

**Annual efficiency and finance assessment
of Network Rail 2008-09**

October 2009



OFFICE OF RAIL REGULATION

Contents

1 Executive summary	1
Expenditure and efficiency.....	2
Finance.....	3
Income.....	4
Financial outperformance	4
2 Introduction	5
Purpose of the document	5
Structure of the document	6
Feedback.....	6
3 Expenditure and efficiency	7
GB expenditure.....	7
2008-09	7
CP3 GB expenditure.....	8
England & Wales and Scotland expenditure.....	10
2008-09 England & Wales and Scotland expenditure.....	11
CP3 England & Wales and Scotland expenditure.....	11
Operating efficiency.....	14
Maintenance efficiency	15
Overall	15
Maintenance unit costs.....	17
Non-WCRM renewals efficiency	17
Budget variance.....	18
Non-WCRM renewals unit costs.....	19
Financial efficiency index.....	20
CP3 cumulative efficiency.....	21
4 Finance	25
Introduction.....	25
Regulatory asset base (RAB)	25
Net debt.....	28
Net debt to RAB ratio.....	30
Adjusted interest cover ratio	31
5 Income	33
Introduction.....	33
Income in 2008-09.....	33
Income in CP3.....	34
6 Financial outperformance.....	37
Introduction.....	37
Outperformance in CP3.....	37

1. Executive summary

- 1.1 This document provides our annual assessment of Network Rail's efficiency and financial performance. It covers both 2008-09 and the whole of control period 3 (CP3), which ran from 1 April 2004 to 31 March 2009.
- 1.2 Table 1 provides a summary of key expenditure, efficiency and financial information for CP3.

Table 1: Summary of key financial data for CP3

2008-09 prices	Actual CP3 total	ACR2003 assumption*
Expenditure		
Controllable operating expenditure	£4.8bn	£5.0bn
Maintenance	£6.3bn	£6.3bn
Renewals (non-WCRM**)	£12.0bn	£11.8bn
Total controllable non-WCRM OMR***	£23.0bn	£23.2bn
Non-controllable operating expenditure	£1.7bn	£1.3bn
WCRM renewals	£3.1bn	£2.6bn
Total OMR expenditure	£27.8bn	£27.1bn
Efficiency		
Efficiency improvement****	27%	31%
Finance		
RAB (estimated)	£29.5bn	£30.1bn
Net debt (nominal prices)	£20.9bn	£20.5bn
Net debt to RAB ratio (at 31 March 2009)*****	70.8%	n/a
Income	27.4bn	27.0bn
Outperformance	£1.2bn	n/a

Notes:

* Adjusted for additional signalling expenditure following our 2005 signalling review and the revenue deferral.

** WCRM is West Coast Route Modernisation.

*** OMR is operating, maintenance and renewals.

**** Relates to controllable operating, maintenance and non-WCRM renewals expenditure.

*****The net debt to RAB ratio at 1 April 2009 after taking account of the revenue deferral and incentive adjustments is 61.2%.

Expenditure and efficiency

- 1.3 Actual controllable non-WCRM OMR totalled £23.0bn during CP3 against our 2003 access charges review (ACR2003) assumption of £23.2bn. This represents a variance of £0.2bn.
- 1.4 In the final conclusions of ACR2003 we made the assumption that Network Rail would be able to achieve at least a 31% improvement in its unit costs over the course of CP3. Overall, the company has failed to achieve the regulatory assumption, achieving 27% in comparison with the ACR2003 assumption of 31%.
- 1.5 We recognise that 27% is a significant level of efficiency improvement for any organisation to achieve over a five year period and we recognise that Network Rail has made strong progress in getting costs under control during CP3. However, we are disappointed in the overall level of achievement given the good progress that Network Rail made earlier in CP3 and because of the significant opportunities that exist for Network Rail to improve its efficiency beyond the 31% level.
- 1.6 Our assessment is based largely on the change in the level of controllable non-WCRM OMR compared to the ACR2003 assumptions (adjusted for the additional expenditure allowance from our 2005 signalling review and, for non-WCRM renewals, adjusting for deferral). We have not been able to use unit costs as the main means of assessing efficiency during CP3 since they have not been of sufficient robustness and coverage.
- 1.7 The unit cost information that is available shows a lower level of efficiency improvement (20%) than our overall assessment of 27%. The company's financial efficiency index (FEI) also shows a lower level of efficiency (25%).
- 1.8 In controllable operating expenditure, the company's efficiency worsened in 2008-09 by 0.4% against the ACR2003 assumption of 5%, following strong improvements early in CP3. Over CP3, Network Rail achieved a 28% efficiency improvement, which fell short of the assumption we made in ACR2003, that an efficiency improvement of at least 30% should be achievable.
- 1.9 In maintenance, Network Rail achieved 5% efficiency between 2007-08 and 2008-09 against an ACR2003 assumption of 8%. Over CP3

Network Rail achieved a 35% efficiency improvement, slightly exceeding our assumption of 34%.

- 1.10 Assessing non-WCRM renewals efficiency is challenging. In particular, it is necessary to take account of deferred expenditure. The company achieved a 7% efficiency improvement between 2007-08 and 2008-09 against a regulatory assumption of 5%, recovering strongly from its performance in the previous year when its efficiency worsened. Over CP3 Network Rail achieved a 24% efficiency, falling short of our assumption of 30%.

Finance

- 1.11 At 31 March 2009, Network Rail's estimated RAB was £29.5bn, an increase of £1.6bn during 2008-09 (including an inflation uplift of £0.8bn). This is an estimate at this stage as Network Rail still needs to provide us with some outstanding information before we can confirm the final value. We anticipate any difference to the value given here to be no more than +/-£0.1bn. We will publish shortly the final value of the RAB (which will include separate information for England & Wales and Scotland).
- 1.12 The RAB at 31 March 2009 was £0.6bn lower than the £30.1bn assumed in ACR2003. The main issue that has affected the value of Network Rail's RAB in 2008-09 is the £1.3bn adjustment for the non-delivery of some outputs in CP3 which Network Rail has deferred into CP4 (as referred to in our Network Rail Q4 monitor 2008-09).¹
- 1.13 At 31 March 2009, Network Rail's net debt was £20.9bn, an increase of £1.5bn during 2008-09, largely due to expenditure of £1.1bn on additional enhancement schemes that were not included in the ACR2003 assumptions. Net debt at 31 March 2009 was £0.4bn higher than the ACR2003 assumption.
- 1.14 Network Rail's net debt to RAB ratio is a key indicator of Network Rail's financial health. At the end of 2008-09 the ratio was 70.8%, which was comfortably within the regulatory limits. The net debt to RAB ratio at 1 April 2009 after taking account of the revenue deferral and incentive adjustments was 61.2%. The adjusted interest coverage ratio (AICR) is

¹ *Network Rail Monitor Q4 2008-09*, Office of Rail Regulation, June 2009. This can be accessed at <http://www.rail-reg.gov.uk/upload/pdf/397.pdf>.

another key indicator of Network Rail's financial health.² The actual AICR for 2008-09 was 2.03 times, which is higher than in 2007-08. This level is generally considered to indicate a strong financial position for a regulated utility.

Income

1.15 Network Rail's total income in CP3 was £27.4bn. This was £0.4bn higher than the ACR2003 assumption of £27.0bn. Overall, this is mainly due to Network Rail's £0.4bn outperformance of the schedule 8 regime, higher usage charges of £0.2bn and higher income from traction electricity charges of £0.2bn partly offset by rebates to Department for Transport (DfT) of £0.3bn.

