



OFFICE *of the*
RAIL REGULATOR

**THE PERIODIC REVIEW OF RAILTRACK'S
ACCESS CHARGES:**

FINAL CONCLUSIONS

VOLUME I

Contents

VOLUME I:

Regulator’s foreword.....	1
1. Introduction and summary	5
PART I: REVENUE REQUIREMENTS	
2. Methodology for resetting price controls	21
3. Activity and expenditure.....	23
4. Efficiency.....	31
5. Cost of capital and financial indicators.....	39
6. Regulatory Asset Base.....	49
7. Other single till income	59
8. Assessing Railtrack’s revenue requirements	65
PART II: INCENTIVE FRAMEWORK	
9. Structure of charges – Schedule 7	77
10. Operational performance – Schedule 8.....	95
11. Possessions regime – Schedule 4.....	111
12. Property allowance scheme – PAS	125
13. Station charges	129
14. Baseline outputs.....	135
15. Information reporting.....	141
16. Interim reviews and the next review	145
17. Enforcement and monetary penalties.....	159
18. Enhancement framework.....	165
PART III: ENHANCEMENT OF THE WEST COAST MAIN LINE	
19. West Coast Route Modernisation.....	178
PART IV: TIMETABLE AND IMPLEMENTATION	
20. Implementation process	185

Appendices

VOLUME I:

Appendix A: Periodic review documents and consultant reports	192
Appendix B: Responses to consultation.....	194
Appendix C: Cost projections	195
Appendix D: Payment of grant by SRA	197
Appendix E: Revenue requirements	199

VOLUME II:

Appendix F: Calculation of capacity charge
Appendix G: Calculation of fixed charge
Appendix H: Calculation of the Schedule 8 payment rates.....
Appendix I: Periodic review notice (track).....
Appendix J: Periodic review notice (Railtrack independent stations)
Appendix K: Periodic review notice (franchised stations).....
Appendix L: General approval (Railtrack independent stations).....
Appendix M: General approval (franchised stations)
Appendix N: Template Schedule 4: Possessions regime
Appendix O: Template Schedule 7: Charges.....
Appendix P: Track usage price list
Appendix Q: Traction electricity price list.....
Appendix R: Incremental output statement price list
Appendix S: Template Schedule 8: Performance regime
Appendix T: Station long term charges.....

Regulator's foreword

1. The railway industry, and Railtrack with it, was privatised in a hurry, with inadequate attention paid to the fitness for purpose of the regulatory and contractual matrix which is essential for the proper functioning of a separated industry which must continue to operate in so many respects in a co-operative and integrated fashion. Railtrack was privatised in 1996 with a weak financial structure which gave it little or no incentive to invest. That was a poor birthright for an industry which needed to promise and deliver so much, so soon. In the past fifteen months, since I took over as Regulator, I have been working to make significant improvements in the regulatory regime. In August 2000 the Public Accounts Committee of the House of Commons published a report which agreed that the steps which I have been taking are the right ones and that I should proceed with all speed to carry them to conclusion. That way, accountability and delivery will be enhanced and put on a sound and stable footing.
2. This periodic review establishes the revenue which Railtrack is entitled to earn from franchised passenger train operators, to enable it to operate, maintain and renew the network. It is also about the value of the core regulatory asset base at the end of the second control period, that is 31 March 2006, the arrangements for monitoring and incentivising delivery and the framework for enhancement.
3. In carrying out this review, I have extensively consulted Railtrack and the rest of the railway industry, the SSRA and other relevant public authorities (including DETR, the HSE and PTEs) and others. As part of this process, I have held several formal hearings. I have listened very carefully to everything which has been said to me, and have adopted a highly transparent process including detailed explanation of my proposals and publication of supporting analysis by my consultants.
4. This is an immensely important time for the railway industry. For the first time probably in its history, it has the combination of a strongly supportive government willing to inject very substantial funds into it, regulatory authorities committed to sound finance and stable conditions for investment, a strong commitment to the significant enhancement of safety on the railways and, not least, demand from passengers and freight customers which has increased greatly in the last few years and shows every indication of continuing to grow fast. The railway is not in decline. It is growing at a pace and to an extent neither seen nor foreseen in modern times. It is a time of considerable opportunity.

5. The commitment by government to a strong public-private partnership on the railways brings with it considerable sums available for investment. The funds to expand and improve the railway come from taxpayers via the Strategic Rail Authority and Passenger Transport Executives, from local authorities and from passengers and freight customers. As well as the public sector, substantial funds will come from private sector commercial enterprises, and may include use of innovative financing techniques by third parties, for example, along the lines of the SRA's proposed special purpose vehicles.
6. At the heart of the industry stands Railtrack. As the monopoly owner and operator of the national railway infrastructure, Railtrack is an essential part of the future development of the industry. The company faces no effective competition for most of its business, and the public interest regulation of the company must be transparent, fair, stable, predictable and proportionate. It must equip it to meet the considerable challenges which it faces in playing its part in the public-private partnership.
7. The most significant single part of my programme of reform has been the restructuring and resetting of the financial regime in which the company operates. The financial framework of the railway industry needs to provide the companies concerned with a stable and sound environment for investment. That means improving the incentives to invest in new capacity and better services, and ensuring that they have certainty and predictability in how that investment will be treated in future regulatory reviews. This is essential if the industry is to raise the finance needed to deliver the required level of investment in the network.
8. It is imperative that the money now made available to Railtrack for the maintenance and renewal of the fabric of the railway and its expansion is spent wisely and well, on the right things at the right times. In this, it is not purely commercial considerations which will apply. Very many people and organisations rely on our transport systems working safely and well, even if they do not use them themselves. The public interest responsibilities of the railway companies, shaped and enforced under the authority of Parliament, are owed to all these people, passengers and non-passengers alike.
9. Accordingly, I have also announced new accountabilities of Railtrack for the proper and timely use of this money, with the ability to check on the progress and quality of spending and work and the ability to correct shortcomings before they become serious. My reforms involve new licence conditions relating to provision of information by Railtrack and the verification of this information by independent

reporters. They also include restraints on the disposal of its assets (including land) which may be needed for railway uses in the future, and the establishment of a reliable and comprehensive register of the condition, capacity and capability of the company's assets.

10. This review delivers a financial framework for Railtrack - and through Railtrack the industry - which establishes a better, clearer and fairer balance of responsibility and obligation in the industry. It creates a virtuous circle of effective incentive-based regulation, strong and empowered management, clear contracts and sound accountability. These things are necessary for a long-term framework for sustained improvement in performance.

11. This review equips Railtrack to invest strongly and efficiently. The shortcomings of the current regime are swept away, replaced by a sound framework for investment and the finance to carry out a rail renaissance whose momentum must increase strongly and quickly. Thus endowed, Railtrack has no more excuses. The responsibility on Railtrack, buttressed by increased accountability through stronger and fairer contracts, a reformed network licence and clear financial incentives, is considerable. Together, this public-private partnership can and must be made to work well for the industry, for investment and above all for passengers and freight.

TOM WINSOR
Rail Regulator
19 October 2000

1. Introduction and summary

Introduction

- 1.1 In July 2000 the Regulator published his draft conclusions on the periodic review of Railtrack's access charges for franchised passenger train services. In doing so, he reiterated the need to create an environment which protects the interests of users and funders whilst creating appropriate incentives for Railtrack to deliver increased investment and improved performance.
- 1.2 The Regulator received extensive responses to the draft conclusions from Railtrack and its contractors, as well as passenger and freight operators and funders (see Appendices A and B). He also held a further formal hearing with Railtrack (with SSRA in attendance as an observer) where it was given the opportunity to present its case to the full ORR Board. In addition, the Regulator has discussed his draft conclusions with the Shadow Strategic Rail Authority (SSRA), the Passenger Transport Executive Group (PTE), the Association of Train Operating Companies (ATOC), the Health & Safety Executive (HSE) and individual contractors, PTEs and operators. All parties have contributed constructively to the process and have provided valuable input to the periodic review.
- 1.3 The draft conclusions highlighted the role of the Regulator's duties under section 4 of the Railways Act 1993 and section 21 of the Channel Tunnel Rail Link Act 1996. In finalising his conclusions, the Regulator is satisfied that he has discharged these duties and taken account of the responses to the draft conclusions. He reiterates the point made in his draft conclusions that he has discharged the duty to take account of the need to protect all persons from dangers arising from the operation of railways including any advice given to him by the Health and Safety Executive. For example, this has implications for the level of safety related expenditure which Railtrack will need to finance. Safety is paramount and well managed companies will be both safe and efficient.
- 1.4 This document sets out the Regulator's final conclusions on the periodic review and the process for implementing these conclusions. In line with the draft conclusions, it is divided into four parts:

- Part I describes the Regulator's conclusions on Railtrack's overall revenue requirements;
- Part II describes the proposed incentive framework including the new structure of charges, the arrangements for defining, monitoring and incentivising delivery of baseline outputs and the enhancement framework;
- Part III describes the proposed approach to the remuneration of enhancements to the West Coast Main Line (WCML); and
- Part IV describes the process for implementing these conclusions and the possible implications of a reference to the Competition Commission.

1.5 Further details of the assumptions underlying these conclusions are contained in appendices in this volume. Volume II contains further appendices comprising the formal review notices, the template schedules to the track access agreements and the new charging tables.

Summary of Part I: Revenue requirements

1.6 Railtrack's overall revenue requirement from access charges for franchised passenger train services for the next control period is built up from the following components:

- the level of expenditure required to operate, maintain, renew and enhance the network to deliver the baseline outputs;
- plus the required return on the company's assets – referred to as the Regulatory Asset Base (RAB); and
- minus the projected income from other sources which are included within the single till (stations, property, freight, open access and other).

Expenditure requirements

1.7 In the light of new information since July 2000 and other responses to his draft conclusions, the Regulator has made a number of modifications to those conclusions:

- further allowance has been made for additional activities required to operate, maintain and renew the network over the next five years – this increases the present value of Railtrack's overall revenue requirements by £272 million over the period; and
 - the assumed rate of efficiency improvement has been reduced – this increases the present value of Railtrack's revenue requirements by £230 million over the period.
- 1.8 The main areas of additional activity relate to the level of maintenance and operating expenditure including, for example, additional maintenance costs associated with the introduction of the Train Protection Warning System (TPWS).
- 1.9 With regard to the scope for efficiency savings, the Regulator remains of the view that there is substantial scope for improved efficiency. Since the publication of his draft conclusions, however, he has given further consideration to the risk that real input prices faced by Railtrack will increase over the next few years due to the increased activity in the construction sector. In particular, he recognises that the rate of investment in enhancements to the railway is likely to put significant upward pressure on Railtrack's costs and that this will tend to reduce the net cost reductions which can be achieved in the short term.
- 1.10 The Regulator has therefore assumed net efficiency savings of 2% in the first year, 3% in the second year, 4% in years three and four and 5% in the final year of the next control period, (this compares with assumed savings of 3%, 4%, 4%, 5%, 5% respectively underlying the draft conclusions). These savings are net of any increase in real input prices due to increased activity and this implies an underlying efficiency improvement of 17% by the end of the period or total savings of 8% over the period as a whole. Compared to the draft conclusions, the simple average annual net efficiency improvement is reduced from 4.2% to 3.6%. Of more relevance, however, the equivalent constant annual rate of net efficiency improvement is reduced from 3.8% to 3.1%. Given the broad range of evidence which the Regulator has assessed during the course of the periodic review, he is satisfied that these savings are challenging but achievable.
- 1.11 The resulting expenditure projection for the next five years is £14,874 million which represents a significant increase over the level assumed in the draft conclusions

(£14,256 million). However, it remains over £1 billion less than the amount claimed by Railtrack (after adjusting for expenditure which is included in the RAB).

Regulatory Asset Base

1.12 The Regulator's assumed RAB for the beginning of the next period is £5,515 million. This is £405 million more than assumed in the draft conclusions (£5,110 million) and £1,345 million less than Railtrack's proposed value (£6,860 million). This value comprises:

- an uplift of 15% on the initial value of equity, which is in line with the draft conclusions and implies an initial value of £3,040 million;
- backlog renewals of £530 million in line with the draft conclusions;
- additional renewals of £700 million which were not anticipated when the initial price controls were established but were anticipated at privatisation, net of the tax savings arising from these additional renewals (this adjustment has been increased from £530 million in the draft conclusions because the Regulator has no longer adjusted for other changes in taxation on the basis that these are unlikely to have been taken into account by investors at flotation);
- enhancement expenditure in the first control period of £1,365 million of which £514 million was previously classified as renewals (this includes £235 million of expenditure which has been included as a result of further information since the draft conclusions); and
- a reduction of £120 million due to under-delivery in the current control period.

1.13 The RAB at the end of the next control period also includes £1,601 million of further enhancement expenditure (including £781 million on train control systems), compared with £1,522 million in the draft conclusions. This difference arises from additional expenditure (which has been agreed with SSRA as the main funder) relating to the Incremental Output Statement (IOS) programme, modern facilities at stations (the stations IOS) and the Corey's Mill scheme on the East Coast Main Line.

- 1.14 The March 2006 value is therefore £7,116 million compared to £6,632 million in the draft conclusions. These changes increase the present value of Railtrack's revenue requirements by £152 million over the next control period.

Cost of capital

- 1.15 The draft conclusions assumed that Railtrack's real pre-tax cost of capital was 7.5%, at the top of the range proposed in the December 1999 periodic review document. However, the Regulator emphasised that his final conclusions on this matter would have regard to the Competition Commission's conclusions in relation to Mid Kent Water Plc and Sutton and East Surrey Water Plc. In considering the relevance of these conclusions, it must be recognised that the appropriate assumption for the cost of capital depends on the specific circumstances of the case and that a substantial element of judgement is required in applying the relevant evidence to a particular case.
- 1.16 In considering the appropriate value for the cost of capital, the Regulator has discharged his duties including the duty not to make it unduly difficult for Railtrack to finance its relevant activities. He has therefore taken account of Railtrack's risk profile relative to that of other utilities and has concluded that this implies a range of 6.9% to 8.2% for the cost of capital. This compares to a range of 8.1% to 8.7% proposed by Railtrack and is significantly higher than the corresponding range allowed in recent reviews of other regulated network businesses. The Regulator has also had regard to the fact that Railtrack will need to raise substantial new debt and/or equity finance in order to deliver the planned investment and has concluded that these factors mean that the allowed rate of return should be set towards the top end of this range.
- 1.17 The Regulator has therefore concluded that Railtrack's revenue requirements as part of the periodic review should include a real pre-tax rate of return on the RAB equal to 8%. This implies a base return of £441 million per annum and increases the present value of Railtrack's overall revenue requirement by £136 million compared to the draft conclusions.

