pipeline, to contribute to improving train performance over CP7 and beyond.

Office of Rail & Road
PR23 Team
Pr23@orr.gov.uk

(By email only)

[redacted]
Head of Access & Strategic

[redacted]

24th February 2023

Dear PR23 Team,

NTL response to PR23 – Consultation on the financial framework for CP7

Thank you for consulting Northern Trains Limited (NTL) on the financial framework for CP7 consultation. We have set out our response to cover the questions asked as part of the consultation as follows:

1. **Cost of capital and cost of debt**

Do you agree with our proposal to specify cost of capital and cost of debt values or Network Rail in CP7?

NTL agrees, however at a sensible rate to be agreed once calculation completed.

2. **Setting and updating regulatory asset base balances for CP7**

Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

NTL agrees with this proposal.

3. **Rebates**

Do you agree with our proposal to retain the current rebate mechanism for CP7?

NTL agrees with this proposal.

4. **<u>Network grant arrangements and dilution provisions</u>**

Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

NTL would prefer a signed network grant documentation from funder before the final determination, which would allow the FTACs to be set for the control period. If this is not achieved, NTL would need to see the impact on our FTACs and understand the position with the DfT on variance to cost target. As NTL shouldn't be required to find more efficiencies from within the business to pay for increases above forecasted costs levels. NTL would require consultation on any proposed changes to the Track Access contract as set out in the proposal.

5. **<u>Re-opener provisions</u>**

Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

NTL supports this proposal. However similar to section 4, any cost increases NTL would need to understand the position with the DfT on variances to cost target.

6. **<u>Management of financial risks</u>**

Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

No comment.

7. **<u>Governments' budgetary processes</u>**

Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

No comment.

8. Performance innovation fund

Do you have any views on the use of the performance innovation fund in CP6?

NTL believes the performance innovation fund (PIF) was a valuable industry asset that allowed for the developments of schemes that would not have had a chance of development under normal business operations. However, it has not been clear on how approved projects have been tested on their success and held to account for improving performance.

Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

NTL would support dedicated funding similar to the performance innovation fund.

Do you have any comments on how such a fund should be managed?

NTL believes the PIF was not utilised to its maximum due to time capability to support this work within the industry, plus the industry needs to improve processes for better capturing problem statements. There is a potential to be focused into the direction of engaging a few with a limited view of the whole system and its opportunities.

The industry would benefit from improved reporting of all PIF funded projects, which shows performance against plan and risks. The PIF projects should not be kept to organisations involved in testing the concept, but progress shared with the whole industry to allow others in the industry to take interest in what is possible and support the development work.

NTL suggests that the funding could be split into two. One to be used to more expeditious opportunities for a problem solution and the other for longer terms early-stage ideation and experimentation stages.

In the future, thought should be given to how none rail industry aligned suppliers could apply for funding to assist with problem statement resolution. This would truly bring innovation to the industry and has the potential to drive costs down.

Yours sincerely,

[redacted]
Head of Access & Strategic Partnerships

railpartners.co.uk

Registered in England and Wales
No. 13894712

Will Godfrey, Director of Economics, Finance & Markets
Office of Rail and Road
25 Cabot Square
London
E14 4QZ
28 February 2023

Dear Will

RE: ORR's PR23 consultation on the financial framework for CP7

Thank you for the opportunity to respond to the ORR's PR23 consultation on the financial framework for CP7. Please find Rail Partners' response to the questions below.

1. Cost of capital and cost of debt

ORR's proposal

ORR acknowledges that the estimate of NR's cost of capital and cost of debt does not have an impact on its revenue requirement given that the company is now cash funded by DfT for operations, maintenance and renewals and that the cost of historic debt is picked up directly by DfT. However, it is proposed to estimate NR's cost of capital for the following reasons:

- Calculating facility charges payable by third parties;
- Providing a benchmark discount rate/internal rate of return for internal projects (and other economic decisions) by Network Rail in CP7; and
- The cost of debt affects the Crossrail supplemental access charge income that Network Rail will receive in CP7.

Rail Partners' response

Rail Partners agrees, for the reasons ORR states, that it should estimate NR's cost of capital even though it doesn't directly affect NR's revenue requirement. We would expect ORR to consult on the methodology and assumptions it will use to calculate the cost of capital. We assume that ORR monitors that NR uses its cost of capital consistently for the purposes set out above.