Financial outperformance

1.16 In financial terms, Network Rail has outperformed the ACR2003 assumptions by £1.2bn. This is largely due to an outperformance of £1.1bn on interest costs and £1.4bn outperformance of the incentives regimes offset by a £1.4bn underperformance on expenditure.

² The AICR measures Network Rail's adjusted net operating cash flow (total income less operating costs, maintenance, capital expenditure and corporation tax) against interest costs. This assesses Network Rail's ability to meet interest payments from net operational cash flows after deducting an allowance for maintenance capital expenditure. The maintenance capital expenditure allowance only includes the level of capital investment that is required to maintain the RAB in steady state, i.e. any capital investment that improves the network is not included. At present maintenance capital expenditure is approximated by the regulatory amortisation charge.

2. Introduction

Purpose of the document

- 2.1 This document provides our efficiency and financial assessment for both 2008-09 and control period 3 (CP3), which ran from 1 April 2004 to 31 March 2009. The purpose of this document is to provide Network Rail's customers, funders and other stakeholders with a summary of Network Rail's efficiency and financial performance.
- 2.2 We have revised the way we monitor Network Rail. Most of the areas covered in our previous annual assessments (including safety risk, train performance, planning and major projects, asset performance and condition)³ are now included in our Network Rail monitor Q4 2008-09.⁴ The Network Rail monitor Q4 2008-09 also includes information on Network Rail's efficiency and financial performance, but this is based on unaudited financial data. During CP4, following publication by Network Rail of its audited regulatory accounts and annual return, we will publish an annual efficiency and financial assessment.
- 2.3 The majority of the financial information in this assessment is taken from Network Rail's 2008-09 regulatory accounts,⁵ its 2008 budget and its 2009 annual return.⁶ Unless otherwise stated, all monetary values are in 2008-09 prices. The values in the net debt section in Chapter 4 are in nominal prices.
- 2.4 The value of the regulatory asset base (RAB) provided is an estimate at this stage as Network Rail still needs to provide us with some outstanding information before we can confirm the final value. We will

³ See for example: *Annual assessment of Network Rail 2007-08*, Office of Rail Regulation, September 2008. This may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/378.pdf>.

⁴ The monitor is published earlier in the year than this document.

⁵ Network Rail's 2009 regulatory accounts may be accessed at <http://www.networkrail.co.uk/browseDirectory.aspx?dir=\Regulatory%20Documents\Regulatory%20Compliance%20and%20Reporting\Regulatory%20Accounts&pageid=2893&root=>.

⁶ Network Rail's 2009 annual return may be accessed at <http://www.networkrail.co.uk/browseDirectory.aspx?dir=\Annual%20Report%20and%20Accounts&pageid=3221&root=>.

publish shortly the final value of the RAB (this will include separate information for England & Wales and Scotland).

Structure of the document

- 2.5 This document follows broadly the same structure and has similar content to the expenditure and efficiency, and finance and income chapters in our 2007-08 annual assessment.
- 2.6 Chapter 3 compares Network Rail's expenditure with the assumptions we made in our 2003 access charges review (ACR2003)⁷ and assesses the extent to which Network Rail has achieved the ACR2003 efficiency assumptions.
- 2.7 Chapter 4 reviews the financial performance of Network Rail in 2008-09 and in CP3. In particular it sets out our estimate of Network Rail's RAB at the end of control period 3 (CP3). It also reviews the company's net debt, net debt to RAB ratio and the adjusted interest cover ratio.
- 2.8 Chapter 5 reviews Network Rail's income in 2008-09 and over the course of CP3 compared to the ACR2003 assumption and the company's 2008 budget.
- 2.9 Chapter 6 summarises Network Rail's overall outperformance against our ACR2003 assumptions for expenditure, income, incentive regimes and interest costs.

Feedback

- 2.10 Comments on the content of this assessment are welcome and can be sent to:

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⁷ *Access Charges Review 2003: Final Conclusions*, Office of the Rail Regulator, December 2003. This may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/184.pdf>.

3. Expenditure and efficiency

Introduction

- 3.1 This chapter summarises Network Rail's operating, maintenance and renewals (OMR) expenditure and efficiency in 2008-09 and for CP3 as a whole.

Context

- 3.2 In ACR2003 we assumed that Network Rail could achieve an improvement of at least 31% in its unit cost efficiency, across controllable non-West Coast Route Modernisation (WCRM) OMR, during CP3. This breaks down into 30% for controllable operating expenditure (controllable opex), 35% for maintenance and 30% for non-WCRM renewals.
- 3.3 In ACR2003 we based our efficiency assumptions on reductions in unit costs, although at the time Network Rail did not have a comprehensive framework to measure its unit costs. Work on capturing unit cost data has progressed during CP3 and Network Rail has improved the way it has collected unit cost data over CP3. However, as in the annual assessments we have previously done, we have not been able to base our assessment of Network Rail's efficiency on unit costs because of the lack of robustness of the unit cost data and its limited coverage.
- 3.4 Therefore, we have based our assessments for controllable opex and maintenance on the change in the overall level of expenditure compared to our ACR2003 assumptions and, for non-WCRM renewals, on the company's budget variance analysis.
- 3.5 This document also discusses the unit cost information that is available for maintenance and non-WCRM renewals and Network Rail's financial efficiency index (FEI). Unit costs are not collected for controllable opex and many of the activities undertaken in controllable opex are not amenable to unit cost measurement.

GB expenditure

2008-09

- 3.6 Network Rail's total 2008-09 expenditure on controllable non-WCRM OMR was £4,678m, compared with £4,327m assumed in the ACR2003

(adjusted for the additional expenditure allowance that we made in our 2005 signalling review).⁸ This represents a variance of £351m. Table 2 shows the difference between 2008-09 actual expenditure and the ACR2003 assumptions.

Table 2: Network Rail expenditure in 2008-09 compared to ACR2003

£m (2008-09 prices)	Actual expenditure	ACR2003 assumption	Variance
Controllable opex	908	890	18
Maintenance	1,104	1,061	43
Of which:			
Permanent way	399	n/a	n/a
Signalling and telecoms	152	n/a	n/a
Non-WCRM renewals	2,666	2,377	289
Of which:			
Track	887	793	94
Signalling	446	611	(165)
Structures	437	400	37
Total controllable non-WCRM OMR	4,678	4,327	351

Source: ACR2003 and Network Rail 2009 regulatory accounts.⁹

Note: ACR2003 did not make assumptions about the breakdown of maintenance expenditure and actual expenditure on permanent way and signalling and telecoms only includes the direct costs.

CP3 GB expenditure

3.7 Controllable non-WCRM OMR expenditure was below our ACR2003 assumptions in the first two years of CP3, due to outperformance of our controllable OMR efficiency assumptions and deferrals of non-WCRM renewals. Expenditure then rose so that in the final year of CP3, expenditure was above our ACR2003 assumptions as Network Rail could not achieve the assumed efficiencies in controllable opex, maintenance and non-WCRM renewals, which was compounded by

⁸ *Signalling Review: final conclusions of the medium-term review*, Office of Rail Regulation, December 2005. This may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/269.pdf>.

⁹ See Network Rail's 2009 regulatory accounts for a full breakdown of OMR expenditure: <http://www.networkrail.co.uk/browse%20documents/regulatory%20documents/regulatory%20compliance%20and%20reporting/regulatory%20accounts/regulatory%20financial%20statements%2031%20march%202009.pdf>.

the re-phasing of the deferred non-WCRM renewals activity from the first two years. In total during CP3, Network Rail's controllable non-WCRM OMR was £23,011m, which was £179m less than our ACR2003 assumption of £23,190m (adjusted for the conclusions of the signalling review). Table 3 shows actual OMR expenditure during CP3 compared to our ACR2003 assumptions.

