Briefing

Rail

BURGES SALMON

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Network Rail funding to 2019 and beyond

Introduction

ORR's Periodic Review of Network Rail's funding puts a challenge to Network Rail and the industry to reduce costs and work closely together with a longer term aim of reducing the public funding required to provide a growing successful railway.

Process

ORR's Periodic Review (PR13) for 2014-2019 (CP5) determines the outputs expected of Network Rail, the income the company will receive and the incentives it will face. The Review assesses how Network Rail's Strategic Business Plan (SBP) attempts to deliver DfT and Transport Scotland's High Level Output Specifications (HLOS) in light of the Statements of Funds Available (SOFA) and sets out the regulator's determination of the funding which it believes Network Rail will require.

That process of review and assessment is now entering its final stages.

Timeline:

- ORR published its draft determination of outputs and funding on 12 June 2013 and commenced consultation;
- This was put in a longer term context by ORR's long-term regulatory statement on 15 July 2013;
- The consultation deadline is 4 September 2013;
- ORR will publish the final determination on 31 October 2013

Context of the review

ORR has considered Network Rail's intentions and proposed funding requirements in the SBP, in the context of a modern railway undergoing substantial growth and changing expectations. Amongst other things ORR refers in its draft determination to:

- Remarkable growth and achievement in the Railway industry in the last ten years including a doubling of passenger numbers (including 7% p.a. rises in passenger revenue) and a 60% increase in freight;
- Forecast further growth during CP5 of 14% in passenger demand and 22% in freight;
- High customer satisfaction and recent safety;
- £4Bn p.a. government funding (noting historic underinvestment in the industry);
- Failure by Network Rail to hit its performance targets for CP4;
- Historic inefficiency of Network Rail compared to other European comparators; and
- The continued need to realise the increased cross-industry efficiency improvement targets in the McNulty report.

Draft determination

In light of this context ORR has set a *"challenging but achievable"* target for Network Rail including reducing its overall net revenue request (5 years) from £29.2Bn to £27.4Bn. This is based upon an assumption that 60% will come from access charges (from train operators), 30% from government grant and 10% from ancillary income sources (including property).

The longer term aim is to improve the extent to which access charges reflect costs and hence Network Rail's reliance on public funding (which falls within the regulatory charging and funding structure imposed by the EU). The ORR notes in its long-term regulatory statement that the structure of funding should be reviewed and the transparency of costs needs to continue to improve.

Key decisions within ORR's approach to setting the funding level include:

- The costs targets are achievable and could in fact be beaten. This gives Network Rail a real incentive to improve costs;
- Network Rail must be encouraged to make savings by working with the operators to reduce costs (who must also be able to make savings in the same way). This reflects the need for more joined up operation noted by Professor McNulty;
- Schedule 4 and 8 compensation for disruption will be increased, incentivising Network Rail to manage maintenance and repair with less impact on passengers;
- Network Rail will be permitted to increase its debt (up to a maximum 70-75% RAB) on a flexible basis to meet unanticipated costs, thus reducing the need for it to be funded to £250M for 'risk buffers.' Debt servicing is expect to run at £1.2Bn p.a.;
- Enhancement costs have been set provisionally but will be reviewed in March 2015 when Network Rail has been able to provide more complete data;

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- Train service reliability must improve with all operators achieving 90% PPM and a national average of 92.5%;
- (By contrast to CP4) Certain cost savings will not be required until later in the Control Period allowing Network Rail to plan how to introduce the necessary measures efficiently;
- Significant increases in variable access charges will be allowed to reflect emerging data which indicates that marginal costs are higher than previously believed;
- Leading to a reduction in the cost of running the railway per passenger km of 28%.

Conclusion

The PR13 is an aggressive example of regulation of an industry performing well with scope for improvement. It calls for greater savings and co-operation within the industry between the various stakeholders. It also shows that ORR is prepared to engage with Network Rail at a detailed level to assess the proposals it makes.

If successful the overall review will see a further reduction of public funding for the industry while usage continues to rise. It is however important that savings are made through genuine efficiency rather than effective maintenance and renewal to ensure safety levels are maintained and enhanced.

Burges Salmon's specialist rail team is chaired by Chris Jackson and includes regulatory, transactional, commercial, real estates and disputes lawyers with a deep knowledge and experience of the industry.

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