OFFICE OF RAIL AND ROAD

2018 periodic review

ORR's Draft Determination – Summary of conclusions for England & Wales

June 2018

Summary of conclusions for England & Wales

Context

- This document sets out a summary of ORR's proposals for the regulation of Network Rail over the five-year period from 1 April 2019 in respect of England & Wales. We have set out our proposals in respect of Scotland in a separate document.

- More detail on these proposals is included in our PR18 Draft Determination Overview, which is available here.

Introduction

1. Today, we set out our draft conclusions on Network Rail's plans for the operation, maintenance and renewal of its network over the five-year control period ('CP6') starting next April.

2. We propose to accept the majority of the company's proposals, subject to it making a small number of important updates to its plans. We have also set out our expectations on what Network Rail should deliver for its passenger and freight customers, including how its investment should protect the condition and reliability of the rail network over CP6.

3. Our decisions take the form of separate draft proposals for England & Wales and for Scotland, reflecting legislative requirements and how Network Rail is funded.

4. We welcome both governments' ongoing support for the railway, which provides a substantial increase in expenditure for operating, maintaining and renewing the network in both England & Wales and Scotland, amounting to over £34bn in the five years to 2024.[1] It is essential that this money is spent efficiently and delivers improvements to passengers and freight users, and our proposals include significant changes to how we monitor Network Rail and how we hold it to account.

5. The remainder of this document sets out our proposals for England & Wales. We have a separate summary for Scotland, which is available here.

The draft determination for England & Wales

6. Our determination for England & Wales will be different from those in previous periodic reviews. This reflects, in particular, that this is the first review to take place after Network Rail was reclassified as a public sector body, and was subject to much

[1] The England & Wales and Scotland statements of funds available (SoFAs) also included funding for other expenditure, including some enhancements.

closer control by governments on its spending, including the removal of Network Rail's ability to raise new finance on its own account. This means that the funding available to the company is effectively fixed.

7. We have carried out a detailed review of the company's plans, challenging whether the plans: include a reasonable degree of stretch (and so are a good basis for measuring how the company performs); provide a credible response to the recent deterioration in the company's efficiency; and are deliverable. We have also looked at whether the plans make appropriate trade-offs between the competing priorities facing the company, including between maintaining the network, renewing it to raise asset condition and spending to raise performance levels delivered to passenger and freight operators in the near-term.

8. In undertaking this work, we have not set detailed outputs, unless required by a government high level output specification (HLOS), nor have we made detailed changes to Network Rail's financial assumptions. We have been guided by four broad principles:

   - **reinforcing the relationship between Network Rail and its customers**, the train operators. We want Network Rail to agree scorecards with its customers and for there to be a clear process to change these scorecards over time;
   - **supporting further devolution to routes and the System Operator** (SO) and more broadly Network Rail's transformation in the way it organises itself;
   - **reflecting the reasons why government provided a significant increase in funding for the railway** which was – as set out in our earlier advice – the desire for a sustainable railway where asset condition is maintained over time through increased renewals; and
   - **learning lessons from CP5**, including the need for the company to 'own' its plans, the importance of deliverable bottom-up plans and the importance of setting a stretching but realistic efficiency challenge.

9. This process of Network Rail preparing, and ORR scrutinising, business plans has benefitted from a number of changes that the company has put in place. First, Network Rail has increased the role of the eight geographic route businesses, and also created a more distinct SO (whose functions centre around maintaining the benefits of having an integrated national network) and the Freight & National Passenger Operator (FNPO) route (responsible for supporting those operators who substantially rely on several geographic routes).

10. This has led to a much clearer set of route business plans covering the next five years, which set out: what the routes plan to deliver (with key deliverables captured in scorecards); the baseline expenditure plans that will support this delivery; the additional funding needed to cover route-level risks; and a series of additional

schemes that could be pursued if risks do not crystalise or efficiency improves faster than forecast.

11. Importantly, these plans have benefitted from closer involvement of train operators and other stakeholders. While there are areas that still need to be improved, the quality of these plans is better than in the 2013 periodic review, with a real sense that each route management team feels fully accountable for its plan.

12. Second, these plans have been prepared and justified on the basis of bottom-up analysis of the work that needs to be done in each route. This has also supported a clearer focus on route-level initiatives, to promote improved efficiency over time.