Single till income

- 1.18 The projected income from stations and other single till items over the next control period is £3,442 million compared to the assumption in the draft conclusions of £3,352 million. This reduces the present value of Railtrack's revenue requirement

from franchised track access charges by £72 million over the next control period. The main source of this difference relates to the inclusion of additional stations income within the single till projections.

Baseline revenue requirements

1.19 Table 1.1 below compares the Regulator's assumptions on the key building blocks with Railtrack's latest assumptions.

Table 1.1: Key assumptions

1998/99 £ million	ORR October 2000	Railtrack September 2000
Cost of capital (pre-tax real)	8.0%	8.1-8.7%
March 2001 RAB	£5,515 million	£6,860 million
Net CP2 RAB enhancements	£1,601 million	£1,700 million
Efficiency (constant equivalent)	3.1% per annum	2% per annum
CP2 allowed expenditure	£14,874 million	£16,069 million
Stations and other single till income	£3,442 million	£3,522 million

1.20 Compared to the draft conclusions, the present value of Railtrack's revenue requirements relating to the next control period is increased by £718 million. However, having regard to his statutory duties, the Regulator has concluded that:

- £502 million of this additional revenue requirement should be funded through an increase in the March 2006 RAB rather than through increased charges over the next five years (given the assumed cost of capital, the 2006 RAB is therefore increased by £738 million);
- in the light of the SSRA's preference for a further increase in the level of grants relative to access charges, part of Railtrack's overall revenue requirements should be funded through grants of £4,700 million relating to the next control period (an additional £855 million compared to the July 2000 draft conclusions); and

- fixed track access charges for franchised passenger train services should start at a lower level than they would otherwise have done and then increase by 5% per annum in real terms (i.e. RPI+5).

1.21 The implications of these conclusions are shown in Table 1.2 below. This shows that the base level of track access charges for franchised passenger train services will reduce by 11.2% in 2001/02, then increase in real terms such that charges in the final year are 6.5% higher than in the current year. In the absence of grants, these charges would increase by 34.5% in the first year and by the end of the period charges would be 62% higher than in the current year.

1.22 The Regulator believes that the outcome of the periodic review will minimise the impact on the Franchising Director's (SSRA's) financial position while not making it unduly difficult for Railtrack to finance its relevant activities. He believes that this will place Railtrack in a strong position to raise new debt and equity finance to enable it to deliver further private sector investment in the railway. In particular, it will be able to finance the baseline expenditure requirements underlying these revenues as well as substantial further enhancements and the Regulator expects that it will be able to finance the full £8 billion enhancement programme set out in its cost submission.

Table 1.2: Annual revenue requirements

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Revenue supported by grants	826	867	910	956	1,004	4,563
Base track access charges¹	1,603	1,696	1,768	1,844	1,925	8,836
% change²	-11.2%	5.8%	4.2%	4.3%	4.3%	
Total	2,429	2,563	2,678	2,800	2,929	13,399
% change²	34.5%	5.5%	4.5%	4.5%	4.6%	

1. Base track access charges include usage, traction electricity, capacity, fixed and supplemental access charges. However, they exclude the costs of the Independent Rail Safety Activity (which will be passed through on an annual basis), IOS charges (which relate to enhanced capacity) and the impact of growth (which is assumed to be self-financing).
2. Franchised track access revenues in 2000/01 were £1,807 million.

Summary of Part II: Incentive framework

Structure of charges

- 1.23 The draft conclusions proposed some refinements to the existing usage and electric traction charges to improve their cost-reflectivity. In addition, the Regulator proposed to introduce a capacity charge equal to 50% of the estimated congestion costs arising from incremental traffic (broadly excluding the component of these costs which arises from the societal element of the performance incentive rates). The Regulator proposed to compensate Railtrack for the remaining congestion costs associated with increased traffic through an adjustment to the RAB following the next periodic review. Similarly, the Regulator proposed that the volume incentive should be introduced through an adjustment to the RAB rather than a variable charge to operators so that Railtrack is incentivised to be more responsive to customers whilst avoiding any impact on the marginal incentives faced by operators.
- 1.24 The proposed capacity charge and the volume incentive were intended to replace the negotiated congestion charge and the negotiated share of net benefit which have been included in the fixed charges in supplemental access agreements during the current control period. These changes were therefore intended to increase the transparency and predictability of the charging regime. Following the publication of the draft conclusions, the Regulator commissioned Halcrow Rail to assess the impact of the proposed structure of charges. They concluded that the new charging structure accords more closely with best practice in economic pricing.
- 1.25 In the light of the responses to his draft conclusions and further discussions with Railtrack, operators and funders, the Regulator confirms the broad proposals in his draft conclusions. The resulting template Schedule 7 is contained in Appendix O and the associated charges will be contained in common charging tables. The revised usage and electric traction charges are set out in Appendices P and Q. Finally, the methodology for calculating the capacity and fixed charges is set out in Appendices F and G respectively and the resulting charges will be sent to the parties shortly. Subject to verification that the established methodology has been applied correctly, the Regulator expects these charges to be incorporated into the new access agreements. The new fixed, usage and electric traction charges will apply from April 2001 and the capacity charge will be introduced in May 2002.

- 1.26 Given these changes, the variable charge paid by operators of existing franchised passenger train services will increase from around 8% to 20% of aggregate track access charges (although this proportion will decline as the fixed charge increases). However, given the proposed adjustments to the RAB, the underlying variability of charges to Railtrack will be greater.

The performance and possessions regime

- 1.27 As indicated in the draft conclusions, the key changes to the performance regime increase the incentive rates (by approximately 100%) reflecting the increased societal rates proposed by the SSRA and recalibrate the performance points (benchmarks) to the expected level of performance over the next control period. The arrangements have also been simplified to a significant degree to improve the transparency and effectiveness of the regime. The revised payment rates and benchmarks have been sent to the parties and, subject to verification of the input assumptions and the calculations, the Regulator expects that these values will be implemented from April 2001. The Regulator has also provided for a supplementary access charge in Schedule 8 to compensate for the expected cost of the passenger charter arrangements.
- 1.28 The performance points (or benchmarks) in the new template Schedule 8 have been rebased on the assumption that Railtrack achieves the established target reduction in Railtrack-caused delay of 7.8% (5% plus catch-up of last year's shortfall) for the current year plus 2.5% per annum over the next control period. Adjusting for the effect of assuming constant TOC-on-TOC delay, means that the improvement in the overall performance points (which include both Railtrack-caused delay and TOC-on-TOC delay) are reduced to 6.1% and 1.9% respectively. In effect, this approach provides Railtrack another year to catch up the shortfall from 1999/2000. If it fails to do so, however, this will result in an automatic and pre-determined financial penalty under the contractual incentive regime. Alternatively, if it exceeds these levels, it would receive additional revenues from the regime. For example, if Railtrack fails to achieve any improvement in performance in the current year (i.e. a shortfall of 6.1%) and this is not caught up next year, this would result in an automatic reduction in revenue of £22 million in 2001/02 (£3.6 million per percentage point). It would incur the same penalty in each year until this shortfall is recovered.
- 1.29 The Regulator also confirms his proposal to modify the existing possessions regime to remove the free possessions allowance and to provide the same compensation to operators regardless of whether the possessions arise from enhancements or renewal

of the network. However, the discounts for early notification which were proposed in the draft conclusions have been reduced and the amended timetable regime (which is currently in Schedule 8) has been incorporated into Schedule 4. The Regulator has also provided for the expected cost of compensation for possessions to be recovered through a supplementary access charge within this schedule rather than through fixed charges.

- 1.30 Finally, the detailed drafting of both Schedules 4 and 8 has been modified in the light of responses from consultees and the resulting template regimes are contained in Appendices N and S.

Station charges and the property allowance scheme

- 1.31 The draft conclusions presented the results of Railtrack's modelling to allocate the long term charge between stations based on relative size and property income. Following responses from consultees and further discussion with Railtrack, operators and funders, the model has been developed to ensure that the charges for small stations are more reflective of the underlying costs as well as the value to customers. The Regulator is considering the default allocation of responsibilities for maintenance and renewal at stations as part of his review of station access conditions.
- 1.32 The Regulator confirms the view expressed in his draft conclusions that the broad structure of the property allowance scheme (PAS) should remain unchanged so that the benefit of outperformance is shared with the industry. He also confirms that the PAS will be extended to cover income from franchised stations. Finally, following publication of his proposed licence modification on asset disposal, he has provided for the PAS to be adjusted if he exercises his powers under this condition.

Defining, monitoring and incentivising baseline outputs

- 1.33 The Regulator has sought to define the baseline outputs which Railtrack is expected to deliver over the next control period. These include measures relating to the capability and performance of the network as well as measures of the condition and serviceability of the assets. He has also proposed three licence modifications to enable him to monitor delivery of these outputs more effectively (these relate to regulatory accounts, the annual return and the appointment of independent reporters).

- 1.34 Although the next control period is intended to last for five years, the Regulator would generally expect Railtrack to be funded for the efficient cost of meeting additional obligations which are imposed upon it during this period (e.g. additional safety or environmental obligations). The Regulator would generally expect this to be achieved through an adjustment to the RAB at the next periodic review (e.g. he has proposed an automatic mechanism for adjusting the RAB to compensate Railtrack for any additional cost arising from his current investigation into broken rails).
- 1.35 In some cases, however, the short term impact on Railtrack's financial position may mean that charges need to be adjusted before the next review. The Regulator has therefore provided for the possibility of an interim review of access charges and he would expect Railtrack to make representations to the Regulator if it believes that there is a compelling case for such a review. The Regulator has also provided for specific interim reviews in a number of areas (e.g. relating to IOS enhancement schemes and modern facilities at stations).
- 1.36 The Regulator has set out the approach which he would expect to adopt for the next periodic review. In particular, he proposes to adjust the RAB to compensate for under- or overspend on train control systems. In other areas, he proposes to increase the RAB so that Railtrack retains the benefit from unanticipated efficiency savings for a period of five years (regardless of whether they are achieved at the beginning or end of the period). On the other hand, he would also expect to reduce the RAB in the event of significant underdelivery against the specified baseline outputs in these areas. This approach should therefore provide a clear incentive for Railtrack to deliver the baseline outputs as efficiently as possible.
- 1.37 Given this incentive based approach to the next periodic review, failure to deliver the expected levels of serviceability and condition or the assumed activity levels would not generally need to result in enforcement action. However, if the company is seen to be falling well short of the relevant targets, this may be an indicator of serious stewardship problems, necessitating immediate enforcement action. As indicated in the draft conclusions, Railtrack has provided constructive input towards defining the relevant targets and the Regulator has sought to define more precisely the circumstances in which action would be required (i.e. the meaning of "well short").

Enhancement framework

- 1.38 The Regulator expects enhancements to be remunerated at the assumed cost of capital of 8% real pre-tax. With regard to the project cost, he considers that the appropriate level of contingency will depend on the precise circumstances of the case.
- 1.39 The majority of schemes (by number) cost less than £100 million and the risks associated with these schemes should be relatively well understood. The Regulator considers that most of these schemes would not therefore justify contingencies in excess of 15% and that the appropriate level of contingency in each case should depend on the risk characteristics of the project.
- 1.40 By contrast, most of Railtrack's projected enhancement expenditure (by value) is on schemes worth more than £100 million and the Regulator considers that, where these schemes require enhancement to the operational railway, the level of risk is likely to be greater and more difficult to quantify. These schemes may therefore warrant a higher level of contingency. However, this is unlikely to exceed 25% except where the project represents a very large complex upgrade of an existing operational route or where Railtrack is committing to a fixed price at an early stage in the development of a project.
- 1.41 In either case, the Regulator would expect the required level of contingency to decline as Railtrack gains greater experience of enhancement projects.

Summary of Part III: West Coast Main Line enhancements

- 1.42 The Regulator has set out the way in which he proposes to establish milestones for delivery of the West Coast Route Modernisation (WCRM) in conjunction with the SSRA and Railtrack. Given the importance and the history associated with this project he has also set out the way in which he would expect to incentivise delivery of these milestones. If Railtrack fails to deliver a milestone it would be required to take remedial measures and may face penalties if it fails to implement these. However, these penalties may be added to the RAB when the outputs are delivered in full.

Summary of Part IV: Timetable and implementation

- 1.43 The Regulator has confirmed his draft conclusions that he must publish a review notice under the current contractual arrangements and a second review notice if the Transport Bill is enacted. He also confirms his view that the charges necessary to

implement the periodic review conclusions (as set out in this document) should be made from April 2001. However, if Railtrack appeals to the Competition Commission under the new arrangements in the Transport Bill, the Regulator's present view is that these charges should be implemented in April 2002 to minimise disruption to the industry.