2. Updating regulatory asset base balances for CP7

ORR's proposal

ORR acknowledges that updating the regulatory asset base (RAB) is not required as part of determining NR's revenue requirement for CP7. However, it is proposed that the RAB be updated for the following reasons:

- Provide a valuation of Network Rail's assets (for example, as used in CP6 for the divestment of the Core Valley Lines);
- Enhance understanding of the long-term financing of the network;
- Facilitate comparability with other regulated network businesses; and
- Support the valuation of assets for disposal or transfer purposes.

Rail Partners' response

Given that updating the RAB will have no impact on access charges, Rail Partners does not object to ORR undertaking this exercise. We do think that it is useful to keep updated in case of divestment of parts of the network such as the Core Valley Lines although it should be noted that the replacement cost of NR's assets is significantly in excess of the value of the RAB, which is more of a financial construct.

One reason for keeping the RAB updated that is not listed, is in case of any future changes to NR's status which would require once again a conventional approach to calculating the revenue requirement and access charges.

3. Rebates

ORR's proposal

There is a current rebate mechanism in track access contracts for franchised passenger operators. It provides for Network Rail to rebate income that it does not require to discharge its obligations under its network licence and any contracts to which it is a party. ORR proposes to retain the rebate mechanism for CP7.

Rail Partners' response

The rebate mechanism is highly unlikely to be exercised and contracted operators would not benefit as it would be passed through to Government. However, Rail Partners think that it is important to maintain this mechanism as it can help to ensure that NR does not overcharge for its services and maintains records that can be used for future comparison purposes and can assist with accountability.

4. Network Grant arrangements and dilution provisions

ORR's proposal

As ORR states, Network Rail recovers a high proportion of its fixed costs through direct network grants from funders. This is in lieu of fixed track access charges (FTACs) paid mainly by contracted passenger operators.
The existing track access contracts held by contracted passenger operators contain network grant dilution provisions. These provide that, in the unlikely event that a network grant payment is not made during the control period, operators would each be obliged to pay a share of the shortfall to Network Rail, three months after the 'dilution date'.

Rail Partners

ORR is proposing the following approach for CP7:

- Seek written confirmation from Network Rail and funders of the dates, amounts and conditions for network grant payments before the final determination. If this is achieved, ORR will reflect network grant payments in FTACs in the same way as for CP6;
- If network grant documentation is not in place before ORR publishes its final determination, it will assume there will be no grant funding for CP7, and the Schedule of Fixed Charges would be set to recover Network Rail's total net revenue requirement. However, ORR would also include a variation clause in passenger operators' track access contracts whereby FTAC amounts would be adjusted downwards to reflect any amount of network grant if this is confirmed before the start of CP7. This would be a change to the process in PR18, where the level of FTACs were set in price lists in December 2018, based on an assumed level of grant funding.

Rail Partners' response

This seems a sensible approach by ORR. Clearly, the increase in FTACs that would be required if no grant funding agreement was in place would have to be an allowable cost under the existing contracts and payable to the TOCs by DfT. However, we fully expect the grant funding agreement to be in place well before the start of CP7. We think it is very unlikely the grant dilution provision would ever be required because the increase in FTACs that this would entail would have to be funded by DfT in any case. However, in principle, we understand the protection to NR's revenue requirement that this provides.

5. Reopener provisions

ORR's proposal

Re-opener provision are common in regulated industries and in rail refer to the ability to amend the revenue requirements that Network Rail can recover through access charges and network grants in extreme circumstances.

ORR proposes to retain the re-opener provision in track access contracts, updated to refer to 'before 1 April 2029'. Re-openers can occur in the following circumstances:

- A material change in the circumstances of Network Rail or in relevant financial markets. Under this provision ORR would consider whether there were compelling reasons to initiate an access charges review, having regard to our duties under section 4 of the Act; and
- If expenditure in Scotland is forecast to be more than 15 percent higher than the determination over a forward-looking three-year period. This provision applies to Scotland only.

Rail Partners' response

Rail Partners supports in principle the continuation of these reopener provisions if it caused only a potential change in FTAC. We would not support it if a reopener might lead to an increase in the variable track access charge and/or the Infrastructure Cost Charge which is levied on open access operators.

ORR should consider reviewing what might be 'compelling reasons' based on lessons learnt in other industries as a result of COVID/high inflation. There needs to remain a strong incentive for NR to be efficient in times of, for example, high input price inflation/inflationary uncertainty, recognising that reality might deviate so far from regulatory assumptions used to set the revenue requirement that a re-opener would be required.