Non-controllable opex and WCRM renewals expenditure

3.8 Network Rail spent £401m on non-controllable opex during 2008-09, against an ACR2003 assumption of £265m. During CP3, Network Rail spent £1,657m on non-controllable opex against an ACR2003 assumption of £1,321m. Both of these overspends are mainly due to increased costs of traction electricity and additional expenditure on British Transport Police. Actual expenditure on the WCRM project was £3,140m compared with an assumption of £2,639.

Table 3: CP3 OMR expenditure compared with our ACR2003 assumptions

£m (2008-09 prices)	2004-05	2005-06	2006-07	2007-08	2008-09	CP3 Total
Controllable opex						
Actual	1,067	965	943	904	908	4,788
ACR2003	1,164	1,072	985	936	890	5,046
Maintenance						
Actual	1,453	1,330	1,231	1,152	1,104	6,269
ACR2003	1,481	1,362	1,253	1,153	1,061	6,310
Renewals (non-WCRM)						
Actual	1,848	2,231	2,598	2,610	2,666	11,954
ACR2003	2,171	2,269	2,475	2,542	2,377	11,834
Total controllable non-WCRM OMR						
Actual	4,368	4,526	4,772	4,666	4,678	23,011
ACR2003	4,816	4,703	4,714	4,631	4,327	23,190
Non-controllable opex						
Actual	282	296	368	310	401	1,657
ACR2003	263	263	264	265	265	1,321
Total WCRM expenditure						
Actual	1,184	736	371	371	478	3,140
ACR2003	1,102	897	205	195	240	2,639
Total OMR						
Actual	5,834	5,558	5,511	5,347	5,557	27,807
ACR2003	6,181	5,863	5,182	5,091	4,833	27,150

Source: ACR2003 and Network Rail regulatory accounts.

England & Wales and Scotland expenditure

3.9 In 2005, we published our conclusions on our approach to regulation in Scotland following the devolution of the responsibility for setting the strategy for, and funding, the railways in Scotland, from the UK government to the Scottish government.¹⁰ That 2005 conclusions

¹⁰ *ORR's approach to regulation in Scotland: Conclusions*, Office of Rail Regulation, December 2005. This may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/267.pdf>.

document includes the split of the RAB and the indicative splits between England & Wales and Scotland of the ACR2003 expenditure and revenue requirement assumptions.

- 3.10 Since then we have reported on expenditure levels in Scotland and the variance to our indicative separation. We also report on Network Rail's financial efficiency index (FEI) in Scotland. However, we do not produce separate assessments of Network Rail's overall efficiency as the ACR2003 assessment did not make separate assumptions for efficiency improvement and we did not disaggregate the efficiency assumptions during the work we undertook to disaggregate the revenue requirement in 2005.

2008-09 England & Wales and Scotland expenditure

- 3.11 In Scotland during 2008-09, total controllable opex was £83m compared to the indicative ACR2003 assumption of £86m. Total maintenance expenditure was £97m compared to the indicative ACR2003 assumption of £99m. The levels of opex and maintenance expenditure were very close to our assumptions. Non-WCRM renewals expenditure was £287m compared to the indicative ACR2003 assumption of £203m. The difference in non-WCRM renewals was driven by higher levels of expenditure on telecoms and structures compared to our indicative ACR2003 assumption.
- 3.12 In England & Wales during 2008-09, total controllable opex was £825m against an indicative ACR2003 assumption of £804m. Total maintenance expenditure was £1,007m against an assumption of £962m. Non-WCRM renewals expenditure was £2,379m against an indicative ACR2003 assumption of £2,172m. The difference was driven by higher levels of expenditure on track and telecoms renewals than assumed in ACR2003.

CP3 England & Wales and Scotland expenditure

- 3.13 Controllable non-WCRM OMR expenditure in England & Wales was similar to the ACR2003 assumptions in 2006-07 and 2007-08. However, in the final year of CP3, expenditure was above the ACR2003 assumptions mainly due to the re-phasing of the deferred renewals activity from earlier in CP3. In total in CP3, Network Rail's controllable non-WCRM OMR expenditure was £12,695m, which was

£296m more than the ACR2003 assumption of £12,399m (adjusted for the conclusions of the signalling review).

- 3.14 Controllable non-WCRM OMR expenditure in Scotland was higher than our indicative split ACR2003 assumptions. In total during the last three year's of CP3, Network Rail's controllable non-WCRM OMR expenditure in Scotland was £1,421m, which was £152m more than the ACR2003 assumption of £1,269m (adjusted for the conclusions of the signalling review).
- 3.15 Tables 4 and 5 show the actual OMR expenditure in England & Wales and Scotland and the indicative OMR expenditure splits (consistent with the ACR2003) between England & Wales and Scotland for the last three years of CP3.

Table 4: England & Wales expenditure

£m (2008-09 prices)	2006-07	2007-08	2008-09	Total
Controllable opex				
Actual	856	823	825	2,504
Indicative split assumption	888	845	804	2,537
Maintenance				
Actual	1,115	1,047	1,007	3,168
Indicative split assumption	1,139	1,045	962	3,146
Renewals				
Actual	2,310	2,333	2,379	7,022
Indicative split assumption	2,235	2,309	2,172	6,717
Total controllable non-WCRM OMR				
Actual	4,281	4,203	4,211	12,695
Indicative split assumption	4,262	4,199	3,938	12,399
Non-controllable opex				
Actual	340	285	371	997
Indicative split assumption	238	240	239	717
Total WCRM expenditure				
Actual	340	364	474	1,178
Indicative split assumption	185	177	217	579
Total OMR				
Actual	4,962	4,852	5,056	14,870
Indicative split assumption	4,685	4,617	4,394	13,696

Source: Network Rail regulatory accounts.

Table 5: Scotland expenditure

£m (2008-09 prices)	2006-07	2007-08	2008-09	Total
Controllable opex				
Actual	87	81	83	251
Indicative split assumption	97	91	86	273
Maintenance				
Actual	116	105	97	318
Indicative split assumption	115	107	99	321
Renewals				
Actual	288	277	287	852
Indicative split assumption	240	232	203	674
Total controllable non-WCRM OMR				
Actual	491	464	467	1,421
Indicative split assumption	451	430	388	1,269
Non-controllable opex				
Actual	28	25	30	83
Indicative split assumption	26	26	26	78
Total WCRM expenditure				
Actual	30	7	4	41
Indicative split assumption	20	19	23	62
Total OMR				
Actual	549	495	501	1,545
Indicative split assumption	497	474	437	1,408

Source: Network Rail regulatory accounts.