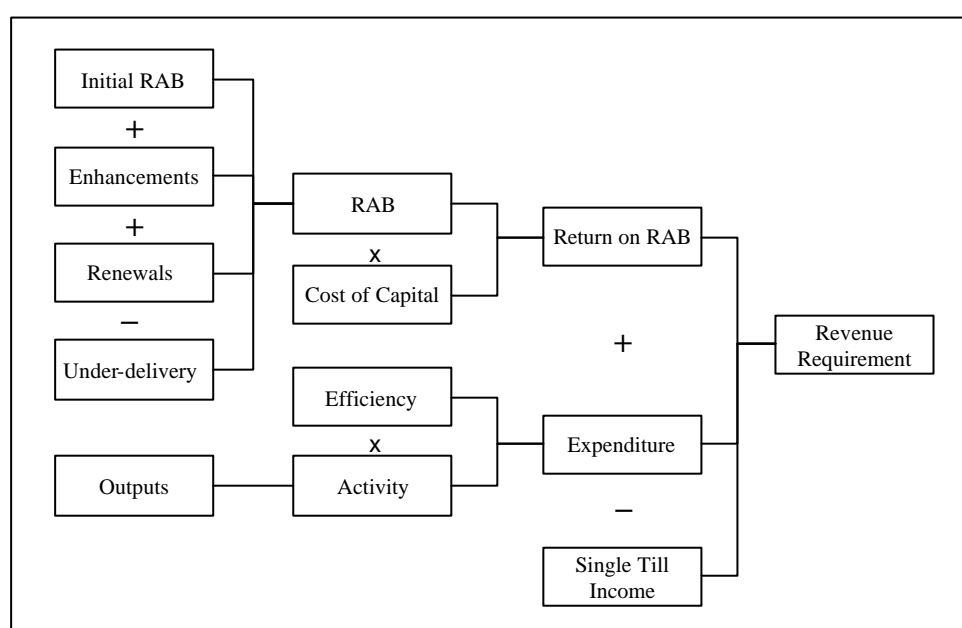
PART I:

REVENUE REQUIREMENTS

2. Methodology for resetting price controls

2.1 Railtrack and other respondents to the previous periodic review documents were broadly supportive of the methodology which the Regulator used to reach draft conclusions on the level of charges for the next control period (summarised in Figure 2.1 below). Some minor comments raised on the proposed methodology are discussed elsewhere in this document.

Figure 2.1: Revenue requirements



2.2 The draft conclusions also highlighted a number of issues relating to the proposed methodology for setting charges at the next periodic review. These relate to the treatment of renewals (pay-as-you-go versus capitalisation) and the treatment of unanticipated cost savings. Railtrack agreed that it is important for the Regulator to set out his views on these issues as part of the current periodic review. It also agreed that there should be a clear policy statement on the duration of the next control period and the circumstances in which an interim review might be required. These issues are discussed further in Chapter 8 and Chapter 16.

3. *Activity and expenditure*

Introduction

- 3.1 The draft conclusions provided for £15,784 million of operating, maintenance and renewal expenditure before efficiency and growth over the next control period. This compared with Railtrack's projection in the July 2000 cost submission of £16,765 million, a difference of £981 million. If Railtrack's figures are adjusted to take account of expenditure which the Regulator proposed to include in the RAB, this difference is reduced to £454 million.
- 3.2 In response to the draft conclusions, Railtrack accepted the proposed transfer to the RAB. However, it argued that the Regulator had made a number of inappropriate adjustments to its projections (e.g. relating to operating costs, maintenance and station renewals) and had misinterpreted the West Coast Route Modernisation (WCRM) figures as pre-efficiency (this issue is discussed in the following chapter). Finally, it identified £452 million of additional expenditure requirements which had not been fully quantified in earlier submissions. The difference between the Regulator's draft conclusions and Railtrack's position is therefore in excess of £1 billion before efficiency and growth (which is assumed to be self financing). Few other respondents commented in detail on the issues raised in this chapter.
- 3.3 The Regulator's detailed assessment of pre-efficiency expenditure requirements is set out in the draft conclusions and associated consultant reports. The Regulator also asked Booz Allen & Hamilton (BAH) to review Railtrack's response and a copy of their report is available on the ORR website. This chapter therefore provides a brief summary of the Regulator's views on the key issues raised by Railtrack.

Maintenance and renewals

West Coast Route Modernisation renewals

- 3.4 In addition to Railtrack's comments on the treatment of WCRM cost estimates as pre-efficiency (which are discussed in the following chapter), the company has expressed concern about the allocation of on-costs and the treatment of global risk. BAH have confirmed that the approach underlying the Regulator's draft conclusions in this area

is appropriate and the Regulator has not therefore made any change to these conclusions.

Non-WCRM renewals

- 3.5 Railtrack has accepted the Regulator's conclusions on the treatment of renewals expenditure on signalling, telecoms, track, electrification, plant and machinery and information systems. The Regulator therefore confirms that he has adopted these assumptions in formulating his final conclusions. As noted in the draft conclusions, this includes significant additional track renewals reflecting the consistent advice from BAH that the activity rates for renewal of key elements of the network were inadequate.
- 3.6 The Regulator's draft conclusions included Railtrack's projections for other asset renewals subject to clarification about the items of future expenditure which are included within this category. Railtrack has since acknowledged that these projections included £10 million for feasibility and lineside buildings which are covered elsewhere. However, it argued that there was a shortfall of £21 million in structures renewal and £105 million in stations renewal. BAH have concluded that Railtrack's arguments in relation to structures and stations do not justify any change in the assumptions underlying the Regulator's draft conclusions. He has therefore adopted the same assumptions for structures, stations and other assets in his final conclusions.

Maintenance

- 3.7 The Regulator's draft conclusions were based on projections in Railtrack's cost submission. However, it has now acknowledged that these projections were described incorrectly as being before any efficiency savings. The pre-efficiency costs were therefore understated by £121 million. In addition, BAH omitted £4 million of WCRM maintenance costs from the summary table in its report. The Regulator has therefore increased the pre-efficiency maintenance cost projections by £126 million to £3,346 million. BAH have advised that £20 million of this additional maintenance should be allocated to the West Coast Main Line.

Additional maintenance and renewals costs

- 3.8 In addition to the cost of installing TPWS, Railtrack's response to the draft conclusions identified an additional £52 million of maintenance cost and accelerated renewal and opex which had not previously been identified. However, BAH have

assessed a more appropriate provision for these costs to be £23 million and the Regulator has provided for this amount in his final conclusions. BAH have advised that £16 million of this amount is maintenance and the remainder is renewals spend.

- 3.9 Railtrack has also identified £13 million of accelerated renewal and additional operating expenditure arising from IOS schemes. However, the Regulator proposes to assess this new information as part of his review of IOS charges by around July 2001.

Operating expenditure

Base operating expenditure

- 3.10 Railtrack argues that the Regulator's draft conclusions underprovided for pre-efficiency operating expenditure by £243 million (including £100 million of unspecified contingencies). Following further discussion with Railtrack, the Regulator has provided for £112 million of this expenditure. This figure comprises adjustments to staff costs (£74 million) and other production/management costs (£38 million).

Insurance

- 3.11 Railtrack claimed that the increased incentive rates in Schedule 8 and the removal of the free possessions allowance in Schedule 4 would result in additional insurance costs of £24 million per annum over the next control period. This insurance provides cover against damage caused by severe events such as derailments, collisions, storms and floods.
- 3.12 The Regulator has allowed Railtrack's existing insurance costs. However, he does not propose to make any allowance for the increase in the cost of insurance due to the change in Schedule 8 rates. This is because these costs are already taken into account in the recalibration of the performance regime since the performance points (benchmarks) are based on historic data including such severe events. The impact of changes to Schedule 4 is discussed further below.

Implementation costs

- 3.13 The Regulator's draft conclusions stated that he was still considering the extent to which the cost of implementing the periodic review conclusions could be accommodated within the existing expenditure projections. Railtrack's response claimed that these costs would be around £46 million (£18 million of initial

implementation costs and £28 million of ongoing costs). However, from discussion with Railtrack it became apparent that these estimates were highly speculative. Railtrack argued that these costs should therefore be subject to further review, but the Regulator does not consider that this would be appropriate.

- 3.14 Most of the £18 million initial implementation costs relate to the cost of new information systems, data collection, legal and training costs. However, the Regulator believes that the cost of these systems should be relatively low if managed as part of the overall IS programme for which the Regulator has allowed £336 million of expenditure before efficiency over the next control period. In addition, he believes that these systems and the associated data would generally be required for the efficient operation of the business and should therefore be covered by its existing system development plans. Finally, due to the increasing liquidity of the energy trading markets, he rejects Railtrack's argument that the cost of procuring electric traction will be increased as a result of Railtrack's inability to procure electricity efficiently in the light of the potential introduction of competition. He has not therefore made any further allowance for these costs.
- 3.15 The Regulator proposes to accept most of the additional ongoing costs identified by Railtrack. These relate to the administration of the new reporting and regulatory accounting requirements, the new charges, and the revised performance and possessions regime (e.g. additional delay attribution costs). However, he has removed some elements of apparent double counting or overstatement of these costs (e.g. annual Schedule 8 audit costs and administration costs associated with changes to access charges). He has therefore provided for £5 million per annum of additional costs. He also considers that there is significant potential for reductions in these costs as Railtrack gains experience with the new system and he therefore proposes to apply the efficiency savings discussed in the following chapter.

Written off project development costs

- 3.16 Railtrack argued that the proposed allowance of £50 million for written off project development costs was inadequate and proposed that this should be increased to £86 million. However, given the RAB adjustment mechanism described in Chapter 16, the Regulator has retained the allowance in the draft conclusions.

Performance

3.17 The increased performance incentives described in Chapter 10 result in higher costs to Railtrack as a result of delay to passenger operators caused by freight and other non-franchised operators. The SSRA has accepted that these costs arise from its policy decisions on the societal value of delay to passenger trains. It has therefore agreed that these costs could be reflected in the fixed charges to franchised passenger train operators. Changes in these charges are passed on to the SSRA under the terms of its franchise agreements. The projected cost of £13 million a year has therefore been included in the Regulator's assumptions about operating costs. He has also included an average cost of £3 million a year to allow for the expected cost of Railtrack's responsibility for payments under the passenger's charter. As discussed in Chapter 16, the impact of growth on the cost to Railtrack of this delay will be taken into account in the RAB at the next periodic review.

Possessions

3.18 Railtrack argued that the draft conclusions made inadequate allowance for possessions compensation. However, given the interim review provisions set out in Chapter 16, the Regulator has retained the allowance of £205 million in his draft conclusions.

Conclusions

3.19 Table 3.1 shows the adjustments which the Regulator has made to the draft conclusions. These resulted in additional operating, maintenance and renewals expenditure of £366 million over the next control period before efficiency and growth. Table 3.2 illustrates the implications for the overall level of expenditure and shows that, on this basis, the Regulator's allowed expenditure is £804 million less than the amount claimed by Railtrack. Table 3.3 summarises the resulting expenditure profile by year and more detailed projections by asset category are provided in Appendix C.

3.20 Figures 3.1 and 3.2 provide a graphical illustration of the projected profile of expenditure over the next two control periods. As emphasised in the draft conclusions, the first graph highlights the fact that the main source of additional expenditure is in train control systems. Similarly, the second graph shows that the expected increase in expenditure can be attributed largely to the WCRM. These graphs also illustrate the fact that, if the assumed level of renewals activity is delivered over the next control period, there should be a significant decline in expenditure in the third control period.

Table 3.1: Adjustments to draft conclusions (pre-efficiency)

1998/99 £ million	Additional expenditure in second control period
Maintenance costs	126
TPWS	23
Operating costs	112
Implementation costs	25
Performance	81
Total	367

Table 3.2: Expenditure projections for control period 2 (pre-efficiency)

1998/99 £ million	ORR July	Railtrack	ORR October
WCRM			
<i>WCRM renewal</i>			
Track	692		692
Train Controls	1,744		1,744
Electrification	176		176
Structures	123		123
Total	2,735	2,795	2,735
<i>WCRM maintenance</i>	415	435	435
Non-WCRM			
<i>Non-WCRM renewal</i>			
Track	1,489	1,489	1,489
Train Controls	1,972	1,972	1,980
Electrification	235	235	235
Structures	819	840	819
Stations & Depots	567	672	567
Plant & Machinery	100	100	100
IS	336	336	336
Other Assets	25	15	25
Total	5,543	5,659	5,551
<i>Non-WCRM maintenance</i>	2,790	2,894	2,911
Opex			
Controllable	2,791		2,928
Non-controllable	1,510		1,591
<i>Total Opex</i>	4,301	5,172	4,519
<i>Total renewal</i>	8,278	8,454	8,286
<i>Total maintenance</i>	3,205	3,329	3,346
Total Maintenance, Renewal & opex	15,784	16,955	16,151

Table 3.3: Annual expenditure projections (pre-efficiency)

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	CP2 Total
WCRM						
Renewals	687	620	620	548	259	2,735
Maintenance	73	81	88	95	97	435
Non-WCRM						
Renewals	1,077	1,114	1,112	1,124	1,125	5,551
Maintenance	591	591	584	578	567	2,911
Opex						
Controllable	560	588	587	592	601	2,928
Non-controllable	317	320	318	317	320	1,591
Total						
Renewals	1,764	1,734	1,732	1,672	1,384	8,286
Maintenance	664	672	672	672	664	3,346
Opex	876	908	905	909	921	4,519
Total M,R&O	3,304	3,314	3,309	3,254	2,970	16,151