13. Third, we now have a separate plan for the SO, following its creation as a distinct business unit within the company. This plan focuses on improving the capability of people and processes, so that Network Rail can make better use of the national network, deliver better timetabling of trains and support funders' decisions on how best to expand the capability of the network. Some of these improvements will take time to deliver for passengers and freight users. However, it is important to raise the capability of the SO, so that future timetables support reliable services and that changes are effectively managed. This has been highlighted by the severe disruption caused by the May 2018 timetable change. We are investigating Network Rail's role in this and carrying out a wider inquiry at the Secretary of State's request into why the system as a whole failed to produce and implement an effective timetable.

14. However, there is still more work for Network Rail to do in areas such as the extent to which the routes can hold the central functions to account. And, as described below, Network Rail's costs have been overstated in some areas and stronger controls are needed in others. Network Rail's transformation therefore remains a work in progress.

15. Overall, we have found that the route, SO and other supporting plans represent an important step forward. The evidence from our work – informed by conclusions from our consultants – is that the plans are broadly fit for purpose. In some areas, we have set out different views to the Network Rail's plans, such as on where the funds for financial risk should be held, the amount of income Network Rail can generate from other sources and the relative priorities for some expenditure.

16. We are mindful of the improved process by which the business plans were produced, and the ownership that the routes and SO have demonstrated of these plans. Reflecting this, rather than requiring detailed changes to the plans, we have asked Network Rail to update its plans in a small number of significant areas where we think that change will produce an outcome which is likely to meet better the needs of passengers and freight customers. Network Rail has agreed to prepare information

that would support such a targeted change to its plans, should it accept the proposals we set out in our draft determination.

17. When identifying these updates, it is important to maintain ownership by the routes, SO and Network Rail overall for the plans as well as accountability for delivery. It is also important to maintain the link to what customers want to see. Consequently, we have set out how Network Rail will engage with its customers and other key stakeholders, particularly in respect of any updates to performance targets. We recognise that the detail of what Network Rail will deliver will evolve over time, and in particular we note the importance of its delivery plan.

Controlling expenditure and improving efficiency

18. We have looked at whether the costs included in Network Rail's plans are justified and reflect a reasonable estimate of achievable efficiency improvements. We have done this through route-level scrutiny of plans (including at least 200 subject-specific meetings with Network Rail since December 2017), analysis of Network Rail's central processes and guidance, and external reviews by technical consultants.

19. In general, Network Rail's approach to planning and costing work has improved, and while there are aspects of the route and SO plans that could be improved, they provide a reasonable basis against which to hold the company, routes and SO to account. However, there are a small number of significant areas where Network Rail needs to adjust its plans to reflect:

    (a) **A greater stretch on efficiency**. Our scrutiny has revealed evidence of the potential for additional efficiency savings across the business plans. A proportion of these could be quantified, but it was not possible to do so for the remainder in light of the data and time available.

    In addition, we are mindful that making a large number of detailed adjustments risks undermining route ownership of the plans. We have, therefore, decided to identify an overall level of additional stretch on efficiency that we consider to be reasonable. In this respect, we have considered the way that Network Rail applied a series of top-down 'headwinds' (i.e. what it considered unavoidable external costs) to its plans. While some of the reasons for these cost pressures may be legitimate, many are poorly justified and are things that the company should be mitigating in any case.

    More generally, we have insufficient evidence that the company has completely removed the inefficiencies that are included in the baseline data used to estimate likely future costs levels. Network Rail has not identified the headwinds or tailwinds it may have experienced in CP5 (which we asked it to do in our earlier guidance). This weakens its arguments for saying that the headwinds it thinks it will face in CP6 are genuinely incremental or are already reflected in the CP5 expenditure data used to forecast CP6 costs.

Furthermore, the changes that the company has been making will have delivered efficiency improvements already, and the scales of these will increase over time. These efficiency improvements are not reflected in its forecasts for CP6.

In light of this, Network Rail's plans should incorporate further efficiency savings. We have used the value of removing most of the 'headwinds' as an indication of the scale of these additional efficiency savings, while recognising that the company has the potential to realise further gains.

This has the effect of providing £586m that can reasonably be included back into the company's baseline plans, which we estimate raises the company's efficiency forecast from 8% to about 10%. In broad terms, this would return the company back to the efficiency levels seen in CP4.