Operating efficiency

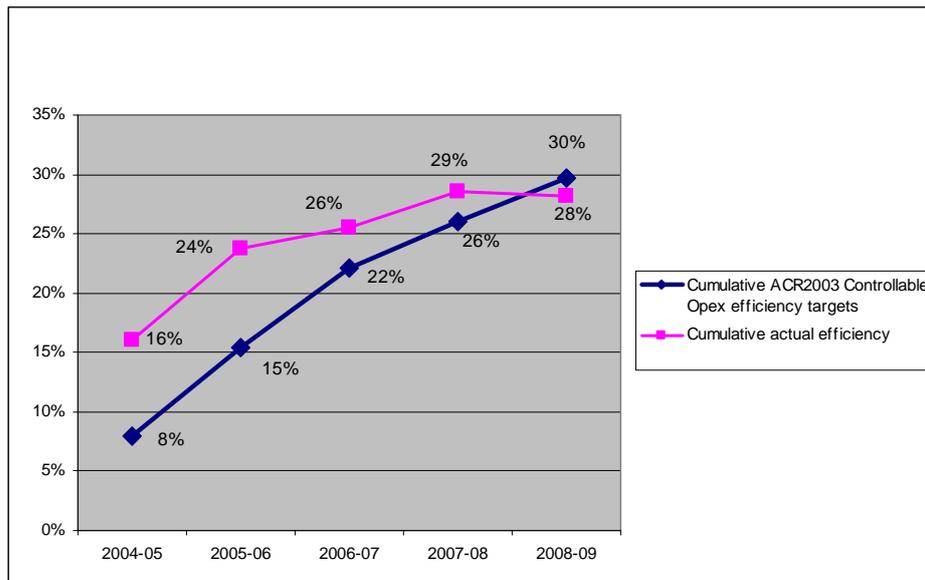
3.16 Network Rail's actual controllable opex for 2008-09 was £908m compared with our assumption of £890m, which assumed that a 5% efficiency improvement was achievable in the year. In assessing Network Rail's performance we have assumed that all underspend against the ACR2003 assumption was outperformance, in line with previous years, on the grounds that there is little practical scope for Network Rail to defer or de-scope operational activity without adversely affecting performance. In 2008-09, Network Rail's cumulative efficiency

worsened by 0.4%, from 28.5% to 28.2%. In total, it fell short of the ACR2003 assumption of 30% by the end of CP3.

3.17 Network Rail significantly outperformed the ACR2003 assumptions in the first two years of CP3 with its performance then flattening off over the last three years of CP3. Network Rail indicated towards the end of CP3 that it was increasingly difficult to continue to improve controllable opex efficiency.

3.18 We do not agree with this view. Based on the work we undertook in our 2008 periodic review (PR08) and Network Rail's strategic business plan, we consider that there is still a significant amount of controllable opex efficiency Network Rail can make and we have assumed that it can achieve at least 16% in control period 4 (CP4), which runs from 1 April 2009 to 31 March 2014.

Figure 3: Actual CP3 controllable opex efficiency compared with our ACR2003 assumption



Source: Network Rail's 2009 annual return.

Maintenance efficiency

Overall

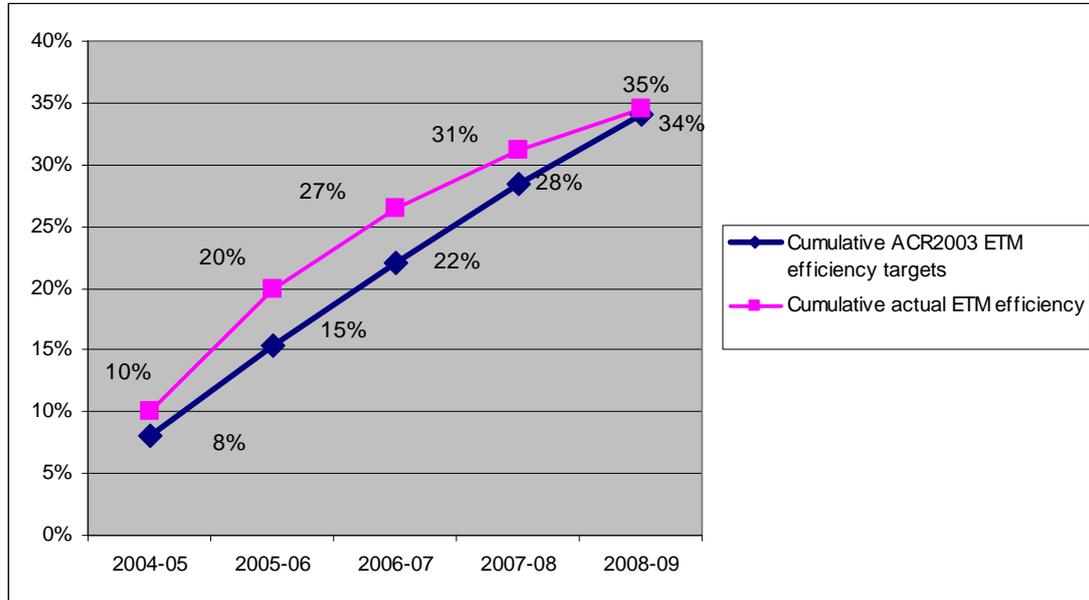
3.19 Since Network Rail does not yet have a robust and comprehensive set of maintenance unit costs that we can rely on to assess its overall maintenance efficiency, we compared Network Rail's actual maintenance expenditure with the ACR2003 assumptions. In that comparison we assume that all maintenance expenditure less than the

ACR2003 assumption is outperformance and that scope efficiencies and/or deferrals do not occur.

- 3.20 We also adjust actual expenditure for the change in the level of equated track miles (ETM).¹¹ Making this adjustment is consistent with how we have reported Network Rail's efficiency throughout CP3. However, in Network Rail 2009 annual return, Network Rail has reported on non-adjusted maintenance efficiency.
- 3.21 Network Rail achieved 5% efficiency in 2008-09, compared to our 8% assumption. Over CP3, Network Rail achieved a 35% efficiency improvement, outperforming the 34% ACR2003 assumption largely due to its outperformance in the first three year's of CP3.
- 3.22 Based on the work we undertook in PR08, we consider that Network Rail can make a considerable improvement in its maintenance efficiency in CP4, of at least 18%.

¹¹ ETMs adjust for different track conditions across the network including traffic levels.

Figure 4: CP3 maintenance efficiency compared with ACR2003 assumption



Source: Independent reporter annual return audit 2009 final report.

Maintenance unit costs

3.23 Network Rail reported on a range of maintenance unit costs (MUC's) in its 2009 annual return, as was the case in previous years. However, MUC's were only available for seven out of 12 months during 2008-09, due to the way Network Rail implemented the changes to its cost codes in September 2008.

3.24 The independent reporter has assigned Network Rail's MUC's a low confidence grade and we have not used the MUC's as part of our annual assessment of Network Rail's efficiency due to the quality and limited coverage of the data but it provided some supporting information. Network Rail is working to improve the quality and coverage during CP4, which is fundamentally important for Network Rail's own management purposes as well as being important for us to be able to accurately monitor efficiency. We will audit Network Rail's new approach before we use it to make our future assessments of the company's efficiency.

Non-WCRM renewals efficiency

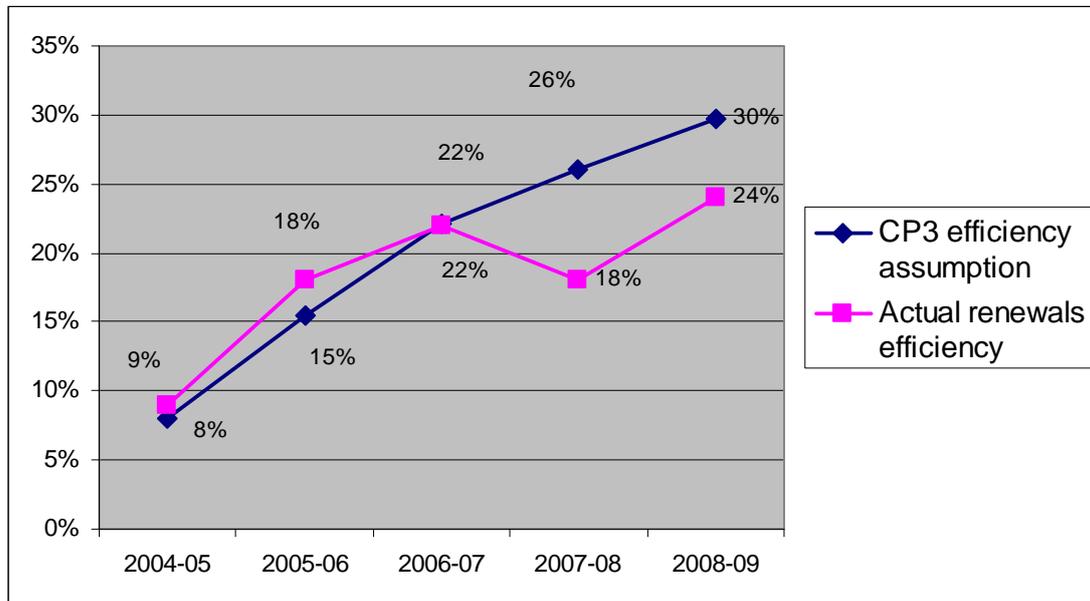
3.25 There is no straightforward methodology for assessing Network Rail's non-WCRM renewals efficiency. The unit cost data that is available only provides a partial picture of non-WCRM renewals efficiency. We

use the unit costs as supporting information and rely principally on the comparison of Network Rail's renewals budget variance compared to the ACR2003 assumptions.