6. Management of financial risk

ORR's proposal

Network Rail is proposing to retain a broadly similar approach in principle to CP7 as is in place for CP6, with some funding in a risk fund and some funding ringfenced to prioritise some asset management activities.

ORR recognises that given the difficult economic environment for the industry and the level of funding in the SoFA, it is unlikely that Network Rail will be able to transfer as much funding from its core plan into risk funds as it did in CP6.

ORR doesn't say what its preferred approach is and simply asks if we have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7.

Rail Partners' response

Rail Partners recognises that Network Rail will not be able to transfer as much funding from its core plan into risk funds as it did in CP6 given constraints on public funding. However we think the structure of the risk fund needs some thought.

The level of funding for NR will be based on future inflationary assumptions which will be highly uncertain. The amount available for a single risk fund will therefore largely depend on the view of how inflationary risk is priced into the core funding. This is likely to be very high because NR will want to be insulated from inflationary pressures.

Rail Partners believes that ORR therefore needs to consider how the mechanism is adapted to reflect the economic and inflationary uncertainty beyond simply having a lower risk fund. Our suggestion is to have the following structure:

- Core funding + Dedicated inflationary risk fund + Other risk fund

NR would have to show that inflation was responsible before it can draw on the inflationary risk fund thus helping to incentivise it to be efficient.

7. Governments' budgetary processes

ORR's proposal

Network Rail faces a number of budget constraints due to Resource Departmental Expenditure Limit (RDEL) and Capital Departmental Expenditure Limit (CDEL) rules that also apply to DfT's own budget. There are also constraints put in place by the Scottish Government.

ORR acknowledges that this is a matter for Governments but asks whether there are any comments on the impact of these budgetary processes for how it designs the financial framework for CP7.

Rail Partners’ response

It’s not obvious to Rail Partners that ORR can do much in the design of the financial framework to take account of the impact of Governments’ budgetary processes. In fact, those budgetary processes ought to ensure that Network Rail is disciplined in its budgeting and cost control.

8. Performance innovation fund

ORR’s proposal

The CP6 Performance Innovation Fund provided Network Rail’s regions, System Operator and train operators access to funding, worth £40 million over the control period, to support the industry in undertaking innovative projects aimed at driving improvements in train performance. In particular, the funding is designed to facilitate collaboration between Network Rail and the wider industry on certain initiatives that may be seen to carry too much risk for one company to develop alone.

The fund is welcome but clearly very small when compared with overall industry funding.

Rail Partners recognises the constraints on the SoFA but we are calling for a real terms increase in the fund in CP7 to £80m. This is still a very small proportion of the overall revenue requirement but can deliver significant benefits.

ORR recognises that the governance of the fund improved over CP6. Rail Partners suggests the following further improvements for CP7:

1. Agree ways (in line with Green Book/WebTAG appraisal processes) of valuing performance enhancements in business cases which don’t just rely on Schedule 8 calculations / revenue benefits. Include things like the true cost of disruption (e.g. higher operating costs), lost customer time, delay repay and safety impacts.

2. Have a much better investment template based on the ones used for other small investment schemes and compare schemes, including non-performance schemes, in the same way.

3. Provide sponsors for each scheme, including from train operators.

4. Allow business cases to apply over the entire remaining life of the assets being improved, and not just arbitrarily to the end of NRCs/PSCs or the next Network Rail control period.

5. Make sure the fund is sufficiently ring-fenced for it not to get cancelled/raided if there are cost overruns elsewhere.

6. Where possible, top it up with funding from other sources, for example co-funding from third parties.

7. Recognising that ORR can’t anticipate what future SoFAs will be, there would be merit in making it a standing/rolling fund and not just for the 5-year control period so that the control period end date does not become an obstacle to identifying and committing to future schemes.

8. It should be made clear that this is an industry-wide fund, not just Network Rail and the governance needs to reflect this with an equal role for operators in that governance. The division between the two is often wholly arbitrary, and schemes should be judged on whole-industry, not narrower TOC or infrastructure merits.

9. Remove the rule that insists the PIF is only to be used for investments that otherwise wouldn't happen. This has led to endless debate about which investments might and might not happen.

10. Similarly, remove the requirement that promoters demonstrate that a scheme is 'innovative'. This is a difficult criteria to prove and has led to endless debate. Perhaps changing the name to 'Performance Improvement Fund'.

