

## **PERIODIC REVIEW:**

### **STATEMENT ON THE IMPLICATIONS OF HATFIELD**

#### **Introduction**

1. The final conclusions on the periodic review of Railtrack's financial framework for the next five years were published in October 2000. These conclusions represented the outcome of an extensive 2½ year process to review Railtrack's expenditure requirements, the outputs it would be required to deliver, the structure of charges and incentives, and the framework for enhancements. The process involved extensive industry consultation. However, the review was completed before the tragic Hatfield derailment occurred.
2. Chapter 16 of the periodic review final conclusions recognised that while the new charging arrangements should generally be expected to apply for a period of five years, there was a need for some flexibility to deal with exceptional circumstances. The Regulator therefore proposed a new provision for interim reviews if there has been a material change of circumstances and that in consequence there are compelling reasons for doing so having regard to his statutory duties including in particular the duty not to make it unduly difficult for Railtrack to finance its relevant activities. The purpose of this statement is to explain the way in which the Regulator expects to apply this general approach to deal with the consequences of the Hatfield derailment which represents a material change of circumstances for Railtrack since the Regulator finalised his conclusions.
3. The immediate financial consequences of Hatfield are occurring under the existing contractual and regulatory framework which was established before privatisation. Railtrack has rightly acknowledged that these consequences are for the company and its shareholders to bear. Neither customers nor taxpayers will pick up the bill for this.
4. Railtrack has announced that the immediate consequences of Hatfield when combined with other factors will leave it in a materially worse financial position from the start of the second control period to that which I assumed in reaching my final conclusions. This may therefore have implications for the appropriate timing of Railtrack's revenues over the next ten years to ensure that the company is able to finance its relevant activities. In particular, it may be appropriate to change the timing of network grants which the SRA has agreed to pay over the second control period or to bring forward grants which would have been paid in subsequent periods. But there is no question in this respect of there being any increase in the overall value of revenues including grants.
5. Once the immediate recovery from the aftermath of Hatfield has been completed, it is likely that there will be ongoing implications for the rail network, both direct and indirect, which may influence the efficient levels of activity or outputs and hence expenditure during the second control

period. These ongoing implications may constitute a material change to Railtrack's financial and operational circumstances which could bring forward the need for an interim review, once the full implications have been properly assessed. However, the Regulator considers that it would not be possible to begin to assess these implications or the need for an interim review in this respect at least until the immediate issues have been dealt with and the implications of the TTCI report into broken and defective rails have been assessed.

6. In these circumstances, the Regulator would consider sympathetically an application by Railtrack for an early interim review to examine the appropriate timing of Railtrack's revenue requirements. He would also consider sympathetically an application by Railtrack for a subsequent interim review during the second control period to consider the ongoing impact of Hatfield on its efficient expenditures and outputs in the second control period. In either case, however, Railtrack would need to demonstrate that:
  - the effects in terms of additional expenditure requirements or financing costs were material; and
  - the impact on Railtrack's financial position would, without further regulatory action in the second control period, make it unduly difficult for the company to finance its relevant activities.

#### **Coverage of interim reviews**

7. An early interim review would ensure that the immediate consequences of Hatfield on the company's financial position were appropriately addressed in the timing of Railtrack's revenues, particularly in relation to the first part of the second control period, having regard to the Regulator's statutory duties. Such a review would not reassess the appropriate level of Railtrack's revenue requirements (including the March 2001 RAB, the expected level of expenditure over the second control period or the cost of capital). It would therefore be confined to the two questions of (a) whether and how Railtrack receives funding spread over the second control period or must wait until after 2006 (i.e. a question of cashflow only) and (b) the mix between access charges and grants. It would not concern any question of any alteration of the level of funding. As indicated in the periodic review documents, the Regulator would expect to assess his proposals against the relevant financial indicators that would be required to maintain a flat A credit rating.
8. Any interim review of the longer term implications of Hatfield would consider the impact of changes, both direct and indirect, to efficient expenditure and revenue requirements over the entire five year control period, including the costs of additional obligations incurred up to the time of the review. It would, however, principally focus on examining the impact of those aspects of the company's operations which were affected by changes in circumstances arising from the ongoing implications of Hatfield. The areas which might be covered would include:

- changes to maintenance and renewal activity and therefore efficient capital and operating expenditure requirements, particularly on track;
  - any implications for the achievable rates of improvement in operational performance, efficiency, and possession costs;
  - any other effects such as necessary and appropriate changes to wider asset management policies triggered in whole or in part by the events of Hatfield; and
  - any implications for Railtrack's revenue requirements, for the associated level of track access charges over the second control period and for the value of the Regulatory Asset Base (RAB) at the end of that period.
9. Such an interim review would therefore be limited in scope and would be incremental to the Regulator's final conclusions on the periodic review. The Regulator would need to exercise judgement as to the extent to which any increases in cost were the result of the relevant changes in circumstances or had been anticipated at the time of the periodic review (and therefore reflected within the expenditures on which the Regulator has already expressed his views in the final conclusions).
10. Chapter 16 of the periodic review final conclusions contains provisions for interim review of narrowly defined elements of the periodic review settlement where further work is needed to finalise long term arrangements. It would be for consideration whether any such review would be combined with that for the longer term implications of Hatfield.

### **Timing and process**

11. As indicated in the final conclusions on the periodic review, the Regulator would expect Railtrack to submit any application for an interim review with representations setting out why it believed the case for such a review to be compelling. In making these representations, he would expect Railtrack to have regard to the terms of the interim review provisions, the wider policy considerations referred to in Chapter 16 of the final conclusions to the periodic review and the further considerations referred to in this statement.
12. Following an application for an interim review into the long term implications of Hatfield, the Regulator would undertake an initial consultation with relevant industry parties including funders. Subject to consideration of the responses to this consultation, the Regulator would expect to initiate the interim review process set out in Part 7, Schedule 7 of the template track access agreements. The Regulator would expect provisional conclusions of this interim review to be completed within six months of the application. These conclusions would be subject to consultation before finalisation.

13. A similar process would apply to an early interim review into the appropriate timing of Railtrack's revenue requirements. In this case, however, the Regulator would expect to complete the review and to seek views from consultees within a shorter period of time. Provided that Railtrack makes an application for interim review in good time, he would expect to be able to implement his conclusions before the first grants are due to be paid in October 2001.
14. It would be for Railtrack to provide relevant documentation to support its case through appropriate submissions and supporting quantification, which demonstrated the basis for the purported changes in costs and revenues in question.
15. The implementation of any proposed modifications arising from any interim review would, under the provisions of the Transport Act 2000, be subject to Railtrack's right to object to the Regulator's conclusions, and the Regulator's ability to refer the issues to the Competition Commission.