(b) **Including investment in research and development (R&D), but reducing the initial funding to reflect the challenges elsewhere in the business**. We strongly support expenditure on R&D and see it as an important way for Network Rail to deliver efficiency, improved asset management and performance improvements over time. The company included £440m of expenditure on R&D across Great Britain (which equates to £399m in England & Wales) over CP6. Given the challenges faced on asset condition, this amount should be reduced, in favour of more work to renew network assets.

Network Rail should, therefore, include a spend of £100m across Great Britain in its updated plan. This equates to £90m in England & Wales, which allows £309m to be allocated to other renewals expenditure across these routes. In the event that Network Rail manages risks effectively, this would allow central risk funding to be used to increase spending on R&D over CP6.

Furthermore, the governance arrangements currently in place to oversee R&D are not sufficient for the scale of the proposed expenditure; do not provide a sufficient focus on attracting matched, third-party funding; raise concerns about deliverability; and do not demonstrate how the lessons (whether positive or negative) from previous R&D expenditure are built into future plans. We have asked Network Rail to propose new governance arrangements.

(c) **Recognising additional income**. We have reviewed Network Rail's income forecasts and have identified £64m of additional income relating to the company's property portfolio. Network Rail told us it had omitted the income from the Crossrail supplemental access charge from its Strategic Business Plan (SBP) It has estimated this at £250 - £300m depending on the cost of debt assumption. We are discussing the treatment of this income with the Department for Transport (DfT). Our view is that this amount could be used to support further progress on improving asset sustainability.

20. In addition, Network Rail included across England & Wales a £1.7bn provision for a centrally-held 'group portfolio fund' and a further £0.6bn in the route plans. It is important that Network Rail is able to efficiently manage the risks faced by its

business, which in turn allows the company to be held accountable for delivery over CP6. However, we do not agree with the approach adopted by Network Rail for this fund.

21. While the overall sizing of the fund looks to be proportionate to the risks faced by the company, we do not consider that holding the majority of this fund centrally would support efficient delivery by the routes. Instead, Network Rail should review its allocation of risk funds to routes and reallocate around £0.9bn of this into route expenditure plans on projects that can be cancelled or delayed relatively easily (and without safety consequences) if risks do materialise.

22. In order to improve incentives and accountability the routes will identify, in advance of CP6, the asset condition and performance improvements that the expenditure would support if risks do not materialise. These improvements would not be included in the initial scorecard targets. However, they would provide additional evidence to allow performance targets to be raised in the event that the risks facing Network Rail moderate, allowing additional work to be delivered.

23. This change would also allow routes to play a larger role in the management of this fund. Although we would expect Network Rail to retain some central controls over this aspect of route spend (as it covers company-wide risks), this would provide a clearer basis for understanding what the routes could deliver, where risk funds are able to be released.

24. More generally, we have asked the company to propose new governance arrangements for the use of the group risk funding and generally for the movement of funding within the business. These arrangements should provide for route managing directors to take a much bigger role in these decisions. Any decision taken by the centre to adjust route budgets (for the purpose of managing the company as a whole) needs to be publicly recorded, and subject to the new arrangements for managing changes; backed by new provisions in the company's licence. Network Rail should also develop an improved methodology for making inter-route trade-offs, in light of the limitations we have identified with the current approach.

Improving safety, asset condition and performance

25. Our earlier decisions have identified resources that can be redeployed to support the delivery of further renewal of the railway in CP6. This provides an opportunity to address some areas where Network Rail's plans do not include sufficient expenditure.

26. The first of these areas is safety. Our scrutiny of Network Rail's proposed plans for CP6 has shown that there is evidence of growing maturity in its management of health and safety. Network Rail has targeted efforts at priority areas in order to

deliver its health and safety strategy – the Home Safe Plan. In doing so, it has ensured its efforts are focused and has secured route commitment to deliver. It is promoting the use of RM3[2] as a tool for securing excellence.

27. Network Rail's own assurance activities have been robust – resulting in progressive challenge to route proposals and securing improved arrangements. This is a positive development. The routes show varying degrees of ambition and maturity – but the matrix framework has the potential to drive the required improvements. In particular, there needs to be an evolution in routes' understanding of what the legal duty of reducing safety risk 'so far as is reasonably practicable' means for their investment decision-making. Indeed, we considered that some aspects of Network Rail's plans do not comply with minimum safety standards.

28. The second main area is the work planned to improve asset condition, which also supports longer-term improvements in performance and safety. This is important as we have long highlighted the importance of maintaining a sustainable asset base; something which supports both value-for-money and a punctual railway. In our February 2017 advice to the DfT, we set out concerns about the deferral of renewal work from both CP4 and CP5 and the detrimental impact it was having on long-term asset condition. The Secretary of State took account of our advice when he confirmed the funding he was providing to Network Rail for CP6.