11. Schemes once authorised should subsequently be reported on just like any other capital scheme and governed accordingly.

Yours sincerely

[redacted]
Director of Policy

Rail Safety and Standards Board's response to the Office of Rail and Road's PR23 consultation on the financial framework for CP7

Submitted on 16 February 2023

Introduction

The office of Rail and Road (ORR) published *PR23 – Consultation on the financial framework for CP7* on 19 December 2022 which sets out the approach to the financial framework for Network Rail (NR) ahead of the forthcoming financial control period. There are eight matters being consulted on, including the Performance Innovation Fund (PIF), which the ORR are seeking views on.

Performance Innovation Fund

At the beginning of CP6 the PIF was created to provide NR regions, System Operator and train operators access to funding worth £40 million to support industry in undertaking projects aimed at driving improvements in train performance. In particular, the funding is designed to facilitate collaboration between NR and the wider industry on certain initiatives that may be seen to carry too much risk for one company to develop alone. The fund is governed by a board with equal representation from NR and train operators.

It is noted in the consultation document that while authorised expenditure of the fund totals £38.6 million, only £12.5 million has been spent (as at the end of 2021 – 2022 financial year).

The issue of money being authorised but not spent was discussed at the most recent Better Operations Programme Board where the NR Director for Network Strategy and Operations admitted that there were challenges within NR's financial governance and procurement procedures that added complexity to releasing the funds which significantly slows down projects that have been approved.

The biggest single project authorised was £4.4 million to facilitate trials of Double Variable Rate Sanders on Northern Class 323s, an implementation of RSSB ADHERE Research Programme (project T1107). Other RSSB research has also been further developed or piloted through PIF funding, including WaterTrack (project SC04-POB-16), cryogenic cleaning of the railhead (project SC04-POB-15), and the Rail Performance Model for Strategic Decision Making (project COF-DSP-05).

Consultation Questions

ORR have posed three questions relating to the PIF within the consultation. The Rail Safety and Standards Board (RSSB) research team consider the PIF to be a valuable tool in supporting implementation of key research projects and have therefore responded to each of the questions to inform the consultation.

Question 1: Do you have any view on the use of the performance innovation fund in CP6?

The PIF has demonstrated its use in facilitating the implementation of strong research and development findings and outputs where there is clear performance improvement but:

- The costs and benefits fall to different organisations.
- It cannot be brought about via supply chain product development, ie, introduction of non-product or significant complexity in the integration of a new or improved product.

An example of the former is the use of the PIF to fund the adoption of solutions from the RSSB research programme ADHERE aimed at improving the management of low adhesion. Responsibility and cost of managing adhesion sits with NR but successful management sits with the operators. Without access to the PIF it would have been more difficult for an individual region or operator to make a compelling case to self-fund the adoption of Double Variable Rate Sanders.

An example of the latter is the use of a novel modelling tool – Rail Performance Model for Strategy Decision Making – for granular timetable analysis leading to a better ability to mitigate performance issues through timetabling intervention.

While the PIF has had notable successes, it has not been fully exploited. In our opinion that is due, in part, to the disconnect between completed research (whether through the RSSB, NR or other research programmes) and obtaining the necessary approvals and release of funds to initiate a PIF project. The fund has demonstrated that it can successfully help bridge the valley of death between research and implementation. To do so systematically the process would greatly benefit from being more closely aligned with outcomes coming from research pipelines to ensure seamless progression (where appropriate) into the pilot/initial deployment phase. This would ensure that individual research can maintain momentum and have a source of funding while all the key stakeholders are engaged.

Question 2: Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

From a research implementation perspective this fund is very much needed to support the adoption of compelling research and development findings that benefit service performance but where a single organisation is not well placed to implement. A dedicated industry fund that is separate from both research and 'day-to-day' operations (but well linked to both) is important because it protects the money so that it can be used to implement truly innovative solutions that cannot be introduced as part of the life cycle of assets. Without this, such solutions are competing for funding against core business activities which can stifle the implementation of new ways of working.

In shaping a future such fund, it is worth considering:

- Other key industry objectives in addition to service reliability that have similar gaps to bridge in operationalising changes emerging from research and development pipelines.
- The role of GBR as the guiding mind in ensuring alignment between research, innovation, and day-to-day' operations.
- The challenge to secure operational time and resources to introduce and learn from change being pursued, in addition to funds for external one-off spend that the PIF focussed on.
- Clarity on the use of such funds beyond the first adopter(s) to create a 'tipping point' after which the change is pursued with confidence under a long-term deployment framework, which will still be needed.