Budget variance

- 3.26 Network Rail produces a budget variance analysis which shows the difference between the company's budget and actual expenditure for each year. The budget variance analysis identifies deferred activity/expenditure which allows us to take deferrals into account, since we do not count deferral as an efficiency improvement.
- 3.27 Between 2007-08 and 2008-09 non-WCRM renewals efficiency improved by 7%, making up for poor performance between 2006-07 and 2007-08, when non-WCRM renewals efficiency worsened by 4%. Over the course of CP3, the company did not achieve the ACR2003 assumption for non-WCRM renewals efficiency, achieving just 24% compared to our assumption of 30%.
- 3.28 The non-WCRM renewals budget variance was assigned a low confidence and reliability grade by the independent reporter. The reporter said that there was evidence that the categorisation process is not being correctly followed and that estimation was used to determine the attribution of the variance over the various categories. The reporter also recommended that there should be consistency between the non-WCRM renewals budget variance figures reported by the company's asset teams and those reported by the finance team.
- 3.29 Due to the lack of robust unit costs we have continued to use the budget variance analysis this year despite these concerns and the cumulative numbers are also based on this analysis. This naturally means that Network Rail's efficiency performance needs to be treated with a degree of caution. This approach will be improved for CP4 and we are working with Network Rail to ensure that adequate improvements are made, and we will audit the new approach before we use it to assess efficiency in CP4. Figure 5 shows cumulative CP3 non-WCRM renewals efficiency.
- 3.30 Based on the work we undertook in PR08, we consider that Network Rail can make a considerable improvement in its non-WCRM renewals efficiency in CP4, of at least 24%.

Figure 5: CP3 non-WCRM renewals efficiency compared with ACR2003 assumption



Source: Independent reporter annual return audit 2009 final report and ACR2003.

Non-WCRM renewals unit costs

- 3.31 Network Rail has continued to develop its cost analysis framework (CAF) for non-WCRM renewals which monitors unit costs for 43 different repeatable work activities. If the coverage and quality was sufficient then, as with the maintenance unit costs, we would use this method as our principal means of assessing efficiency, as we said in ACR2003 that our efficiency assumptions were based on unit cost improvement.
- 3.32 The unit costs available indicate (broadly supporting the assessment based on the budget variance analysis) that the company has made up some of the efficiency it lost in 2007-08. Overall, the cumulative improvement in unit cost efficiency was 20%, lower than the level of efficiency improvement derived using the budget variance approach (24%). This could be due to scope efficiencies being included in the budget variance approach and/or it could be because of the lack of robustness of the CAF and that its coverage is not wide enough.
- 3.33 Table 6 contains a summary of Network Rail's non-WCRM renewals unit cost efficiency over CP3. Track unit cost efficiency (based on composite unit rates for plain line track) improved by 5% from 2007-08, however improvements of only 18% have been made over the control period compared with ACR2003 assumption of 30%. Major signalling

unit costs improved by 4% this year to give a cumulative CP3 total of 34%. Civils unit costs improved by 4% this year and by 30% over CP3. Telecoms unit costs have improved this year by 5% and the improvement over CP3 remains at 31%. A full breakdown of renewals unit costs is provided in Network Rail's 2009 annual return.

- 3.34 Based on the available evidence we consider this performance disappointing, since ACR2003 assumed a 30% reduction in unit costs was possible. Moreover, the high levels of deferrals of non-WCRM renewals activity by Network Rail from the early to the later years of CP3, should have helped the company achieve, if not outperform, the ACR2003 efficiency assumption.

Table 6: Renewals unit cost efficiency improvements over CP3

Asset category	Cumulative CP3 efficiency improvement (%)
Track	18
Major signalling	34
Civils	30
Telecoms	31
Overall renewals total (non-WCRM)	20

Source: Network Rail 2009 annual return.

- 3.35 As with maintenance, we are working closely with the company to ensure that sufficient improvements in quality and coverage of its renewals unit costs are made to allow accurate measurement of efficiency during CP4. This is important not only for us but also for the company's management and we will audit the company's new approach, as mentioned above.

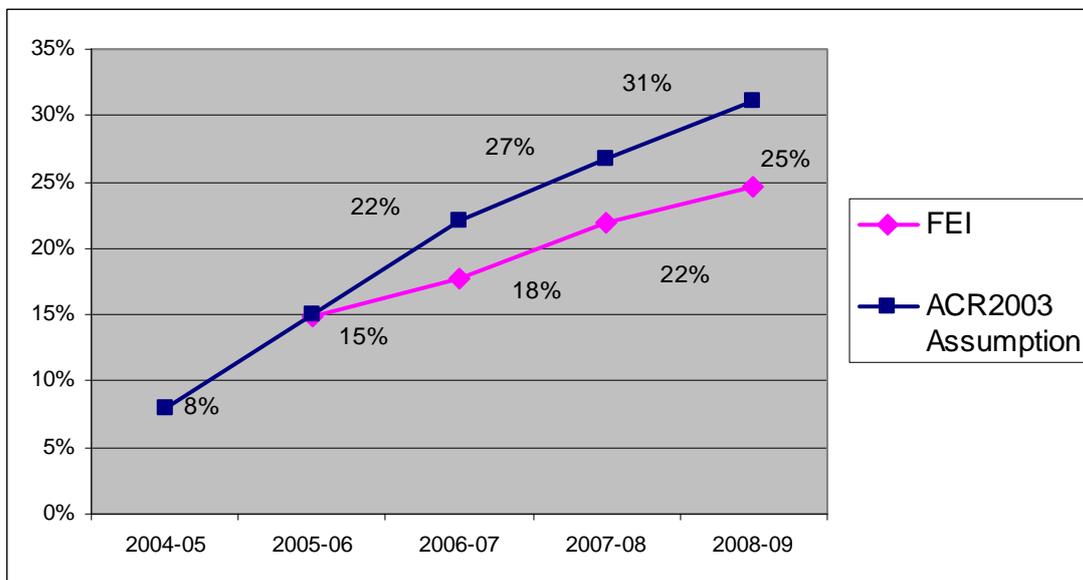
Financial efficiency index

- 3.36 In developing our view of the company's overall performance in improving its efficiency we also considered the financial efficiency index (FEI). This index shows that Network Rail has achieved a 25% cumulative efficiency in CP3, which is below the ACR2003 assumption. Figure 6 shows the actual FEI in CP3 compared to ACR2003 efficiency assumption (data is not available for the first year as the method for calculating the index changed during the control period). The method

also changed in 2007-08 to include some signalling renewals costs and the previous numbers were restated.