Figure 3.1: Maintenance, renewal and operating expenditure by asset

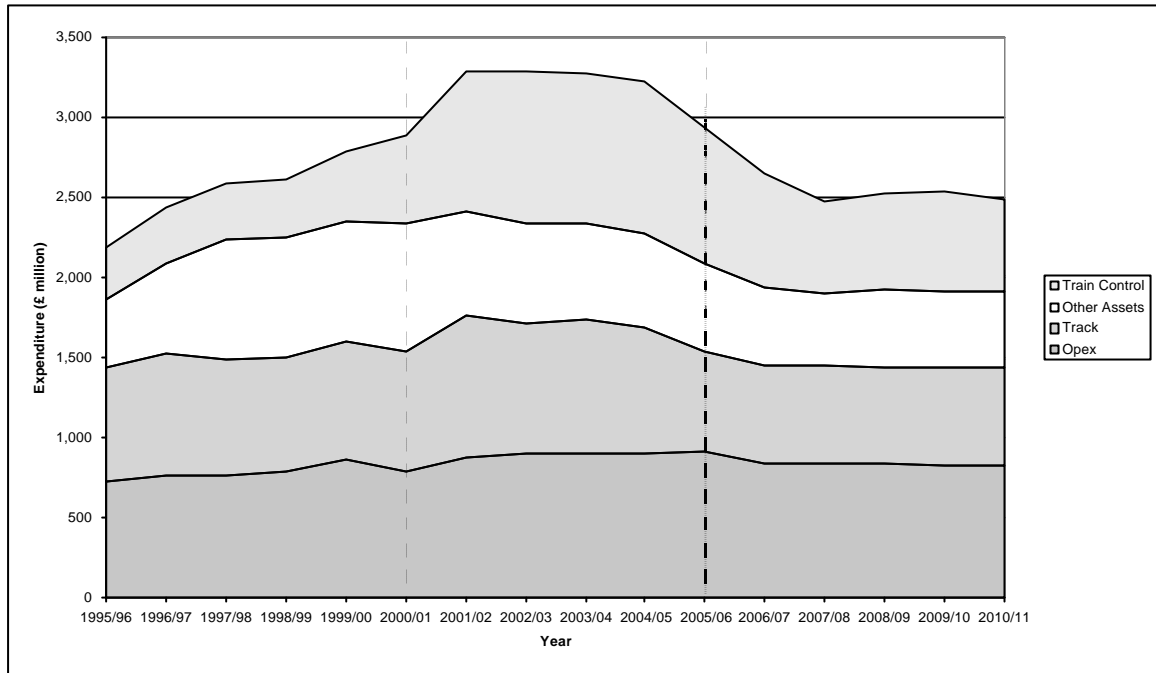
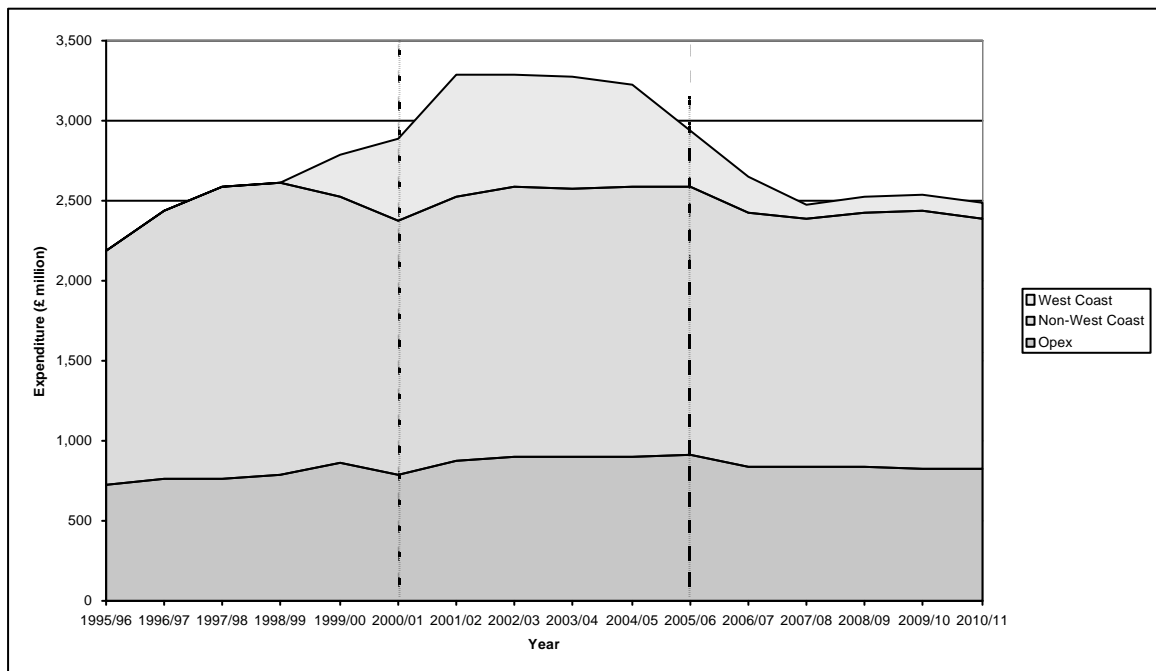


Figure 3.2: West Coast and other expenditure



4. *Efficiency*

Introduction

4.1 The July 2000 draft conclusions on the periodic review concluded that, over the next control period as a whole, Railtrack should be able to achieve efficiency savings towards the top end of the 3-5% range referred to in the December 1999 periodic review document. This assessment was based on bottom-up assessments of the potential for efficiency savings (including a review of contracting strategy and evidence of international best practice), comparisons with other privatised industries, comparisons with the assumptions made by other regulators, and benchmarking of productivity trends in other railways.

4.2 However, the Regulator emphasised that it is important to set the efficiency target so that:

- the resulting cost levels are achievable having regard to Railtrack's current position and the need to achieve savings in a manner which is sustainable without compromising the required outputs;
- Railtrack is incentivised to outperform the assumed efficiency savings by being allowed to retain the benefits for a period of years; and
- it is not unduly difficult for Railtrack to finance its relevant activities.

4.3 Given this, the Regulator indicated that he was minded to assume annual efficiency savings which average around 4% per annum on all controllable costs from the current year to the end of the next control period. He also stated that he was still considering whether this rate of efficiency saving should be applied from 1999/00 which represents the date of the last audited accounts. However, he accepted that there is likely to be less scope for savings in the early years of the next control period.

4.4 The Regulator's draft conclusions therefore assumed savings of 3% in the first year of the next control period, followed by 4% per annum for the next two years and 5% per annum for the last two years. This implied an average rate of cost reduction of 4.2%. In present value terms, however, this is equivalent to a constant annual improvement of 3.8%.

4.5 In response, Railtrack argued that the Regulator had not found any convincing justification for the proposed efficiency target and that there was compelling evidence for a lower target. In particular, it argued that:

- the broad range of top-down evidence supports a regulatory target in the 2-4% range, rather than the 3-5% range used by the Regulator;
- differentiating factors mean that Railtrack's path of efficiency change will always be flatter than its comparators and that an appropriate target would be at the bottom end of the range which emerges from comparisons with other industries;
- evidence from the bottom-up analysis of commitments already made indicates that 40% of Railtrack's controllable expenditure in the next control period is non-compressible; and
- the cost plan for the West Coast Route Modernisation (WCRM) has been developed assuming higher levels of efficiency than are generally currently achieved within Railtrack and that further efficiencies are not achievable.

4.6 Several infrastructure contracting companies and the Railway Industry Association provided strong support for Railtrack's view that the assumed rate of saving was unachievable and suggested that this would squeeze margins. Some train operating companies also argued that the assumed efficiency savings may be too demanding and that this could damage investment in the industry or detract from other initiatives such as improved performance. Other operators supported the Regulator's proposals and English Welsh and Scottish Railways (EWS) provided detailed analysis in support of its view that the Regulator's proposed efficiency targets understated the potential savings. EWS also supported the use of 1999/00 as the starting point for the assumed efficiency savings (rather than the current year).

4.7 The Regulator's detailed assessment of the potential for improved efficiency is set out in the December 1999 and July 2000 periodic review documents. These views are supported by independent reports from three separate sets of consultants. These documents address most of the specific issues raised by respondents in some detail. This chapter therefore provides a brief summary of the Regulator's views on the key issues raised by respondents, with particular emphasis on new arguments or issues.

Top-down evidence

4.8 The Regulator does not accept Railtrack's view that he has placed undue weight on selected pieces of evidence. In particular, he notes that:

- contrary to the assertion made by Railtrack, the Regulator's proposed range of 3-5% per annum is consistent with OFGEM's recent statement that the results of top-down analysis supports the range of 2.8-3.8% which emerged from its bottom-up assessment of NGC. For example, NGC has been in the private sector for twice as long as Railtrack and the easy savings are more likely to have been achieved;
- other regulators have assumed efficiency savings well in excess of 3% for relatively inefficient companies. Railtrack has acknowledged that it had not focussed on improved efficiency during the first control period, but said that a number of new initiatives are now being developed;
- substantial savings have been achieved in gas as well as electricity transmission and distribution, and the lower savings of 3% per annum achieved in the water sector may reflect the greater increases in quality standards and the lower competitive pressure (the Regulator has made separate allowance for the cost of increased quality);
- the evidence from international benchmarking, nature of work comparisons and academic privatisation literature (in mainly competitive and non-infrastructure businesses) does not take account of the potential for catch-up efficiency savings which have been achieved by other utilities; and
- the Regulator has emphasised the fact that his proposed efficiency assumptions relate to the unit cost of achieving specified outputs rather than the total level of expenditure since this also depends on the level of activity.

4.9 The Regulator therefore remains of the view that this evidence supports efficiency savings which average 3-5% per annum on all controllable costs to the end of the next control period.

Differentiating factors

- 4.10 Railtrack has argued that there are a number of differentiating factors which indicate that it will only be able to achieve savings towards the bottom end of the range achieved by its closest comparators. It argues that the most important of these differentiating factors is the impact of relative price inflation arising from the volume of activity on the network and the resulting constraints in the supply market. In particular, Railtrack has referred to independent forecasts which indicate that real construction prices are expected to increase by around 2% in the current year and an average of 1% per annum over the next control period. Several contractors also referred to supply industry constraints causing upward pressure on unit costs. However, other independent forecasters have predicted real price reductions following the short term increase.
- 4.11 The Regulator accepts that, given the likely level of activity in this sector, there is a risk of real price increases which were not taken fully into account in the draft conclusions. Moreover, he considers that this risk is likely to be greatest over the next few years since the potential supply constraints are likely to arise partly from the period of relatively low activity in the industry in the first control period as well as Railtrack's historic supply chain management over this period. He has therefore adjusted the assumed efficiencies in his draft conclusions to take account of this risk.
- 4.12 Railtrack also reiterated its earlier arguments relating to the other factors which differentiate it from similar infrastructure companies (e.g. relating to complexity, safety case approval, the proportion of work outsourced and increased investment activity). These issues were discussed and considered in the draft conclusions and the Regulator does not believe that any further allowance is required to adjust the assumed efficiency savings for these other factors.

Bottom-up analysis

- 4.13 Railtrack argues that 25% of costs are already committed and are included in Railtrack's base projections. It also claims that a further 15% of costs are included in the base projections with all efficiencies included. Once these costs are excluded, it therefore argues that only 60% of the cost base is "compressible" in the next control period and that the Regulator's proposed efficiency assumptions imply savings of around 6% a year on these costs. As noted above, some contractors supported this argument.

- 4.14 However, the Regulator considers that Railtrack has overstated the extent to which costs are committed – for example Booz Allen & Hamilton (BAH) argue that only some 8% of Railtrack's controllable costs in the second control period can be regarded as “non-compressible” in the way that Railtrack has described. These costs relate to maintenance and renewal costs over the next 24 months. In any case, Railtrack has argued that its contracting process is efficient and the Regulator considers that there is therefore no reason why these contracts should not deliver similar savings to those observed in comparable situations.

West Coast Route Modernisation

- 4.15 Railtrack claims that the cost plan for the WCRM has been developed using higher levels of efficiency than are generally currently achieved within Railtrack. It argues that it is not therefore possible to achieve further savings on this cost estimate. Railtrack asserts that the Regulator's treatment of these costs must be a mistake since his consultants have been closely involved in the joint project team (JPT) review of the WCRM.
- 4.16 However, the BAH report on WCRM and the Regulator's June 2000 periodic review document explained why the JPT figures should be treated as before efficiency. Indeed, BAH argued that Railtrack should be able to achieve savings on these costs which are significantly greater than the assumed savings in the July 2000 periodic review document.

Conclusions

- 4.17 The Regulator remains of the view that there is substantial scope for improved efficiency. Since the publication of his draft conclusions, however, he has given further consideration to the risk that real input prices faced by Railtrack will increase over the next few years due to the increased activity in the construction sector. In particular, he recognises that the rate of investment in enhancements to the railway is likely to put significant upward pressure on Railtrack's costs (e.g. because of labour shortages and increased contractor margins). This will tend to reduce the net cost reductions which can be achieved in the short term as a result of improved working practices and other efficiency improvements.
- 4.18 The Regulator also indicated in his draft conclusions that he intended to consider further whether the assumed rate of efficiency improvement should be applied from 1999/00 rather than from the current year. Railtrack argues that this would amount to

clawback of efficiencies which are achieved in the current period. This is incorrect. In order to predict the level of expenditure in 2001/02 onwards, the Regulator has taken account of the most recent available data and it is clearly necessary to roll this forward taking account of efficiency savings since this base data was compiled. In the case of controllable operating expenditure (20% of controllable expenditure), the base data relates to the current year's budget, which is consistent with the approach adopted in the draft conclusions (although it can be argued that it would be more appropriate to rely on the previous year's audited operating expenditure). Maintenance costs (22% of controllable expenditure) are also based on current contracted rates. By contrast, the unit cost assumptions underlying most renewals expenditure (58% of controllable expenditure) are based on the contractual payment rates from earlier years. This implies that the assumed rate of efficiency improvement for these costs should be applied from these earlier dates. Alternatively, if efficiency savings are only applied from the current year, this should mean that a higher average rate of efficiency improvement would be achievable.

- 4.19 In the light of these considerations, and the other factors referred to in paragraph 4.2, the Regulator has reduced the assumed efficiency savings underlying his draft conclusions. His final assessment of Railtrack's revenue requirements is based on savings of 2% in the first year, 3% in the second year, 4% in years three and four and 5% in the final year of the next control period. This implies underlying efficiency improvements of 17% by the end of the period and total efficiency savings of 8% over the period as a whole.
- 4.20 Table 4.1 compares the effect of these assumptions with the assumptions underlying the draft conclusions. The first column shows that the simple average annual efficiency improvement is reduced from 4.2% to 3.6%. However, the second column shows that the equivalent constant annual efficiency improvement is reduced from 3.8% to 3.1%. This is the constant annual rate of efficiency improvement which yields the same present value of the overall expenditure projections. It is therefore comparable with the flat 2% improvements proposed by Railtrack, the assumptions made by other regulators and the achievement of Railtrack's closest comparators. The final column shows that the equivalent constant annual rate of efficiency improvement on a 1999/00 base is reduced from 2.8% to 2.3% which is only slightly higher than Railtrack's proposed assumption.
- 4.21 Table 4.2 and Figure 4.1 below illustrate the resulting impact on the projected level of maintenance, renewal and operating costs for the next control period (assuming zero

growth). The total expenditure of £14,874 million is £618 million more than was assumed in the draft conclusions but over £1 billion less than claimed by Railtrack.