Question 3: Do you have any comments on how such a fund should be managed?

It has been noted in the consultation that there seems to be an uneven split of awards and size of awards across regions (paragraph 8.2). Given that performance is intrinsically a cross-industry issue, this could be improved by reviewing the existing governance board to ensure it is truly representative of the whole industry and that it reports openly cross-industry groups around the proposals that are submitted, the reasons behind its decision to either fund or not fund, and how each project is anticipated to support wider industry adoption.

The process for applying for funding should also be streamlined to allow research projects (from RSSB, NR and other research programmes) to transition quicker from the research phase into a pilot, trial or initial deployment. This could be achieved by the original case for research being used as the basis to justify PIF funding which can be accessed immediately on the condition that the research project demonstrates a positive industry business case and a clear roadmap for end user adoption. This would enable research projects to maintain momentum and increase the attractiveness of supporting new research to industry as there is a clearer pathway for how research can progress at pace onto the network. This would also help to demonstrate the feasibility of the business case proposed by the research and provide a template for how other parts of the industry could implement the findings with real data/experience to support their business case.

[redacted]
Track Access & HS1 Contracts Manager
SE Trains Limited

FAO – PR23 Team

14th March 2023

REF - PR23 – Consultation on the financial framework for CP7

With reference to the Consultation issued by Network Rail on 19th December 2022 in relation to the Consultation on the financial framework for CP7, this letter constitutes SE Trains Limited's (SETL) formal response.

SETL has reviewed the document and consulted with colleagues internally who have provided the following answers to the questions that were set out within the Consultation.

1. Cost of capital and cost of debt

Question - Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?

SETL's Response

Yes – provided we have full visibility of the work of the UKRN's Cost of Capital Working Group and how it is applied to the final specified value.

2. Setting and updating regulatory asset base balances for CP7

Question - Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

SETL's Response

Broadly yes. However, ORR should consider whether CPI is appropriate to be used as an inflator for all asset categories rather than apply by default to all categories.
Also, how are disposals treated in this situation and where does the gain/loss from any disposal go?

3. Rebates

Question - Do you agree with our proposal to retain the current rebate mechanism for CP7?

SETL's Response

We believe a rebate mechanism should be retained but the requirement for Network Rail to be confident that surplus funds will not be required should be removed. Network Rail with naturally never be confident that the surplus is not required as they will want to do the work and spend the money, whereas TOCs will have paid the money and seen no benefit. This is in our view overly cautious and means that rebates are only every likely towards the end of the Control Period, or even not likely at all.

We propose that surplus should be monitored on an ongoing basis and joint governance put in place to identify and agree more timely release of surplus funds.

We agree that any release should not create risks to the financial sustainability of Network Rail's business, however, we also identify that failure to release surplus funds should also not create risks to the financial stability of TOCs who face annual spending targets and budgetary pressures.

4. Network grant arrangements and dilution provisions

Question - Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

SETL's Response

Yes, we agree that this would improve the overall governance and assurance around Network Rail's funding certainty for CP7. However, the current CP6 approach naturally incentivises Network Rail to maximise grant finding based on initial estimate, else they would have to go to TOCs for more FTAC than determined. The new approach removes some of that incentive, whereby not any grants not contracted at the date of the Final Determination are already funded through FTAC and so Network Rail are fully funded. We believe there should be specific provision/targets to incentivise Network Rail to maximise the amount of grant funding post final determination to reduce the overall FTAC level post determination.

5. Re-opener provisions

Question - Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

SETL's Response

No, as the existing provisions do not consider wider industry or TOC related scenarios. Even with the significant impact of Covid-19 during CP6, there was no re-opener. We believe there should be scope for re-opener if a majority of TOCs believe there is a case for re-opener due to underlying financial and commercial circumstances.

6. Management of financial risks

Question - Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

SETL's Response

We understand flexibility will be required when setting initial plans. However, we are concerned that operators are being asked to contribute to a risk fund where we have no certainty around its use. What are the governance arrangements around these provisions from an ORR/TOC perspective? If this is a ringfenced fund, any surplus should be separately monitored and rebated to TOCs on an annual basis.

7. Governments' budgetary processes

Question - Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

SETL's Response

We highlight that there is a distinct disconnect between the suggested approach and how TOCs are funded. TOCs are given annuals expenditure targets +/-% of previous years with no ability to defer 10% CDEL etc.