- 3.37 The FEI is one of Network Rail’s measures of its efficiency and weights total operating and maintenance costs, and plain line track, switch & crossing and major resignalling renewals in a single index. It covers around 60% of total controllable opex, maintenance and non-WCRM renewals expenditure.
- 3.38 There appear to be various inconsistencies in the methodology used to calculate the FEI and we are not convinced that the index gives a good indicator of efficiency. We and the independent reporter have pointed out some of these issues and Network Rail’s Board remuneration committee did make adjustments to the FEI when it made its remuneration decisions for 2008-09.
- 3.39 Network Rail has developed a new, and more comprehensive, index to measure and report its overall efficiency for CP4, which we will audit before we use it in our assessments of the company’s efficiency.

Figure 6: FEI compared with ACR2003 OMR efficiency assumption



Source: Independent reporter annual return audit 2009 final report and ACR2003.

CP3 cumulative efficiency

- 3.40 The overall CP3 efficiency profile paints a mixed picture. Improvements at the beginning of the control period were strong and show significant outperformance of the ACR2003 assumptions. However, in 2007-08 the company’s efficiency worsened, due to poor performance in track renewals. It then recovered and made further improvements in 2008-

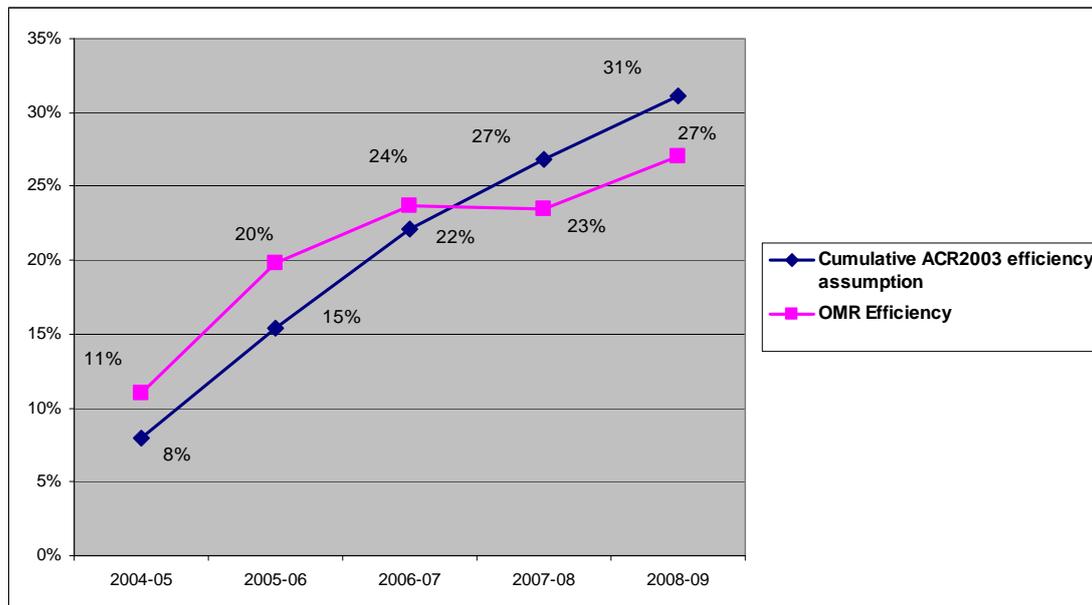
09. Overall, the company achieved a 27% efficiency improvement in CP3 and failed to achieve the ACR2003 assumption of 31%.

3.41 We recognise that 27% is a significant level of efficiency improvement for any organisation to achieve over a five year period and we recognise Network Rail has made strong progress in getting costs under control during CP3. However, we are disappointed in the overall level of achievement given the good progress that Network Rail made earlier in CP3 and because of the significant opportunities that exist for Network Rail to improve its efficiency beyond the 31% level.

3.42 In our ACR2003 final conclusions, we said that many of the initiatives that Network Rail could implement to generate savings should be able to be implemented quickly and at relatively little cost to the business. This is consistent with the company's actual performance in the early part of CP3.

3.43 However, as the work we did in PR08 highlighted, there remains a significant efficiency gap between Network Rail and the best performing railway infrastructure managers in Europe. In our PR08 determination for CP4 we assumed that, in overall terms, Network Rail should be able to improve its OMR efficiency by 21%.

Figure 7: Cumulative CP3 efficiency improvement



Source: Network Rail 2009 annual return, previous ORR annual assessments and the 2009 independent reporter audit of Network Rail's annual return.

3.44 The residual efficiency between Network Rail's 27% improvement in CP3 and the ACR2003 assumption of 31% has been taken into

account in assessing the scope for efficiency improvement in CP4 that we made in PR08. The efficiency 'gap' between Network Rail and the peer group we benchmarked it against is based on Network Rail's projected CP3 performance, which was also 27% at the time we undertook this work (albeit with some small differences in the underlying controllable opex, maintenance and non-WCRM renewals values), rather than the ACR2003 assumption of 31%.

4. Finance

Introduction

- 4.1 This chapter reviews Network Rail's financial performance in 2008-09 and in CP3. Comparisons are made against the ACR2003¹² assumptions and in some cases with Network Rail's 2008 budget.
- 4.2 This chapter covers the following issues: RAB, net debt, net debt to RAB ratio, and the adjusted interest cover ratio.

Regulatory asset base (RAB)

- 4.3 This section outlines the movement in the regulatory asset base (RAB) in 2008-09 including the adjustments made in our PR08 determination and calculations of subsequent adjustments for the actual CP3 outturn.
- 4.4 In our PR08 determination we estimated Network Rail's CP4 opening RAB to be £34.2bn. We said in our determination that we will update this estimate for actual expenditure ("actual outturn"), resulting in a control period 5 (CP5) opening RAB adjustment.¹³
- 4.5 The value of the CP3 closing RAB in this document is only an estimate at this stage as Network Rail still needs to provide us with some outstanding information before we can confirm the final value. We anticipate any difference to the value given here to be no more than +/- £0.1bn. We will publish shortly the final value of the RAB (this will include separate information for England & Wales and Scotland).

¹² The ACR2003 assumption includes the revenue deferral and the signalling review adjustments. The revenue deferral adjustment is explained in the *Access Charges Review 2003: Regulator's approval of Network Rail's proposed financing arrangements*, Office of Rail Regulation, March 2003, this document may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/188.pdf>. The signalling review adjustment is explained in the *Signalling Review: final conclusions of the medium-term review*, Office of Rail Regulation, December 2005. This document may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/269.pdf>.

¹³ See paragraph 15.13 of *Periodic review 2008: Determination of Network Rail's outputs and funding for 2009-14*, Office of Rail Regulation, October 2008. This document may be accessed at <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>.

4.6 At 31 March 2009, Network Rail's RAB, was £29.5bn.¹⁴ This was £0.8bn higher than the RAB at 31 March 2008, which was £28.7bn (after adjusting to 2008-09 prices). This is largely due to:

- the addition to the RAB of £3.8bn renewals and enhancement expenditure, less the amortisation assumption of £1.7bn; and
- the effect of the adjustment for the non-delivery of some outputs which Network Rail has deferred to CP4 (as referred to in our Network Rail monitor Q4 2008-09 document), resulting in a RAB reduction of £1.3bn in CP3.¹⁵

4.7 Table 7 summarises the movements in the RAB in 2008-09.

Table 7: Analysis of movements in the RAB

£bn (2008-09 prices)	RAB value	RAB value
Opening balance at 1 April 2008		27.9
Inflation		0.8
Amortisation		-1.7
Additions:		
Renewals assumed in ACR2003	2.6	
Enhancements assumed in ACR2003	0.3	
Other additions not funded in ACR2003	0.9	
Reductions in the RAB	-1.3	
Total additions		2.5
Total movement in the RAB		1.6
Closing balance at 31 March 2009		29.5
Adjustments for revenue deferral and incentives		4.6
CP4 opening RAB 1 April 2009		34.1

Source: Network Rail 2008-09 regulatory accounts, Network Rail submissions to ORR and ORR own calculations.