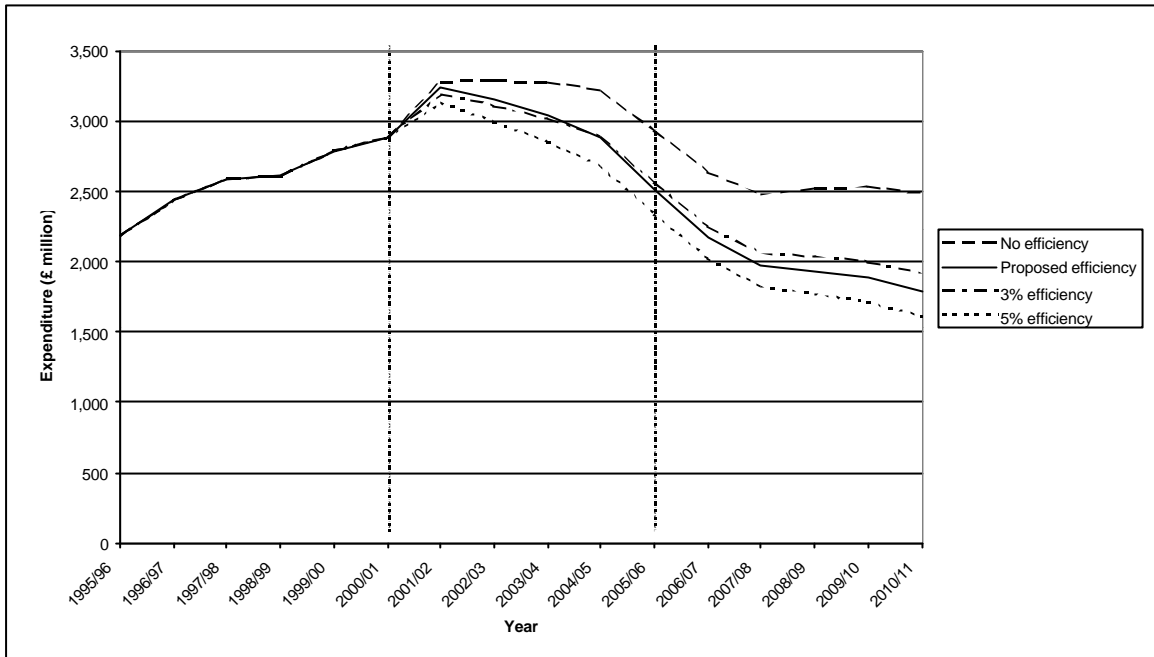
Table 4.1: Annual efficiency assumptions

	Simple average	Constant equivalent from 2000/01 base	Constant equivalent from 1999/00 base
July 2000 draft conclusions	4.2	3.8	2.8
October 2000 final conclusions	3.6	3.1	2.3

Table 4.2: Expenditure projections (constant traffic)

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	CP2 Total
WCRM						
Renewals	673	589	566	480	216	2,524
Maintenance	72	77	81	83	81	394
Non-WCRM						
Renewals	1,055	1,059	1,015	985	936	5,049
Maintenance	579	562	533	506	472	2,652
Opex						
Controllable	548	559	536	519	500	2,662
Non-controllable	317	320	318	317	320	1,592
Total						
Renewals	1,729	1,648	1,580	1,465	1,152	7,573
Maintenance	651	639	614	589	553	3,046
Opex	865	879	854	836	821	4,254
Total M&R	3,245	3,166	3,048	2,890	2,525	14,874

Figure 4.1: Expenditure projections (constant traffic)



5. Cost of capital and financial indicators

Introduction

- 5.1 Chapter 4 of the December 1999 periodic review document highlighted the need for consistency with the approach to the cost of capital which has been adopted by other regulators. With regard to the general cost of capital assumptions (the risk free rate and the equity risk premium), the Regulator therefore adopted values which were consistent with the approach adopted by other regulators. With regard to the company specific assumptions (gearing, debt premium, and equity beta), he focussed on the extent to which the underlying risks faced by Railtrack are different from those faced by other regulated network businesses.
- 5.2 Given this approach, the Regulator identified a range of 5.9-7.9% for the pre-tax real weighted average cost of capital. In the light of the uncertainty relating to the level of the risk free rate and the need for the Regulator to be confident that the rate of return would be sufficient to enable Railtrack to raise new finance without undue difficulty, the Regulator indicated that he intended to assume a value towards the top end of his assumed range. His provisional conclusion was that the appropriate value for the real pre-tax cost of capital was in the range 7.0-7.5%. He pointed out that this is 0.5-1.0% higher than the value proposed by OFGEM on the same basis for electricity distribution. This difference reflects differences in the underlying risks of the businesses and the need for Railtrack to raise substantial new finance, including new equity.
- 5.3 The remainder of this chapter discusses the following issues before setting out the Regulator's conclusions on the cost of capital:
- the implications of the recent Competition Commission reports on the Mid Kent Water Plc and Sutton and East Surrey Water Plc;
 - the impact of Railtrack's risk profile on its cost of capital, including the impact (if any) of the periodic review and the model clauses for track access charges; and
 - the cost of new and existing debt.

Competition Commission conclusions

5.4 The Regulator's provisional conclusions indicated that, if any of the water or electricity distribution price controls were referred to the Competition Commission, his final conclusions on the cost of capital would have regard to the conclusions from these inquiries. Subsequently, Mid Kent Water Plc and Sutton and East Surrey Water Plc were referred to the Competition Commission. The Commission's reports were published on 13 September 2000 and the implications for the Regulator's assumptions on the generic cost of capital issues are discussed below. In assessing these issues, however, it must be recognised that the individual components of the cost of capital calculation can only inform the judgement on the cost of capital. Similarly, the assumed cost of capital is only one element of the overall package which makes up the final settlement in a charges review.

Risk free rate

5.5 The December 1999 periodic review document assumed a range of 2.25-3.0% for the real risk free rate. Although this was based on recent evidence on gilt yields, the Regulator noted that this range was substantially higher than the current real yield on index-linked gilts.

5.6 The Competition Commission concluded that there are specific UK liquidity related issues which have tended to reduce these yields (e.g. arising from the increasing maturity of UK pension funds and the low UK government borrowing). It argued that in assessing the risk-free rate relevant to the cost of equity, it is appropriate to adjust gilt yields for these liquidity factors (since they obviously do not affect the cost of equity). In conclusion, it considered a range of 2.75-3.25% and used the middle of this range, 3%, in assessing the cost of equity.

5.7 This compares with the range of 3.5-3.8% in the MMC report on Cellnet and Vodaphone in 1998. In addition, the Regulator agrees with OFGEM's view that the longer the present relatively low yields on index-linked and conventional gilts persist, the more persuasive becomes the argument that these lower yields are not simply a feature of shorter term market conditions.

5.8 Adopting the value proposed by the Competition Commission would increase the estimated cost of capital by 0.46% compared to the mid-point referred to in the provisional conclusions.

Equity risk premium

- 5.9 The December 1999 periodic review document assumed a range of 3.25-3.75 for the equity risk premium.
- 5.10 The recent Competition Commission report indicated that the historical average premium may overstate the current premium if returns on gilts and Treasury Bills have been depressed by factors such as unanticipated inflation and exchange controls and that investors in the second half of the twentieth century may have enjoyed higher than expected returns. It also pointed out that the main argument against using historical data is that the current equity premium may now be lower than in the past, for instance due to diminished risk of the underlying cash-flows associated with equity investment or increased appetite for risk among investors. It concluded that the best estimate of the equity risk premium was 4%, noting that this was somewhat below the historical average but above the current estimates of market expectations.
- 5.11 This compares with the ranges of 3.5–5.0% in the MMC report on Cellnet and Vodaphone. In addition, the Commission notes that the longer that equity valuations remain high, the more confidence it is possible to have that the equity risk premium is lower than the historical average.
- 5.12 Given the central beta estimate of 1.2, the assumed gearing of 50% and the proposed tax wedge of 1.43 referred to in December 1999, adopting the value proposed by the Competition Commission would increase the estimated cost of capital by 0.43% compared to the mid-point referred to in the provisional conclusions.

Tax wedge

- 5.13 The December 1999 periodic review document proposed a pre-tax measure of the cost of capital. This included a tax wedge of 1.43 based on a marginal tax rate of 30%.
- 5.14 By contrast, the Competition Commission report treated tax as a cost and did not therefore take account of the tax shield on debt. For comparability purposes, the report also presented estimates of the pre-tax cost of capital based on an effective tax rate of 20% derived from its financial modelling of the companies.
- 5.15 Railtrack's effective tax rate is expected to be close to zero over the next control period. Although this is partly attributable to enhancement projects which fall outside the scope of the periodic review, the effective tax rate associated with the relevant

measure of profits on the baseline network is still likely to be significantly less than 30%. An effective tax rate of 20%, for example, would reduce the cost of capital by around 0.7%, offsetting most of the impact of the other adjustments referred to above.

- 5.16 Using the current effective tax rate, this approach would, in principle, imply a higher pre-tax rate in future if and when the effective tax rate increases. In addition, Railtrack argues that the tax wedge adjustment proposed in December 1999 is the most accurate representation of the tax liabilities associated with marginal investment projects over the full life of the assets (although this ignores the benefit from accelerated tax allowances). It therefore argues that this approach should be retained because the cost of capital should be set in such a way as to ensure that the business can raise the necessary finance for these marginal investment projects.

Railtrack's risk profile

Base rate of return

- 5.17 The December 1999 periodic review document assumed that Railtrack's equity beta was equal to 1.1 to 1.3 based on 50% gearing and assuming that the structure of charges is broadly cost reflective. Due to the identified differences in risk (particularly the high level of operational gearing), this is 0.1 to 0.3 (i.e. 10% to 30%) higher than the comparable betas assumed by OFGEM for electricity distribution and by the Competition Commission for water and sewerage.
- 5.18 Railtrack updated the beta estimates provided by the Regulator in the December 1999 periodic review document and confirmed that these do not differ significantly from the estimates which led the Regulator to conclude that a range of 1.1 to 1.3 would be appropriate for Railtrack going forward. However, it argued that the lower end of this range should be adjusted upwards since the move to more cost reflective charges means that backward looking evidence should provide an absolute lower bound on the assumed beta. It also argued that it was not unreasonable to assume that the premium of Railtrack's beta over traditional regulated utilities (excluding BAA) would double from its historical range of around 0.1-0.2 due to the introduction of more cost reflective charges. Finally, it pointed out that up to date estimates of BAA's beta fall in the range 1.2 to 1.45, which is higher than the range assumed by the Monopolies and Mergers Commission (MMC) four years ago.
- 5.19 As indicated in the December 1999 periodic review document, the Regulator believes that considerable caution is required in interpreting statistical evidence on equity

betas. For example, comparisons with BAA need to take account of the fact that only around a quarter of its income derives from regulated airport and traffic charges. CAA's April 2000 consultation paper on NATS also indicated that recent evidence on BAA's beta was consistent with the MMC's earlier conclusions. A significant degree of judgement is therefore required. Having considered the responses to his December 1999 and July 2000 periodic review documents, the Regulator remains of the view that the proposed range for the equity beta provides sufficient allowance for the risks which Railtrack would face under a broadly cost reflective charging structure.

- 5.20 Railtrack argues that the introduction of a volume incentive would serve to increase its exposure to non-diversifiable risk and therefore its cost of capital. The Regulator has acknowledged that a symmetric volume incentive (where the potential upside was broadly equal to the potential downside) would need to be reflected in the assumed cost of capital. However, the proposed volume incentive will only result in a reduction in the post-2006 RAB if there is an absolute decline in volume over the next five years. The Regulator therefore considers that there is no material downside risk to the company and that the volume incentive does not necessitate any adjustment to the proposed range for Railtrack's equity beta.

Impact of model clauses for track access agreements

- 5.21 The Regulator has published provisional conclusions on model clauses for track access agreements and has invited Railtrack to quantify its view of the additional costs and risks (if any) associated with these clauses.
- 5.22 Railtrack's response welcomed any proposal which clarifies the respective obligations of the relevant railway industry parties. However, it argued that the model clauses initiative risks going far beyond the clarification of the parties' existing liabilities, and would appear to involve a shift in the balance of risk under the existing track access agreements to the disadvantage of Railtrack. It has also expressed concern that some aspects of the model clauses proposals may lead to a litigation culture which will reduce the level of industry cooperation. The Regulator does not accept that strong and clear contracts will result in a litigation culture. Indeed he considers that the opposite is true since all parties will have a better understanding of their rights and obligations enabling them to achieve delivery without resort to legal action.
- 5.23 Railtrack argues that there should be no shift in the balance of risk without corresponding recognition in its financial framework as part of the periodic review.

The Regulator agrees that the cost to an efficient operator of additional risks arising from the introduction of new liability arrangements would generally need to be paid for by Railtrack's customers and funders. Railtrack has accepted the principle that the need for any change in revenues should be assessed in terms of the change in costs which an efficient operator would expect to incur as a result of the introduction of model clauses. It would therefore need to take account of the probability that an efficient operator would incur liability under the contract, including damages for breach.