8. Performance innovation fund

8.1 Do you have any views on the use of the performance innovation fund in CP6?

SETL's Response: We believe it is important that all TOCs have fair and equal ability to access the fund. We would welcome the establishment of a performance innovation fund in CP7 and would seek to have active representation in any associated governance.

8.2 Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

<u>SETL's Response:</u>
We believe a dedicated performance innovation fund should be used in CP7. We would also like to suggest that a separate carbon innovation fund is established to specifically help initiate projects to contribute to carbon reduction.

8.3 Do you have any comments on how such a fund should be managed?

<u>SETL's Response:</u>
Such a fund should ensure that not all of the funding (contributed by all stakeholders) is concentrated on specific geographical areas, we suggest a certain level of ringfencing by region to ensure a fair split of funding available to all users.
We welcome governance by a board with equal representation from Network Rail and train operators.

Yours sincerely,

[redacted]
Track Access & HS1 Contracts Manager

Transport for London

London

21st February 2023

Dear Sir/Madam,

Periodic Review 23: Consultation on the financial framework for CP7

Thanks for offering us the opportunity to comment on this matter. I can confirm that TfL is content for any part of its response to be made public. Our comments are provided below.

Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?

A cost of debt approach which uses benchmarks from other regulated industries and reports from bodies such as UKRN, though objective, is highly likely to mean an increase in Network Rail's cost of debt for CP7 compared to previous periodic review determinations.

As Network Rail's cost of debt is, we understand, substantially only of relevance for calculating the Crossrail Supplementary Access Charge (CSAC), any determination should look at the historic cost of debt used for borrowings related to Crossrail On Network Works incurred over the course of the Crossrail Project, rather than contemporaneous benchmarks (which may factor in more recent volatility in debt markets and changes in underlying interest rates); with the latter otherwise potentially leading to windfall gains for NR against the actual cost to NR of the financing those works.

Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?

We agree with the approach proposed. It will help to facilitate any future transfer of services to TfL.

Do you agree with our proposal to retain the current rebate mechanism within track access contracts for franchised operators for CP7?

We agree with the approach proposed, provided that any rebates are calculated in a manner that is specific to individual operators, enabling all funders of the network to benefit.

Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?

We do not agree with the approach proposed as it exposes us to the risk of very significant additional costs for our National Rail concessions if the Network Grant is not agreed prior to the Determination, with a severe adverse impact on our financial position. We consider that the current approach of setting Fixed Track Access Charges assuming that Network Grant will be paid should be retained to avoid this significant and unreasonable financial risk.

If the approach proposed is progressed then it is essential that any subsequent adjustments to Fixed Track Access Charges once a Network Grant is agreed are backdated to cover the entire Control Period so any increased costs incurred by funders are fully compensated for.

Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?

We agree with the proposal.

Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?

Risk provision is important and should be based on an analysis of risks that have materialised in the past to enable trends over time to be established and adequate financial provision to be made for CP7.

Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?

Flexibility is important to enable change to be managed. The movement of funding between years in a Control Period should be permitted where it is legitimate to support project and programme delivery.

Do you have any views on the use of the performance innovation fund in CP6?

We have no comment to make in response to this question.

Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

We have no comment to make in response to this question.

Do you have any comments on how such a fund should be managed?

We have no comment to make in response to this question.

Yours sincerely,

[redacted]
Principal Planner,
Transport for London.

[redacted]
Head of Rail Finance
Rail Directorate
Mobile: [redacted]
[redacted]

TRANSPORT
SCOTLAND

Office of Rail and Road (ORR)
25 Cabot Square
London
E14 4QZ
By e-mail only, pr23@ORR.gov.uk

Date: 30 March 2023

Dear Sirs,

PR23 Consultation on the financial framework for CP7 – Response from Transport Scotland

Thank you for providing the opportunity to reply to the ORR's consultation on the financial framework for CP7. This reply provides (at Annex A) responses to the individual questions posed in the consultation, but I also wish to provide some broader comments on related rail issues for consideration by the ORR as it begins to prepare its final determination for CP7 for the Scotland route:

- For the financial framework in which the rail sector in Scotland is operating to be efficient, Scottish Ministers consider it must be coherent, simple and transparent. It must respect the integrity of the devolved settlement for Scotland's railway, increasingly so given the additional functions devolved to Network Rail Scotland during Control Period 6 (CP6) and the new circumstances for the whole of the next Control Period (CP7) whereby both service providers in Scotland will be under public sector control.