29. Reflecting this, we have asked Network Rail to make a targeted set of important adjustments to its plans. In particular, Network Rail needs to do the following.

    (a) **Include in its baseline plans £80m of additional safety-related expenditure,** rather than treating them as discretionary projects. This will increase spending on level crossings in particular and a number of important driver and worker safety initiatives.

    (b) **Change the sustainability of assets**: more work should be included to improve asset condition beyond the levels indicated in Network Rail's plans, which should also address safety risks that we have identified. Consequently, there should be around an extra circa £1bn of expenditure on a range of assets, with particular priorities including earthworks, drainage, track and structures. This work should be included in the baseline route plans, and would improve safety, the resilience of the railway and, when completed, have a positive impact on the performance levels delivered to passenger and freight users.

    (c) **Change performance targets**: we have required three routes – Anglia, Wessex and South East – to change the targets relating to their contribution to overall passenger performance (referred to as the consistent route performance measure), as their proposals were not prepared on a consistent basis to the

[2] RM3 describes what excellent management capability would look like for the key elements of an organisation's health and safety management system as measured against five maturity levels.

other routes. This will support better comparison between the routes and outcomes for passengers. More generally, while the position on performance remains challenging, the focus on improving asset condition will improve passenger and freight performance over time.

(d) **Launch a performance innovation fund**. While the principal focus of the adjustments to Network Rail's plans is to improve asset sustainability, there is an opportunity to provide a moderate amount of additional funding to support innovative proposals to improve passenger and freight performance. We have asked Network Rail to bring forward governance proposals for such a fund, and to identify £10m of initial funding to support the testing and implementation of new ideas. These might involve new operational approaches, research or changes to how industry rules apply in certain circumstances.

(e) **Address concerns with the profile of expenditure** so that there is a smoother profile of work within CP6 and an orderly transition into the following control period. A smooth profile of work is likely to be more efficient and better for supply chain management. Network Rail also needs to do further work to provide assurance that the increased work planned for CP6 is deliverable. In doing so, it will also need to take account of the public sector financial rules that HM Treasury will be applying to the company in CP6. These principally limit the transfer of funding between years, making it more important that Network Rail accurately forecasts spend in each year of CP6, so that it can maintain efficient delivery within the rules.

30. When updating its plans, we want Network Rail to improve on the process it followed in discussing and agreeing performance targets for PR18. Overall, while there was good initial high-level discussion on route objectives, this was not repeated as discussions moved on to the detail of individual targets where a generally late start was made to these discussions. The additional planning that Network Rail now needs to undertake provides a valuable opportunity for all parties to reach greater levels of agreement. This will require train operators to engage constructively, build on the lessons learnt from the process to date, and focus on what can be delivered (and how this can be achieved) in practice – it will not be sufficient for operators to point to their franchise targets, if there are good reasons why these cannot be delivered.

31. The proposed changes address the requirements set out by the Secretary of State in his HLOS, and reflect the priorities identified by ORR for PR18. In particular, they better secure the safe operation of the railway, make greater progress to improve asset condition by reversing the historical deferrals in renewing the network and, in so doing, improve the performance levels delivered to passengers and freight customers.

32. Overall, and taking account of the above adjustments, we consider that the Secretary of State's HLOS is affordable.

33. As a public body, Network Rail is subject to a set of budgetary controls, which it must operate within when delivering in CP6. The UK Government has set out the budgetary flexibility it expects to allow Network Rail in CP6, which will, for example, allow up to 10% of capital expenditure budgeted for a particular year to be moved to other years. This proposal gives Network Rail significantly more flexibility than most other arms-length public bodies, but increases the importance of accurate forecasting of expenditure, not least due to the need to provide predictable work volumes to the supply chain.

Holding Network Rail to account in CP6

34. The improvements in the quality of the business plans, taken alongside our approach to only require Network Rail to make changes where there is a strong case to do so, mean that the original route and SO plans remain largely valid. Indeed, the key challenge in coming months is to supplement these plans with additional activity.

35. This means that the up-front investment made by the routes and the SO in these plans has paid off, and the plans can be built on as a basis for delivery in CP6. This also strengthens the route's ownership of them.