- 5.24 The Regulator considers that there is no evidence that this risk is systematic and market related and, since the cost of capital does not allow for these types of risk, any change in risk would need to be reflected in allowed operating costs rather than the allowed rate of return. There is therefore no need for any adjustment to the range of equity betas referred to above.
- 5.25 More fundamentally, the Regulator believes that it is better to make an adjustment to track access charges (if any) on a case-by-case basis when the new liability arrangements are introduced, rather than as part of the periodic review. This is because the impact on the financial position of the parties is likely to depend on the scope of the agreements in question (e.g. whether they provide for major enhancement or access to existing capacity), the way in which model clauses are used (e.g. the precise level of any negotiated caps on liability) and the date on which the new terms are introduced (e.g. they may be introduced in conjunction with the franchise replacement process). Given this, it is not possible, at this stage, to provide a meaningful estimate of any additional costs which might arise as a result of model clauses. Moreover, to do so would undermine the incentives of the parties since they would prefer to minimise their exposure to risk without regard to the pricing implications.
- 5.26 The Regulator's final conclusions on model clauses will therefore set out the way in which he would expect track access charges to be adjusted (if at all) when these clauses are introduced. This adjustment will depend partly on the Regulator's guidelines on the appropriate caps on liability as well as his final conclusions on the treatment of force majeure. This would therefore ensure that the charges are consistent with the allocation of risk underlying the model clauses but would not prevent the parties from proposing an alternative allocation of risk provided that this is justified and reflected in the level of charges.

Cost of debt

5.27 The December 1999 periodic review document assumed a debt premium of 1.2% to 1.5% over the risk free rate. Given the central value for the risk free rate adopted by the Competition Commission, this implies a real cost of debt of 4.2% to 4.5%. Assuming inflation of 2.5%, this translates into a nominal cost of debt of 6.7% to 7.0%.

5.28 By comparison, Railtrack has argued that the nominal cost of debt in the next five year period is likely to rise above 7.0% and has proposed a range of 7.0% to 7.25%. This is based on:

- a weighted average yield of 6.74% on Railtrack's existing portfolio of fixed rate debt;
- yields of approximately 7.1% on Railtrack's five year debt;
- an up to date estimate of the yield on an existing portfolio of sterling debt with longer term maturities of 6.8% to 6.9% (although in recent months they have been as high as 7.0% to 7.1%); and
- the need to place new debt at a premium to existing bonds and to raise a substantial proportion of new debt from foreign markets where yields are higher than the sterling markets by between 10 and 20 basis points.

5.29 The Regulator recognises these arguments. In particular, he agrees that it is important to examine the overall forward looking cost of debt (rather than considering the risk free rate and the debt premium in isolation) having regard to the impact of gearing. He therefore proposes to adopt a range of 4.5% to 4.75% for the real cost of debt. This implies a premium of 1.5% to 1.75% over the assumed risk free rate.

Conclusions on the cost of capital

5.30 Table 5.1 below illustrates the implications for Railtrack's cost of capital of the assumptions discussed above. The first two columns reproduce the Regulator's provisional conclusions from the December 1999 periodic review document. The third and fourth columns combine the Competition Commission's central estimates for the risk free rate and the equity premium with the Regulator's proposed range of assumptions for the debt premium, the equity beta and the tax wedge. These

adjustments have little impact on the upper end of the range proposed by the Regulator (which increases from 7.9% to 8.2%). By contrast, the lower end of the range is increased significantly (from 5.9% to 6.9%). Using the Competition Commission's ranges for the risk free rate and the equity risk premium (rather than their central estimates) to assess the cost of equity results in a wider range.

Table 5.1: Illustrative cost of capital calculations

	December 1999 provisional conclusions		October 2000 based on Competition Commission central values	
	Low	High	Low	High
Cost of debt				
Risk free rate	2.25%	3.0%	3.0%	3.0%
Debt premium	1.2%	1.5%	1.5%	1.75%
Pre-tax cost of debt	3.5%	4.5%	4.5%	4.75%
Cost of equity				
Risk free rate	2.25%	3.0%	3.0%	3.0%
Equity risk premium	3.25%	3.75%	4.0%	4.0%
Equity beta	1.1	1.3	1.1	1.3
Post-tax cost of equity	5.8%	7.9%	7.4%	8.2%
Tax adjustment	1.43	1.43	1.25	1.43
Pre-tax cost of equity	8.3%	11.3%	9.3%	11.7%
Gearing	50%	50%	50%	50%
WACC pre-tax	5.9%	7.9%	6.9%	8.2%

5.31 Following publication of the Competition Commission report, Railtrack made a further submission to the Regulator. Although Railtrack's view of the cost of debt is in line with the range proposed by the Regulator, its assessment of its beta, and hence the cost of equity, is significantly higher than he has assumed. It also argues that the Regulator's previous approach to the tax wedge remains appropriate. Given this, it concludes that the appropriate range for the cost of capital is 8.1% to 8.7% and that the Regulator must set a cost of capital of at least 8.1% for the next five years. Before the publication of the Competition Commission report, Railtrack had argued that the Regulator should at least adopt a value at the top of the 7.0% to 7.5% range, which he published in December 1999.

5.32 In considering the appropriate value for the cost of capital, the Regulator has discharged his duties including the duty not to make it unduly difficult for Railtrack to finance its relevant activities. He has therefore had due regard to the scale of the

investment programme which Railtrack is expected to undertake and the need to raise substantial new debt and equity finance in order to deliver this investment. As indicated in December 1999, he considers that these factors mean that the allowed rate of return should be set towards the top end of his estimated range for the cost of capital. His final conclusions on Railtrack's revenue requirements as part of the periodic review therefore assume a real pre-tax rate of return of 8%.

- 5.33 As explained in Chapter 17, the Regulator would expect the same rate of return to be applied to enhancements which fall outside the scope of the periodic review (except where Railtrack takes an element of demand risk) since construction and delivery risks should be factored into the estimated capital cost.

Financial indicators

- 5.34 The draft conclusions confirmed the Regulator's view of the critical values for the key financial ratios which are relevant to his assessment of Railtrack's ability to finance its relevant activities. These ratios are reproduced in Table 5.2 below. The Regulator considers that the key ratios are the EBIT interest cover and the FFO interest cover since these ratios are likely to have most significance to investors.

Table 5.2: Constraints on relevant financial indicators

	ORR	OFWAT	OFGEM
EBITDA interest coverage	Min 3x	Min 3x	Min 2.25x
EBIT interest coverage	Min 2x		Min 1.5x
FFO interest coverage	Min 3x		Min 2x
FFO to total debt	Min 15%		Min 12%
Cashflow to capex ratio	Min >40%	Min 40%	

- 5.35 Railtrack did not comment on these values, but argued strongly that a cushion should be applied to these critical values in assessing the financeability of different projected outcomes. In particular, it argued that that the ratios were in danger of being reduced to an unfinanceable level as a result of adverse shocks to the business and that a cushion of around 0.25 was required over the stated interest cover ratios.

- 5.36 In response to these arguments, the December 1999 periodic review document indicated that the Regulator was minded to assess his proposals against the relevant

financial indicators that would be required to maintain a flat A rating (although many respondents had argued that a rating of A- would be reasonable). The draft conclusions indicated that the Regulator had discussed these issues with relevant financial institutions and that he was not convinced a further cushion was necessary.

- 5.37 The Regulator remains unconvinced that a further cushion is necessary in the long term. In finalising his conclusions for this review, however, he has examined the extent of headroom over these critical values and this issue is therefore discussed further in Chapter 8.

6. *Regulatory Asset Base*

Introduction

6.1 The July 2000 periodic review document concluded that the Regulatory Asset Base (RAB) for the beginning of the next control period should be set at £5.11 billion (compared with Railtrack's proposal of £6.86 billion). This value includes:

- an uplift of 15% on the first day trading value of equity - this is at the top end of the 10-15% range proposed in December 1999 and implies an initial value of £3.04 billion;
- backlog renewals of £0.53 billion based on the provisions which were made when the initial price controls were established;
- additional renewals of £0.53 billion which were not anticipated when the initial price controls were established but were anticipated at privatisation (adjusted to remove the offsetting reduction in expected corporation tax payments);
- enhancement expenditure of £1.13 billion in the current period, including £0.40 billion of expenditure which was previously classified as renewals but provides additional outputs; and
- a reduction of £0.12 billion due to under-delivery in the current period.

6.2 The proposed RAB for the end of the next control period also included £1.52 billion of further enhancement expenditure over the next control period, implying a March 2006 value of £6.63 billion. This consists of:

- safety and performance related expenditure on TPWS and other train protection systems;
- enhancements which SSRA has shortlisted from the original list of enhancements which was provided in the December 1999 Incremental Output Statement (IOS);

- completion of initial works on the East Coast Main Line which Railtrack initiated without a formal contract; and
- expenditure on modern facilities at stations (which are to be treated in the same way as other IOS enhancements) and platform stepping distances.

6.3 Railtrack welcomed the movement made by the Regulator in this area but argued that the proposed opening March 2001 RAB continued to be significantly understated by £1.65 billion. The key differences relate to disallowed enhancements and tax. Railtrack also indicated that it agreed with the approach taken by the Regulator in dealing with enhancements in the next control period, but noted that enhancements which are funded outside the periodic review would have implications for its financial ratios.

6.4 Most other respondents supported the Regulator's proposed approach to the RAB. However, some consultees were concerned that the RAB may be too low and that this may reduce Railtrack's ability to fund investment. Others expressed concern about the need to ensure delivery of future enhancements which are included in the RAB.

6.5 The reasons for the Regulator's draft conclusions on the RAB are set out in detail in the December 1999 and July 2000 periodic review documents. This chapter therefore focusses on the key issues raised by respondents and the Regulator's reasons for the proposed changes to his draft conclusions.

March 2001 RAB

Uplift on first day trading value

6.6 The draft conclusions on the initial RAB included an uplift of 15% on the first day trading value of equity. This was therefore at the top end of the 10-15% range proposed by the Regulator in December 1999. In response, Railtrack argued an uplift of 23% was required. However, it did not provide any further evidence in support of this view. The Regulator has therefore adopted his proposed uplift of 15%.

Backlog spending at stations

6.7 The draft conclusions on the initial RAB included £530 million relating to backlog spending at stations and environmental liabilities, both of which were provided for at privatisation. Railtrack has argued that this should be increased to £650 million.

6.8 This difference is attributable mainly to the higher provision for stations backlog which was accepted by the Regulator when the charges were set. However, as indicated in July 2000, this difference is dealt with as part of the additional renewals which are discussed below. In addition, the Regulator considers that, if the higher provisions for station backlog were included in the RAB, it would be inconsistent also to include the provision for environmental liabilities since this was not accepted when the charges were set by the Regulator. The Regulator has therefore retained the approach set out in his draft conclusions.

Additional renewals expenditure in the current period

6.9 The draft conclusions on the initial RAB included £530 million of additional renewals which were anticipated at privatisation net of the offsetting reduction in expected corporation tax payments. This amount was calculated present value of the additional renewals minus the present value of the reduction in tax during the first control period. This reduction in tax included both the value during the first control period of the tax shield associated with the additional renewals plus the value of other changes in tax treatment at privatisation.

6.10 The Regulator remains of the view that only the present value of the additional renewals should be added to the first day trading value since this represents the value of the liability. He also considers that this amount should be reduced by the total present value of the tax shield arising from these additional renewals whether or not this value is realised in the first control period or in subsequent periods. However, he accepts that the value during the first control period of other changes in tax treatment may not have been anticipated by investors and would not therefore have been reflected in the first day trading value of equity. This results in a net allowance for additional renewals of £700 million.

6.11 In response to the draft conclusions, Railtrack initially argued that the full amount of the additional renewals should be included in the RAB without any allowance for the value of the tax shield (i.e. £1,189 million). However, it has now accepted the approach described above.

6.12 The Regulator has therefore included £700 million of additional renewals in the March 2001 RAB.

Additional revenues from performance regime

- 6.13 Railtrack supported the Regulator's conclusion that claw back of the additional profits under the performance regime would not be in the long term interests of operators and funders because of the impact on perceived risks and incentives. The Regulator confirms his proposed approach on this issue.

Under-delivery by Railtrack in the current control period

- 6.14 Railtrack argues that the Regulator's proposed approach to adjust the RAB downwards by £120 million due to under-delivery in the current control period is arbitrary and unwarranted.
- 6.15 However, the Regulator remains of the view that an adjustment of at least this amount is warranted. In particular, the Regulator provided detailed evidence to Railtrack on the under-delivery of track renewals in the first control period (valued at around £170 million) which explains part of the increase in projected track renewals for which Railtrack is being funded in the second control period. In addition, Booz Allen & Hamilton's (BAH) initial report provided significant evidence of under-delivery in other areas.
- 6.16 The Regulator also rejects Railtrack's claim that this amount is arbitrary. As noted above, he considers that an adjustment of at least this amount is warranted, but he has calibrated the actual adjustment based on the scale of adjustment proposed by other regulators for relatively poor performance. This was explained in the December 1999 periodic review document. The Regulator therefore confirms his proposed approach on this issue.

Logged up enhancements in the current control period

- 6.17 The draft conclusions indicated that £1,130 million of the £2,038 million expenditure which Railtrack logged up as enhancements in the first control period should be included in the March 2001 RAB. This included £390 million of the £953 million of expenditure which Railtrack had reclassified from renewals.
- 6.18 In response, Railtrack argued that a further £690 million should be included in the RAB giving a total of £1,820 million. Following further discussion with Railtrack the Regulator has made the following adjustments:

- the draft conclusions excluded £157 million of expenditure where the definition of the output was unclear pending further information from Railtrack. Following receipt of this information, the Regulator has included £120 million of this expenditure in the March 2001 RAB since this expenditure represents a genuine enhancement;
- the Regulator previously disallowed £37 million of reclassified renewals schemes where there was a mix of renewal and enhancement. Following further discussion with Railtrack he has included £8 million of performance related schemes on the basis that these represent additional capability;
- the draft conclusions disallowed £105 million of expenditure on major stations schemes where the Regulator had not yet received appropriate documentation. As explained in Chapter 7, he considers that £67 million of this expenditure should be included in the RAB; and
- the draft conclusions disallowed £75 million of expenditure on the Settle-Carlisle line since the Regulator regarded this as remedial renewal works. In response, Railtrack argued that this scheme provided for a substantial increase in capacity for freight trains compared to the capacity at privatisation. EWS provided some support for this view. The Regulator accepts that this route is in better overall condition than it was at privatisation and that it is now better placed to accommodate the projected volume of freight traffic which is included in the single till projections. However, he considers that this work is partly renewals (e.g. part of the authorised expenditure relates to drainage and vegetation maintenance) and that the level of expenditure is likely to have been increased as a result of the need to take remedial action (e.g. because the company did not understand the impact which freight trains would have on the track). The Regulator has therefore restricted his allowance for this expenditure in the RAB to £40 million.