- The financial framework in CP7 should allow Transport Scotland (TS) acting as funder, to build on the ***financial alignment*** and associated arrangements developed between Transport Scotland (TS) and Network Rail, ScotRail Trains Limited and other partners, either as part of "Team Scotland" or "Scotland's Railway[1]". These strong partnerships, often with public sector only bodies participating, allow for aligned and therefore better financial arrangements; working together on large scale renewals, new stations, enhancement projects, procurement arrangements, etc, with scope and purpose clear from the outset and robust governance throughout, all ensuring that costs are kept under control and value for money solutions achieved.

- For Scottish Ministers, PR23 is taking place during an especially challenging financial and economic context in respect of the significant uncertainty associated with high levels of inflation, lack of clarity from the UK Government over long-term funding for the rail enhancements' budget (which in turn impacts on renewals spend), and rail patronage in Scotland likely to recover only slowly to pre-COVID-

[1] Scotland's Railway - Better In The Making (scotlandsrailway.com)

19 levels, if at all. It is precisely for that reason that Scottish Ministers would expect the ORR to be able to provide as much flexibility as possible in rail's regulated financial framework to allow best use of scarce public funds (and reduced revenues) over the whole control period. Such flexibility should also apply both to exit from CP6 and entry into CP8.

- As with CP6, the financial framework should reflect the expectation that Network Rail in Scotland will be aligned to best practice for a publicly funded body, with the framework supporting behaviours and decision-making that require robust governance, transparency, effective planning and financial discipline.

- Scottish Ministers are clear that irrespective of the financial challenges facing Network Rail in CP7, the railway works best when the industry works collaboratively to deliver solutions that are focussed on the needs of customers and end-users. And, as described in the Scottish Ministers' HLOS, key to meeting the "net cost" challenge for the network is by delivering Value for Money through a transparent approach in determining and managing costs efficiently.

- A whole system approach is fundamental to achieving Value for Money, where savings in one area can be reinvested more effectively elsewhere within the system. Consequently, Scottish Ministers have, through the HLOS, specified effective integration between Network Rail and ScotRail Trains Ltd, which is public sector controlled and the primary provider of rail services in Scotland. Greater integration will be reinforced still further by Scottish Ministers' recent decision[2] also to bring into public sector control, the Caledonian Sleeper[3] service, as certain HLOS requirements for Network Rail in Scotland also extend to the Sleeper operator.

- This approach means a greater focus on the passenger through greater integration between track and train. This integrated and whole system approach is part of a clear direction being set by Scottish Ministers for the railway in Scotland and TS would ask the ORR to consider how best to support these developments as part of its considerations of the future financial framework for CP7 (and final determination).

TS is content for this reply to be published as one of the consultation responses. I trust this response (copied to Jennifer Cullen at the ORR) is helpful. If you have any comments do not hesitate to contact Raymond Convill or me.

Yours sincerely,

[redacted]

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[2] Caledonian Sleeper to be delivered by the Scottish Government | Transport Scotland

[3] ".... the network must be operated at a level which is fully consistent with the commitments specified in the agreements or franchise contracts between the Scottish Ministers and Scottish Rail Holdings and ScotRail Trains Ltd. and Caledonian Sleeper and the industry "network change" process." (para 3.6, Scottish Ministers HLOS)

Annex A

1. **Do you agree with our proposal to specify cost of capital and cost of debt values for Network Rail in CP7?**

   Yes - in respect of first and third bullets but it would be helpful to understand the benefits of the second and third bullets better and in particular how the second relates to Network Rail status as a central government body and any proposed changes envisages as part of the development of Great British Railways.

2. **Do you agree with our proposals for setting and updating regulatory asset base balances for CP7?**

   Yes - in respect of asset valuation but would be helpful to better understand the other benefits mentioned and in particular the additional resource required in respect of them.

3. **Do you agree with our proposal to retain the current rebate mechanism for CP7?**
   Yes - we see no need for changes within this Control Period 7. We do have concerns regarding the time taken for decisions to be made and we would appreciate this to be further discussed during the next control period.