Notes:

1. The RAB is adjusted for inflation every year. The RAB at 1 April 2008 was £28.7bn after adjusting for inflation.
2. Differences may arise due to rounding.

¹⁴ This does not include the addition to the RAB of £3.7 billion to reflect the revenue deferral in the first two years of the control period and the addition to the RAB of £0.9bn of CP3 incentive payments for the volume incentive and asset stewardship incentive which are added to the 1 April 2009 CP4 opening RAB, but are not part of this assessment. Including these adjustments the 1 April 2009 opening RAB is £34.1bn.

¹⁵ The reasons for these adjustments are discussed in more detail in paragraphs 15.6 to 15.13 of the PR08 determination. The adjustment is higher than expected in the PR08 determination due to a further deferral of expenditure into CP4.

- 4.8 The RAB at 31 March 2009 was £0.6bn lower than the £30.1bn assumed in ACR2003, mainly due to:
- the effect of the adjustment for the non-delivery of some outputs in CP3 which Network Rail has deferred to CP4 (as referred to in our Network Rail monitor Q4 2008-09 document) resulting in a RAB reduction of £1.3bn;
 - a £0.5bn reduction in the RAB in relation to the adjustment for actual 2003-04 out-turn expenditure;¹⁶ and
 - a £0.3bn reduction in the RAB due to underspend on enhancements in the first year of CP3, which are remunerated on an emerging cost basis, i.e. the underspend is not retained by Network Rail so needs to be deducted from the RAB;¹⁷ partially offset by
 - additions to the RAB of £1.5bn for enhancements that were not originally funded in the ACR2003, but nevertheless qualify to be added to the RAB.
- 4.9 The RAB at 31 March 2009 was £1.7bn lower than the assumption of £31.2bn made by Network Rail in its 2008 budget, mainly due to:
- the effect of the adjustment for the deferral of renewals and enhancement expenditure included in ACR2003 from CP3 into CP4 and the non-delivery of some outputs which Network Rail has deferred to CP4 (as referred to in our Network Rail monitor Q4 2008-09 document) resulting in a RAB reduction of £1.3bn;
 - actual inflation (used to index the RAB) being lower than assumed in the 2008 budget, which meant the RAB was £0.3bn lower; and

¹⁶ Network Rail's expenditure in 2003-04 was lower than the forecast included in the ACR2003.

¹⁷ By emerging cost basis we mean enhancements for which we have not set a fixed price in ACR2003. Instead we will add the actual expenditure incurred on the enhancement to the RAB with effect from the year concerned. For further details please refer to the Enhancements funded in ACR2003 section of *Regulatory Accounting Guidelines, March 2009*. This document may be accessed at [http://www.networkrail.co.uk/browseDirectory.aspx?dir=\Regulatory%20Documents\Regulatory%20Compliance%20and%20Reporting\Regulatory%20Accounts&p ageid=2893&root=.](http://www.networkrail.co.uk/browseDirectory.aspx?dir=\Regulatory%20Documents\Regulatory%20Compliance%20and%20Reporting\Regulatory%20Accounts&p ageid=2893&root=)

- spend on projects that can be added to the RAB being lower than the 2008 budget, largely due to £0.1bn of savings on the Thameslink programme.

Net debt¹⁸

4.10 Table 8 shows the movements in net debt over the course of CP3.

Table 8: CP3 movements in net debt

(£bn, nominal prices)	2004-05		2005-06		2006-07		2007-08		2008-09	
Net debt at 1 April		12.9		15.6		18.0		18.6		19.4
Total income		-3.1		-3.1		-5.1		-5.2		-5.4
Expenditure										
Operating expenditure	1.2		1.1		1.2		1.2		1.3	
Maintenance	1.3		1.2		1.1		1.1		1.1	
Renewals	2.7		2.7		2.8		2.9		3.1	
Enhancements	0.7		0.4		0.4		0.6		1.3	
Other income	-0.7		-0.8		-0.8		-0.8		-0.8	
Total expenditure		5.1		4.6		4.7		5.0		6.1
Net interest paid		0.7		0.8		1.0		1.0		0.9
Other*		-0.1		0.1		-0.1		0.0		-0.1
Movement in net debt		2.7		2.4		0.6		0.8		1.5
Net debt at 31 March		15.6		18.0		18.6		19.4		20.9

Source: Network Rail and ORR calculations.

* 'Other' includes outperformance fund expenditure, capital expenditure not qualifying for RAB addition and working capital movements.

4.11 The £1.5bn increase in net debt during 2008-09 was £1.3bn higher than the increase assumed in ACR2003 (£0.2bn). This was mainly due to:

- £1.1bn higher enhancement spending than assumed in ACR2003; and
- £0.5bn higher spending on renewals mainly due to overspend on WCRM renewals (£0.2bn) as a result of an increase in the cost of delivering the December 2008 timetable change and overspend on non-WCRM renewals of £0.3bn largely due to expenditure on

¹⁸ The net debt section is in nominal prices unless otherwise stated.

the efficient engineering access (EEA) programme (£0.1bn), expenditure on the Future Telecoms Network (FTN) programme (£0.2bn) and lower efficiencies than assumed at ACR2003 offset partly by lower volumes of work; partially offset by

- £0.3bn lower interest payments, as financing costs averaged 4.5% in 2008-09 compared to the ACR2003 assumption of 6.0%, and as average net debt was £0.2bn lower than assumed in the ACR2003.

4.12 Net debt at 31 March 2009 was £0.4bn higher than the ACR2003 assumption. This was mainly due to:

- higher expenditure on enhancements of £1.1bn largely due to additional enhancement schemes; and
- higher expenditure on renewals of £0.7bn mainly due to an overspend on the WCRM project of £0.5bn; partially offset by
- lower financing costs of £1.0bn as the interest rates paid and average debt levels of Network Rail have been consistently lower than the ACR2003 assumption; and
- Network Rail has also received approximately £0.4bn more income than assumed in ACR2003 as explained in the income chapter.

4.13 Net debt at 31 March 2009 was £0.4bn less than assumed in Network Rail's 2008 budget. This was largely due to renewals expenditure being £0.4bn less than budget mainly as a result of deferrals of the FTN programme (£0.1bn) and the EEA programme (£0.1bn) as a result of delays to these programmes.

4.14 Expenditure in nominal prices was fairly stable over the first four years of CP3. In the final year of CP3 there was a significant increase in expenditure largely due to the additional enhancement schemes mentioned above and increased spend on renewals (explained above). The year-on-year movements in Network Rail's actual cash flows are mainly due to:

- the effect of the revenue deferral scheme reducing income in the first two years of CP3 and increasing income in the last three years of CP3 with a net impact of £2.7bn over CP3;¹⁹
- an increase in expenditure as a result of inflation;
- a reduction in expenditure as a result of improved efficiency;
- a relatively higher level of enhancement expenditure in the first year of CP3, followed by lower expenditure in the next two years and then an increase in the final two years of CP3 due to additional schemes and overspend on the WCRM project; and
- an increasing level of net interest costs mainly due to an increase in net debt of between £0.6bn to £2.8bn per year, due to Network Rail's significant net new investment in the network and the revenue deferral scheme as set out in ACR2003.²⁰ Since 2006-07 interest costs also include an annual financial indemnity mechanism (FIM) fee of £0.1bn that Network Rail has paid to DfT for providing the financial indemnity of its debt; and
- average interest costs reduced in 2008-09, mainly due to the Retail prices index (RPI) being relatively low over the second half of 2008 and at the start of 2009, which meant that the interest charges on index linked debt issued by Network Rail were relatively low in 2008-09.