6.19 In conclusion, the Regulator has included an additional £235 million of enhancement expenditure in the March 2001 RAB. The total allowed enhancement expenditure in the first control period is therefore £1,365 million of which £514 million was previously classified as renewals.

Enhancements in the next control period

- 6.20 The draft conclusions provided for £1,539 million of enhancement expenditure in the next control period. This includes £781 million of expenditure on train control systems, which comprise £321 million of renewable expenditure plus £460 million of enhancement expenditure relating to TPWS, ERTMS and other train protection systems. The Regulator confirms that this expenditure has been included in the RAB as it is expected to be incurred.
- 6.21 Since the draft conclusions, Railtrack has provided the Regulator with a further submission on the cost of the shortlisted IOS schemes. These schemes have been subject to a further review by BAH and details of their conclusions have been sent to Railtrack. The SSRA has also confirmed the schemes which it expects Railtrack to develop further (121 schemes) and the projected expenditure on these schemes has been included in the RAB as it is expected to be incurred. Access charges will be increased when these outputs are delivered and the expected revenues from these additional charges have therefore been deducted from the overall revenue requirement (see Chapter 9). As explained in the draft conclusions, the projected costs and associated revenues will be subject to review by around July 2001 (see Chapter 16).
- 6.22 Railtrack has also provided further information in response to the SSRA's station IOS specification. This increases the projected cost from £197 million to £225 million over the period as a whole. This amount has been included in the RAB as it is expected to be spent and the station long term charge will be increased as the outputs are delivered (see Chapter 13). As with other IOS schemes, the projected costs and associated revenues will be subject to review around July 2001 (see Chapter 16).
- 6.23 The draft conclusions provided for £42 million of expenditure on the first phase of work on platform stepping distances and indicated that the outturn costs would be taken into consideration when establishing appropriate charges for subsequent phases. However, Railtrack expressed concern that this review could result in asymmetric risk and, to avoid this, the Regulator proposes to establish with SSRA and Railtrack how the construction and delivery risk should be allocated when level 5 cost estimates have been produced.
- 6.24 Railtrack argued that the same approach should also be applied to disabled access. However, the Regulator considers that it is more appropriate to deal with these costs through station specific adjustments to long term charges. This could either be dealt

with as part of the IOS review referred to above, or through the general framework for enhancement.

- 6.25 Railtrack claimed that the proposed allowance for performance was inadequate. However, as explained in Chapter 10, the Regulator is satisfied that the projected level of performance is fully funded by the periodic review settlement as a whole.
- 6.26 Following the draft conclusions, SSRA has indicated that it is prepared to fund an enhancement scheme at Corey's Mill on the East Coast Main Line (ECML) which will deliver enhanced electric power supply facilities. It has therefore indicated that it would support the inclusion of this scheme in the RAB (including the cost of compensation to operators and finance during construction). The Regulator has therefore included an additional £26 million in the RAB as part of the ECML upgrade (i.e. in addition to the Leeds First scheme).
- 6.27 With the exception of the IOS schemes, the stations modern facilities and the Corey's Mill scheme, the projected enhancement expenditure to be included in the RAB over the next two control periods is in line with the projections in the draft conclusions. Taking account of the impact on depreciation of IOS schemes, these changes increase the March 2006 RAB by £79 million compared to the draft conclusions. This is illustrated in Table 6.1 below.

Table 6.1: Projected enhancement spend

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Schemes included in RAB						
Train Protection	242	163	107	118	150	781
Platform Stepping	14	14	14	0	0	42
Shortlisted IOS schemes	56	193	121	28	11	409
Performance	10	10	10	10	10	50
Waterloo – Fawkham Jn	22	24	4	0	0	50
ECML Phase I	57	0	0	0	0	57
Stations modern facilities	40	70	80	25	10	225
Total	441	474	337	181	181	1,615
Enhancements not in RAB	886	1,403	1,708	1,643	920	6,560
Total	1,328	1877	2,045	1,824	1,101	8,175
1998/99 £ million	2006/07	2007/08	2008/09	2009/10	2010/11	Total
Schemes included in RAB						
Train Protection	120	116	98	77	0	412
Performance	10	10	10	10	10	50
Total	130	126	108	87	10	462
Enhancements not in RAB	304	106	77	72	28	587
Total	435	233	185	159	38	1049

Conclusions

6.28 Table 6.2 below summarises the Regulator's conclusions on the RAB for each year of the next control period and compares them with the draft conclusions published in the July 2000 periodic review document. This shows that the March 2001 RAB is increased from £5,110 million to £5,515 million (compared to Railtrack's proposed value of £6,860 million). The March 2006 RAB is increased from £6,632 million to £7,116 million.

Table 6.2: The Regulatory Asset Base (RAB)

	July 2000	October 2000	Difference
Initial value (1996 prices)			
Equity	1,995	1,995	0
Uplift at 15%	299	299	0
Debt	544	544	0
Total	2,838	2,838	0
Initial value (1998/99 prices)	3,040	3,040	0
Roll forward in first control period			
Backlog spending	530	530	0
Renewals	530	700	170
Enhancements in first control period	1,130	1,365	235
Under-delivery adjustment	-120	-120	0
Total (1998/99 prices)	2,070	2,475	405
Roll forward second control period¹			
2001/02	461	441	-20
2002/03	430	474	44
2003/04	246	334	88
2004/05	185	177	-8
2005/06	200	175	-25
Total (1998/99 prices)	1,522	1,601	79
Year end RAB (1998/99 prices)			
March 2001	5,110	5,515	405
March 2002	5,571	5,956	385
March 2003	6,001	6,430	429
March 2004	6,247	6,764	517
March 2005	6,432	6,941	509
March 2006	6,632	7,116	484

1. The figures are net of depreciation in relation to work-in-progress on IOS schemes.

7. Other single till income

Introduction

7.1 This chapter explains the Regulator's projections of Railtrack's income from other single till items (stations, property, freight, open access and depots). These sources of income are deducted from Railtrack's overall revenue requirements and therefore reduce the level of track access charges for franchised passenger train services.

Stations

7.2 In his July 2000 draft final conclusions, the Regulator set out his proposed approach to the establishment of the long-term charge for stations (following his earlier consultation on station charges).

7.3 Railtrack agreed with the Regulator's projections but proposed that major stations other income and first reserved rents should also be included within the figures. The Regulator agrees that the element of first reserved rents that Railtrack retains should be included within stations single till income. This increases stations single till income (and reduces the revenue required from track access charges) by £140 million over the next control period. However, other income from major stations is included within other operating income which is netted off against the other operating expenditure and does not therefore need to be included in stations single till income.

7.4 Railtrack also submitted estimates of the income relating to station enhancements which have not been logged up because their long term charge has yet to be approved. The additional trading income associated with these schemes is currently included in projected property income. Where the long-term charge is expected to be at or close to zero, the cost of these enhancements is therefore included in the RAB. For the other schemes, the trading income has been deducted from the projected single till property income.

7.5 Expenditure on modern facilities at stations has been included in the RAB. Since these incremental output statement (IOS) schemes will be funded through increased long term charges when the output is delivered, the return on the RAB has been included in stations single till income.

- 7.6 Finally, the projected long-term charge has been adjusted to take account of the change in the Regulator's assumptions relating to the cost of capital and the scope for efficiency savings. This increases the projected single till income.
- 7.7 One respondent was concerned that Railtrack intended to take a greater role in stations and that this, combined with the re-leasing process, may result in higher income. However, the Regulator is satisfied that the allowed property income includes a reasonable assessment of the income.
- 7.8 Given these considerations, the Regulator has adopted a projection of £1,240 million for stations single till income over the next control period, as shown in Table 7.1 below.

Table 7.1: Income from stations

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
ORR July 2000	212	212	211	211	210	1,056
Major stations LTC	15	15	15	15	15	75
Franchised stations LTC	166	166	166	166	166	830
Stations IOS LTC	2	6	12	16	18	54
Major stations (QX recovery)	29	29	28	28	27	141
Franchised stations first reserved rent	28	28	28	28	28	140
ORR final conclusions	240	244	249	253	254	1,240

Property

- 7.9 The draft conclusions explained the basis for the Regulator's projection of Railtrack's property income (based on work carried out by DTZ Pidea).
- 7.10 In response, Railtrack raised several technical points relating to DTZ Pidea's income projections. The Regulator has discussed these issues with Railtrack and DTZ Pidea and has concluded that the following adjustments should be made to the single till projections:
- the DTZ forecasts represent actual realised income assessed from a base year of 1999/2000 and have therefore been rebased to 1998/99 prices for consistency with the other assumptions adopted by the Regulator;

- hypothecated gains which do not realise income for Railtrack have been excluded;
- retail income from enhancements which are not included within the RAB have been excluded; and
- income from wayleaves has been removed since this is already included within other operating income which is netted off against operating expenditure.

7.11 Due to these adjustments, the Regulator has adopted a projection of £901 million for property income over the second control period (see Table 7.2).

7.12 One respondent was concerned that a high property income estimate may encourage Railtrack to develop stations to the detriment of passengers. The Regulator intends to monitor this situation but believes this can be tackled through current arrangements (e.g. major developments can require a partial closure consent).

Table 7.2: Property income

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
ORR July 2000	190	195	195	195	200	975
Rebased to 1998/99 prices	185	190	190	190	195	951
Hypothecated gains	-1	0	-2	-1	0	-4
Retail income from non-RAB schemes	-1	-1	-1	-1	-1	-5
Income from wayleaves	-8	-8	-8	-8	-8	-40
ORR final conclusions	175	181	179	180	186	901

Freight

7.13 The draft conclusions were based on NERA's forecast of freight income. This amounted to £865m over the next control period.

7.14 This projection is based on the current freight charging policy using NERA's economic analysis of the freight market. This income is well below NERA/Symonds estimate of the standalone cost of a freight-only network, which provides a theoretical cap on freight track access charges. However, it is close to Railtrack's estimated

freight-specific costs (adjusted to reflect the Regulator's estimate of usage costs). This confirms that freight services are not being cross-subsidised by passenger services.

- 7.15 Several respondents to the draft final conclusions referred to emerging findings from the freight review and suggested the single till estimate should be adjusted to reflect this. Given the approach described in Chapter 16, however, the Regulator has retained the projected freight income from the draft conclusions (see Table 7.3).
- 7.16 Railtrack pointed out that current freight income and the NERA forecast includes some connections income and that the draft conclusions therefore included this income twice. Rather than adjusting the freight forecast, the Regulator has deducted this from other single till income.

Table 7.3: Freight income

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
ORR July 2000 and final conclusions	181	178	174	169	163	865

Open access

- 7.17 The main sources of projected open access income are from Heathrow Express, London Underground Limited and Eurostar. The draft conclusions accepted Railtrack's projections for open access income subject to a reconciliation of the income to the logged up enhancements.
- 7.18 One respondent was concerned that the single till assumption was too flat and expected significant growth in open access income from competition between passenger operators. However, the existing projection is consistent with the Regulator's assumption on growth. Due to the way in which the variable charges have been established, the Regulator expects that incremental income from new services (i.e. usage charges, electric traction charges and capacity charges) will cover the incremental costs of that growth.
- 7.19 Since the draft conclusions, Railtrack has presented evidence in support of its claim that there is no cross-subsidy between Eurostar and other passenger services. The Regulator accepts that evidence, and therefore supports Railtrack's estimates and concludes that the total single till income for open access over the next control period

will be £241 million, as shown in Table 4.1 below. On this basis, he has also included the Eurostar enhancements within the RAB.

Table 7.4: Open access income

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
ORR July 2000 and final conclusions	50	47	48	48	48	241

Other single till

7.20 Other single till income includes income derived from connections, depots and private sidings. The draft conclusions accepted Railtrack's estimate of £215 million. However, Railtrack's response pointed out that some connection and private sidings income amounting to £4 million per annum had also been included within the freight income or other operating income. This has now been deducted from other income.

7.21 The Regulator concludes that the total level of other single till income is expected to be £195 million over the next control period, as shown in Table 7.5 below.

Table 7.5: Other single till income

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
ORR July 2000	43	43	43	43	43	215
ORR final conclusions	39	39	39	39	39	195

Conclusions

7.22 Table 7.6 below summarises the Regulator's conclusions for single till income over the next control period. This income is netted off against the projected expenditure requirements to determine Railtrack's net revenue requirement over the next control period.

Table 7.6: Single till income

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
July 2000 Total	676	675	671	666	664	3,352
Stations	240	244	249	253	254	1,240
Property	175	181	179	180	186	901
Freight	181	178	174	169	163	865
Open Access	50	47	48	48	48	241
Other	39	39	39	39	39	195
October 2000 Total	685	689	689	689	690	3,442

8. Assessing Railtrack's revenue requirements

Introduction

8.1 The July 2000 periodic review document assumed that Railtrack would be paid £3,945 million in grants relating to the exceptional level of renewals expenditure over the next six years. Given this, the Regulator concluded that baseline track access charges for franchised passenger train services would need to increase by around 2.5% in 2001/02. Before allowing for the impact of traffic growth (which would be broadly self-financing), these charges would remain constant in real terms for the remainder of the next control period (i.e. $X=0$). The draft conclusions also indicated that, without these grants, the required increase in baseline track access charges would have been 43.5% in 2001/02 with $X=0$ for the remainder of the period. The Regulator invited consultees to comment on the overall level and profile of revenues and the treatment of grants.