4. **Do you agree with the proposal set out above in respect of how we will take account of network grant funding for CP7?**

   The grant agreement arrangements between Transport Scotland and Network Rail could not be changed to reflect a grant in aid arrangement in the same way that would be possible for DfT without further devolution of accountability of Network Rail to Scottish Ministers. This was proposed for CP6 but was not agreed so the Scottish Network Grant arrangement was structured to reflect the cash funding that Scottish Ministers contribute to Network Rail, with provisions to limit the amount of excess cash that Network Rail can retain at the end of each rail reporting period to ensure that cash grant is not paid in advance of need. In principle we agree that it would be of benefit to set out the schedule of grant payments and dates in advance in order to determine the level of FTAC required in advance of the determination.

   However, this will rely on forecast information from Network Rail to align with the overall funding identified in the CP7 Statement of Funds Available (SoFA). We are also keen to continue to work with ORR and Network Rail to review the balance of funding appropriate for Scotland between the Network Grant and FTAC.

5. **Do you agree with our proposal to retain the re-opener provision in track access contracts for CP7?**

   Yes. TS considers that the re-opener provision could be an appropriate mechanism to respond to the significant uncertainty posed by high rates of inflation in the UK economy. TS would welcome the ORR's views on this point.

6. **Do you have any comments on the approach that should be adopted for the use of risk funds to manage financial risks in CP7?**

We consider that the level of risk funding allocated in CP7 should be proportionate to the level of risk that it would be reasonable for Network Rail to be expected to manage, in line with the P20 probability of activities not being completed. It would be helpful to consider this in terms of defining a framework under which risks can be more easily shared to enable funding authorities to have a greater influence on significant strategic decisions required in light of risks arising.

7. **Recognising that the budgetary processes themselves are a matter for governments, do you have any comments on their impact for how we design the financial framework for the infrastructure manager in CP7?**

Scottish Ministers would be keen to retain the 10% budget flexibility allowed by HM Treasury in CP6 and are seeking to continue that agreement with HM Treasury in CP7. Depending on the outcome of those discussions the impact of any revised arrangements will need to be carefully considered but it is likely to mean greater reliance on Network Rail achieving forecast expenditure if budgetary flexibility is reduced. The fact that Enhancement funding is no longer included in the SoFA means that it is not likely to be possible to balance variations between budgets for Network Grant and Enhancements. The timing of requests is also different for Scotland because Transport Scotland must first engage with Scottish Government who can then reflect agreed adjustments as part of the UK Budgetary Estimates process in a similar fashion to DfT. The flexibility was allowed due to the changes in debt funding in CP5 to grant funding in CP6. Due to the COVID outbreak it has been difficult to fully understand the year on year impact from debt to grant and the 10% flexibility should remain at least for a further control period

8. **Do you have any views on the use of the performance innovation fund in CP6?**

In your own 2022 annual assessment[4], the ORR provided the following description in respect of the PIF and Network Rail Scotland

> *In years 1 and 2 of the control period, Network Rail Scotland struggled to gain authorisation for schemes requested through the Performance Innovation Fund (PIF). However, there was some improvement in year 3, with £2.2 million of spend authorised.*
>
> *It made good progress on a programme to install Global Positioning System (GPS) trackers on High-Speed Trains (HSTs). However, its trial of an innovative approach to reduce the impact of leaf fall on*

[4] Annual efficiency and finance assessment of Network Rail 2021-22 (orr.gov.uk)

autumn performance (using laser trains and cryogenics) has been delayed pending further assessment.

We will continue to monitor Network Rail Scotland's delivery of PIF schemes in CP6

These outcomes reflect in practice concerns previously expressed by TS that because the PIF is a central Network Rail fund, its alignment with and benefits to Scottish Ministers' objectives would be weak.

TS did not agree with this fund in CP6 and as governed in CP6, would find it difficult to justify public expenditure on it in CP7.

8.6 Do you have any comments on whether a dedicated performance innovation fund similar to that used in CP6 should be used in CP7?

Unless clear evidence can be provided of improvement by, say, end September 2023, TS would propose that any agreed share of funds be allocated to Network Rail Scotland from the outset of CP7, which it would operate on a devolved basis, and reporting on appropriately to TS. It should also operate on a whole systems basis and explicitly should be allocated on a best value basis to either ScotRail Trains Ltd. or Network Rail to secure the best contribution from available funds in pursuit of the Scottish Ministers key 92.5% ScotRail PPM specification.

8.7 Do you have any comments on how such a fund should be managed?

The fund should be devolved to the Scotland route and for it to manage. Allocation and deployment of such funds should be expedited to avoid the damaging delays and constraints experienced with the CP6 process. Alternatively, if an efficient, whole system approach cannot be agreed, the funds should be retained by TS.