Net debt to RAB ratio

4.15 Network Rail's net debt to RAB ratio is a key indicator of Network Rail's financial health. Network Rail's net debt to RAB ratio at the end of 2008-09 was 70.8%, which was comfortably within the regulatory limits set out in the licence and 1.4% higher than the ratio of 69.4% at 31 March 2008. This was due to both net debt and the RAB increasing by £1.5bn (in nominal prices).²¹ The net debt to RAB ratio at 1 April 2009

¹⁹ Part of Network Rail's grant income in the first two years of the control period was re-profiled to later years. The resulting shortfall in income of £1.6 billion in 2004-05 and £1.7 billion in 2005-06 (both numbers in nominal prices) has been financed through additional borrowing. Footnote 10 provides the reference to a document that provides more details of this income re-profiling.

²⁰ Net new investment is spending on renewals and enhancements less amortisation as set out in ACR2003.

²¹ Even though both net debt and the RAB increase by the same amount, the ratio increases as net debt increases by a larger proportion than the RAB.

after taking account of the revenue deferral and incentive adjustments is 61.2%.

Adjusted interest cover ratio

4.16 The adjusted interest coverage ratio (AICR) is one of the financial indicators that can give an indication of Network Rail's financial health.²² The actual AICR for 2008-09 was 2.03 times, which was higher than in 2007-08. This level is generally considered to indicate a strong financial position for a regulated utility.

²² The AICR measures Network Rail's adjusted net operating cash flow (total income less operating costs, maintenance, capital expenditure and corporation tax) against interest costs. This assesses Network Rail's ability to meet interest payments from net operational cash flows after deducting an allowance for maintenance capital expenditure. The maintenance capital expenditure allowance only includes the level of capital investment that is required to maintain the RAB in steady state, i.e. any capital investment that improves the network is not included. At present maintenance capital expenditure is approximated by the regulatory amortisation charge.

5. Income

Introduction

5.1 This chapter reviews Network Rail's income in 2008-09 and over CP3.

Income in 2008-09

5.2 Network Rail's income is comprised of track access charges, grant income and other single till income (OSTI) (including net income from schedule 4 and 8). Total income in 2008-09 was £6.2bn. This was:

- the same as the income in 2007-08 of £6.2bn;
- £0.1bn higher than the ACR2003 assumption of £6.1bn; and
- £0.1bn higher than Network Rail's assumption in its 2008 budget.

5.3 Table 9 shows the income for 2008-09 broken down into the various income categories compared with the ACR2003 assumptions and Network Rail's 2008 budget.

Table 9: Comparison of actual income in 2008-09 with ACR2003 and Network Rail's 2008 budget

£bn (2008-09 prices)	Actual 2008 (A)	ACR2003 2008 (B)	Budget 2008 (C)	ACR2003 variance (A-B)	Budget variance (A-C)
Franchised track access income	1.4	2.7	2.9	-1.3	-1.5
Grant income	4.0	2.6	2.5	1.4	1.5
OSTI	0.8	0.9	0.7	-0.1	0.1
Total income	6.2	6.1	6.1	0.1	0.1

Source: Network Rail 2008-09 regulatory accounts, Network Rail submissions to ORR and ORR own calculations.

Note: Differences may arise due to rounding.

5.4 Actual income in 2008-9 was £0.1bn higher than assumed in the ACR2003 determination. Lower income, from OSTI due to a decrease in property rental income, reflecting generally difficult economic conditions, was offset by higher income from access charges (including traction electricity charges paid by train operators and higher income

from the capacity charge) and a net income from the schedule 4 (possession) and schedule 8 (performance) regimes.

- 5.5 Grant income from DfT in 2008-09 was £1.4bn higher than assumed in ACR2003 due to an additional £1.5bn grant from DfT partially offset by a rebate to DfT of £0.1bn.²³
- 5.6 Franchised track access income was £1.3bn lower than assumed in ACR2003. This is due to the net effect of a £1.5bn rebate of track access charges to train operators, which exactly offsets the additional £1.5 billion grant from DfT. This is offset by £0.2bn higher income than assumed in the ACR2003, largely as a result of higher income from traction electricity charges.

Income in CP3

- 5.7 Network Rail's total income in CP3 was £27.4bn. This was £0.4bn higher than the ACR2003 assumption of £27.0bn. Overall, this is mainly due to Network Rail's £0.4bn outperformance of the schedule 8 regime, higher usage charges of £0.2bn and higher income from traction electricity charges of £0.2bn partly offset by rebates to DfT of £0.3bn.
- 5.8 Table 10 shows the income for CP3 broken down into the various income categories compared with the ACR2003 assumptions.

²³ This is a rebate paid by Network Rail to reflect the difference between the level of opening net debt as at 1 April 2004 assumed in the ACR2003 and the actual net debt at that date.

Table 10: Comparison of actual income in CP3 with ACR2003

£bn (2008-09 prices)	Actual (A)	ACR2003 (B)	Variance (A-B)
Franchised track access income ¹	7.9	10.3	-2.4
Grant income	15.4	12.5	2.9
OSTI	4.1	4.2	-0.1
Total income	27.4	27.0	0.4

Source: Network Rail regulatory accounts, Network Rail submissions to ORR and ORR own calculations.

Notes:

1. The ACR2003 income is stated after the re-profiling of income of £1.6 billion in 2004-05 and £1.7 billion in 2005-06 (both in nominal prices). Footnote 12 provides the reference to a document that provides more details of this income re-profiling.
 2. Differences may arise due to rounding.
- 5.9 Grant income from DfT in CP3 was £2.9bn higher than assumed in ACR2003 due to additional grants of £3.3bn from DfT partially offset by rebates to DfT of £0.3bn.²⁴
- 5.10 Franchised track access income was £2.4bn lower than assumed in ACR2003. This is due to the net effect of £3.3bn of rebates of track access charges to train operators, which exactly offsets the additional £3.3 billion grant from DfT. This is offset by £0.8bn higher income, than assumed in ACR2003, largely as a result of Network Rail's £0.4bn outperformance of the schedule 8 regime as train delays were less than assumed in ACR2003, higher usage charges of £0.2bn as a result of more traffic on the railway than envisaged in ACR2003, and higher income from traction electricity charges of £0.2bn.

²⁴ These are rebates paid by Network Rail to reflect the difference between the level of opening net debt as at 1 April 2004 assumed in the ACR2003 and the actual net debt at that date.

6. Financial outperformance

Introduction

6.1 This chapter summarises Network Rail's financial outperformance of ACR2003.

Outperformance in CP3

6.2 Table 10 shows the financial outperformance broken down into the various income and expenditure categories.

Table 11: Financial outperformance against ACR2003

£bn (2008-09 prices)	Outperformance
Operating and maintenance costs	0.3
Renewals	-0.7
West Coast Route Modernisation	-1.0
Variable charge income	0.2
Other income	-0.1
Incentives regimes	1.4
Interest costs	1.1
Total	1.2

Source: Network Rail Annual Return 2009.

6.3 Network Rail's outperformance in CP3, based on its methodology, is £1.2bn. This was largely due to:

- outperformance of interest costs of £1.1bn, due to the average interest rate paid on Network Rail's net debt being lower than assumed in ACR2003, partly due to the effect of Network Rail being provided with a financial indemnity from the government, and lower average debt over the course of CP3 than assumed in CP3; and
- increased income from incentives of £1.4bn;
partially offset by
- a net overspend of £1.4bn on expenditure.