8.2 The remainder of this chapter addresses the following issues:

- the implications for Railtrack's overall revenue requirements of the Regulator's final conclusions on each of the building blocks discussed in the preceding chapters;
- the level and profile of grants and access charges consistent with these overall revenue requirements; and
- the implications for charges and for the financial position of Railtrack and the Franchising Director or SRA.

Implications of final conclusions for Railtrack's gross revenue requirements

8.3 The draft conclusions were based on assumptions about each of the key building blocks which are used to establish Railtrack's revenue requirements for the next control period: that is, operating, maintenance and renewal expenditure projections; the RAB; the cost of capital; and other single till income. The assumptions on these building blocks have been revised in the light of further information and other responses to the draft conclusions. Table 8.1 below summarises the Regulator's conclusions and compares these with Railtrack's proposals.

Table 8.1: Key assumptions

1998/99 £ million	ORR October 2000	Railtrack September 2000
Cost of capital (pre-tax real)	8.0%	8.1-8.7%
March 2001 RAB	£5,515 million	£6,860 million
Net CP2 RAB enhancements	£1,601 million	£1,700 million
Efficiency (constant equivalent)	3.1% per annum	2% per annum
CP2 allowed expenditure	£14,874 million	£16,069 million
Stations and other single till income	£3,442 million	£3,522 million

8.4 Table 8.2 compares the present value of the gross revenue requirement (i.e. before grants) which is implied by these building blocks with the equivalent revenues implied by the Regulator's draft conclusions. This shows that the present value of Railtrack's revenue requirement is increased by £718 million compared to that assumed in the Regulator's draft conclusions.

**Table 8.2: Impact of final conclusions on base revenue requirements
(October 2000 compared to July 2000)**

1998/99 £ million	Change in NPV (at assumed cost of capital) of base track access charges for franchised passenger train services
Adjustments to RAB	+152
Increase in assumed cost of capital	+136
Reduction in assumed efficiencies	+230
Other expenditure adjustments	+272
Revenue and single till adjustments	-72
Total adjustment	+718

8.5 By comparison, Railtrack argued that the draft conclusions were £2 billion short of the required levels. This implies a remaining shortfall of over £1 billion due to differences in the allowed levels of expenditure and returns. The Regulator's assumptions on these building blocks have been subject to extensive analysis and consultation (see the discussion in the preceding chapters) and he is satisfied that the

resulting revenue requirements are robust. The implications for Railtrack's financial position depend on the profile of revenues and these are therefore considered in the following section.

The level and profile of grants and access charges

8.6 Given the additional revenue requirement of £718 million in present value terms relating to the next five years, this section considers the way in which this should be paid. In particular:

- the extent to which the additional revenue requirement should be funded over the next control period or through an increase in the March 2006 RAB;
- the profile of charges for franchised passenger train services over the next control period (i.e. the level of X); and
- the tradeoff between additional grants and additional fixed track access charges for franchised passenger train services.

Profiling charges between the second control period and the March 2006 RAB

8.7 In considering the extent to which the additional revenue requirement of £718 million referred to above should be funded over the next control period or through an increase in the March 2006 RAB, the Regulator has taken account of his statutory duties, particularly the duties:

- not to make it unduly difficult for Railtrack to finance its relevant activities; and
- to have regard to the financial position of the Franchising Director (or the SSRA).

8.8 In considering the duty to ensure that Railtrack is able to finance its functions, the Regulator has taken account of the implications of the periodic review for Railtrack's financial position, with particular regard to the financial ratios referred to in Chapter 5 (including the covenants relating to Railtrack's existing debt). In considering these financial ratios, he has examined a range of assumptions relating to the additional enhancement expenditure which Railtrack may be expected to finance over the next control period as well as the alternative accounting treatments of renewals

expenditure and grants. In each case, he has examined the degree of headroom over the critical values for the financial ratios referred to in Chapter 5.

- 8.9 With regard to the Regulator's duty in relation to the Franchising Director's (SRA's) financial position, he has taken account of the fact that both the grants and the access charges for franchised passenger train services will need to be funded by the Franchising Director or the SRA (either directly, in the case of grants, or indirectly in accordance with the terms of the franchise agreements which were signed at privatisation). The SSRA has indicated that substantial increases in charges over the next control period (in addition to the grants referred to in the draft conclusions) could impact on the franchise replacement programme or its ability to fund further infrastructure enhancement during this period. If so, this could have implications for its ability to deliver the objectives of the Government's ten-year plan.
- 8.10 In the light of these considerations, the Regulator has concluded that £502 million of the £718 million additional revenue requirement should be funded in the 2006 RAB rather than from revenues over the next control period. Including the cost of finance at 8% real pre-tax, the March 2006 RAB is therefore increased by £738 million (502×1.08^5). The remaining £216 million is funded through a combination of changes to access charges and grants relating to the next control period.
- 8.11 This RAB adjustment is equivalent to the change in the assumed rate of efficiency improvement (£230 million) and the other adjustments to Railtrack's expenditure projections (£272 million). In broad terms, this approach is therefore equivalent to capitalising this additional expenditure allowance plus the cost of finance over the next control period into the 2006 RAB.
- 8.12 The Regulator considers that this approach minimises the effect on the Franchising Director's financial position while ensuring that it is not unduly difficult for Railtrack to finance its relevant functions.

Profiling access charges over the next control period

- 8.13 The draft conclusions highlighted the possibility that charges could start at a lower level and then increase in real terms. In response, Railtrack proposed that access charges should increase by between 8% and 11% per annum so that they assist it in financing its business efficiently (including a significant level of enhancements). Following the final periodic review hearing with Railtrack, the company indicated

that, even on the basis of the Regulator's cost projections in July 2000, real price increases of 5% per annum would be required to provide an appropriate financial profile. It acknowledged that this would imply a significant initial reduction in charges to maintain the same present value.

- 8.14 SSRA and DETR also indicated that they would prefer to profile the charges so that they are lower at the beginning of the next control period with real increases in charges for the remainder of the period. The SSRA agreed with Railtrack that this would help the company to finance further enhancement to the network. Since any change in the fixed charge is passed on to the SSRA through the terms of the franchise agreement, few other respondents commented on the appropriate profile of charges.
- 8.15 The Regulator has examined the implications of alternative revenue profiles for Railtrack's financial position. In doing so, he has had regard to the factors referred to above in relation to the profiling of revenues between the next control period and the March 2006 RAB.
- 8.16 In the light of the views of the parties and the implications for Railtrack's financial position, the Regulator has concluded that fixed track access charges for franchised passenger train services should increase by 5% a year in real terms from the second year of the next control period (i.e. RPI+5 or X=5). This revenue profile creates some headroom over the critical values for the key financial ratios throughout the next control period. It also results in significant real annual growth in earnings per share throughout the period.

Grant income

- 8.17 As noted above, the draft conclusions assumed that Railtrack would be paid £3,845 million in grants relating to the next control period and a further £100 million relating to the third control period.
- 8.18 In response to these draft conclusions, PTEs welcomed the proposal to fund part of Railtrack's revenue requirements through grants. In addition, SSRA and DETR expressed a preference for a further increase in the level of grants relative to access charges. In the light of the Regulator's duty to have regard to the Franchising Director's financial position, the Regulator has therefore discussed these trade-offs with DETR and SSRA and has taken account of their views in reaching final

conclusions on these matters. The resulting profile of grants is shown in Table 8.3 below. This shows that total grants relating to the next period are increased by £855 million to £4,700 million.

8.19 The revenue requirement which is supported by these grants has been profiled to rise in line with the profile of fixed track access charges (i.e. real increases of 5% per annum). The sum of the grants payable is greater than the expenditure to which it relates because Railtrack is allowed to earn a rate of return equal to its assumed cost of capital on the deferred element of the grant. The £100 million grant paid in mid 2006/07 is not shown in the table since this relates to the third control period.

Table 8.3: Assumed grants

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	Total
Revenue supported by grants¹	826	867	910	956	1,004	n/a	4,563
Mid-year grant re current year	150	150	150	550	500	0	1,500
1 April grant re prior years	0	250	1,350	800	300	500	3,200
Net effect on cash-flows²	-676	-467	590	394	-204	500	137
Net effect inc 1 year deferral³	-426	633	40	-106	-4	0	137

1. Including financing costs at the assumed cost of capital.

2. Line 2 plus line 3 minus line 1.

3. Line 2 plus line 3 for following year minus line 1.

8.20 With regard to the treatment of grants, Railtrack confirmed the Regulator's view that these payments should be accounted for in the same way as fixed track access charges for franchised passenger train services. It argued that failure to do so would severely harm Railtrack's financeability. Following discussion of this issue with ORR, the SSRA has provided the Regulator with a draft undertaking to pay the amounts shown in Table 8.3 on specified dates (a copy of this draft letter is contained in Appendix D). Given that the payment of grant has been provided for in this way, it is no longer necessary for the Regulator to include specific provision for the access charges to be adjusted if the assumed grants are not paid.

Implications for charges

8.21 Table 8.4 illustrates the implications of the Regulator's conclusions on the level and profile of grants and access charges. This derives the aggregate level of fixed track access charges for franchised passenger train services in each year of the next control

period. The projections are based on current traffic levels on the basis that growth will be broadly self-financing (either through additional charges or adjustments to the RAB).

- 8.22 Given the assumed level of grants and an X factor of 5% applied to fixed track access charges, the aggregate fixed track access charges for 2001/02 will fall by 20.5% in real terms compared to the current charges. The base level of track access charges for franchised passenger train services (including electric traction, usage and capacity and supplementary access charges, as well as fixed charges) for 2001/02 falls by 11.2% in real terms, then increases in real terms by an average of 4.7% a year (this compares with an initial increase of 2.5% with X=0 in the draft conclusions). In the absence of grants, however, these charges would have increased in real terms by 34.5% in the first year followed by 4.8% on average each year for the next four years (compared to 43.5% with X=0 in the draft conclusions).
- 8.23 Aggregate revenues including the value of grants would therefore be £13,399 million which compares with revenues of around £10 billion over the last five years. However, the annual average revenue is broadly in line with the level of maintenance, renewal and operating expenditure in the recent years (e.g. budgeted expenditure for the current year is £2.8 billion implying a five year total of £14 billion).
- 8.24 Compared to the draft conclusions:
- Railtrack's revenues are increased by £367 million over the next five years due to additional cash receipts of £340 over the next six years (equivalent to the present value of £216 million referred to above);
 - given the profile of charges, there is a net reduction in revenue in the first two years and a significant increase in the last two years; and
 - the March 2006 RAB is increased by £738 million (in addition to the increase of £484 million referred to in Chapter 6) to £7,854 million.

Table 8.4: Annual revenue requirements

1998/99 £ million	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Return on initial RAB	441	441	441	441	441	2,205
Depreciation/return on enhancements	18	55	89	111	127	400
Allowed expenditure	3,245	3,166	3,048	2,890	2,525	14,874
Total cost	3,704	3,662	3,578	3,442	3,093	17,479
Stations and other single till income	-685	-689	-689	-689	-690	-3,442
IRSA income	-36	-35	-30	-26	-26	-153
IOS income	-1	-6	-17	-29	-36	-89
Gross revenue requirement	2,982	2,932	2,842	2,698	2,341	13,795
Funded by March 2006 RAB	-121	-121	-121	-121	-121	-605
Reprofiling	-432	-248	-43	223	709	209
Reprofiled revenue requirement	2,429	2,563	2,678	2,800	2,929	13,399
Grants	-826	-867	-910	-956	-1,004	-4,563
Base track access charges	1,603	1,696	1,768	1,844	1,925	8,836
% change¹	-11.2%	5.8%	4.2%	4.3%	4.3%	
Schedule 4 and 8 supplements	20	44	44	45	46	199
Electric traction charge	133	136	140	143	147	699
Usage charge	145	145	145	145	145	725
Capacity charge (at cap)	0	79	95	95	95	364
Capacity charge offset (at cap)	0	-79	-95	-95	-95	-364
Base fixed charge	1,305	1,371	1,439	1,511	1,587	7,213
% change²	-20.5%	5.0%	5.0%	5.0%	5.0%	

1. Franchised track access revenues in 2000/01 were £1,807 million.

2. Revenues from fixed charge in 2000/01 were £1,641 million.

Conclusions

8.25 In reaching his conclusions on Railtrack's revenue requirements, the Regulator is satisfied that he has discharged all his statutory duties. This requires him to balance the duty not to render it unduly difficult for Railtrack to finance any relevant activities

with his other duties, including the duty to have regard to the financial position of the Franchising Director.

- 8.26 The periodic review has established Railtrack's revenue requirements for the next control period and the value of the base RAB at the end of that period. These values have been derived from a detailed analysis of the amounts which Railtrack requires to enable it to finance the outputs which its customers and funders want to buy. The Regulator has consulted the relevant parties extensively throughout the periodic review process. He has also sought the views of Railtrack, the SSRA and DETR about the trade-off between grants and access charges and their preferred profile of charges within the next control period.
- 8.27 In response to the draft conclusions, Railtrack claimed that given a realistic view of its costs, the Regulator's draft conclusions would not allow it to fund even its committed enhancements. It therefore argued that it needed substantially higher revenues to meet its costs for the existing network and for investing in new infrastructure.
- 8.28 The Regulator's final conclusions incorporate material modifications to both the level and profile of Railtrack's revenues over the next control period. Given this, he is satisfied that the implementation of these final conclusions will minimise the effect on the Franchising Director's financial position while not making it unduly difficult for Railtrack to finance its relevant functions. He believes that this will place Railtrack in a strong position to raise new debt and equity finance to enable it to deliver further private sector investment in the railway. In particular, it will be able to finance the baseline expenditure requirements underlying these revenues as well as substantial further enhancements. The Regulator expects that Railtrack will be able to finance the full £8 billion enhancement programme set out in its cost submission.