36. For our part, we need to put in place the arrangements for monitoring the company and for holding the routes and SO to account. This will build on the changes that we are making to our bi-annual Network Rail Monitor document and monitoring teams, to focus more on route comparison.

37. To support this, there are a number of changes that we expect of Network Rail, and which it has committed to the following.

    (a) **Develop credible plans for improvements to SO systems**, as we move from the current early-stage plans into specifications that can be costed and contracted for in detail. As part of this, the SO business plan will introduce a clear decision-point so that customers, governments and ORR have sufficient confidence that the improvements will deliver tangible benefits before the full spending on these is committed.

    (b) **Improve the way customers are involved in decisions** to set performance targets, update route plans and finalise the CP6 delivery plan; reflecting the lessons-learnt from the way customers were engaged previously during PR18.

    (c) **Reform its internal governance arrangements** so that routes and the SO have greater control over whether they buy services from other parts of the company and what they buy. And where choice is not possible, that they have much more influence over these centralised decisions. Network Rail has recently made a number of changes that move the company in this direction, and is reviewing the arrangements for Infrastructure Projects, but further work will be needed so that they have the desired practical effect. If the routes and

SO cannot, in practice, hold these parts of the business to account, we will adapt our approach and increase our direct oversight of these areas of the business.

(d) **Identify appropriate governance arrangements for the agreed level of Digital Rail spend**, so that the expenditure is ring-fenced for this purpose, involves funders and other stakeholders and applies the lessons learnt from recent reviews of enhancements delivery.

38. In order to sharpen the incentives on Network Rail to deliver against its plans, we will do the following.

(a) **Improve the monitoring of whether efficiency improvements are likely to be delivered**, by identifying a set of leading indicators such as the percentage of required possessions that are booked.

(b) **Apply new arrangements to manage changes to Network Rail's plans and structure**, so that there is sufficient transparency around changes to those plans and that major changes that could undermine the effectiveness of our regulation of the company are reviewed and could – in certain circumstances – be prevented from taking place. These changes will include handling the impact on operations, maintenance and renewals spend of new enhancements required by funders.

(c) **Restructure Network Rail's network licence to make accountabilities clearer**, by reflecting the creation of distinct routes and the SO in the company's licence. This will support our route based regulatory approach by improving our ability to target our monitoring and enforcement to the relevant parts of Network Rail – holding the right management team to account.

(d) **Monitor and report on the performance of routes and the SO against the CP6 plans**, and make greater use of public comparisons across routes and the SO, including on the performance levels delivered to customers, putting more scrutiny on those parts of the company that are lagging behind. Equally, we expect to take the opportunity to highlight the successes of the individual management teams, supported by our own route-based monitoring teams. A route comparison scorecard will form the basis of these comparisons.

(e) **Improve the monitoring of efficiency and financial performance.** We will move to providing a better understanding of the efficiency of Network Rail's routes by putting greater emphasis on reviewing and reporting on how routes have delivered efficiency improvements. We will make greater use of information from our safety role, for example, drawing on insights from safety reports where relevant; and we will provide more assessment of cost drivers, unit costs and productivity measures over time and across routes.

(f) **Update our approach to escalating concerns and enforcement**, so that we make better use of reputational incentives alongside our existing licence enforcement powers. This will include holding the management teams of the routes, SO and other business units to account for their actions, including through the potential for ORR hearings between routes/SO and affected parties; a change that we will reflect in an update to our monitoring and enforcement policies on which we plan to consult later this year.

Charges and incentives

39. Our draft determination decisions are consistent with the high-level decisions that we have already set out in respect of the charges that operators will pay and the financial incentives in place to encourage improved performance on the network. This will lead to a major simplification to charges and incentives, with the removal of the route-level efficiency benefit sharing mechanism, volume incentive, capacity charge and coal spillage charge, and simplification of other freight charges.

40. We are also confirming the detail behind our earlier consultation on charges, setting out proposals that provide a balanced package that provides operators with time to adjust where cost pressures are putting upward pressure on charges. In particular, we confirm the following.

(a) **Variable network access charges for freight and charter operators will be capped**, so that variable usage charges only increase to reflect the full costs of wear-and-tear on the network (as required by relevant legislation) towards the end of CP7. This will mean that, on average, total variable charges will remain flat for freight and charter operators for two years and then increase over the last three years of CP6; variable usage charges will be capped to achieve this profile. The average annual increase in the total variable charges over CP6 will be 2.1% for freight and 1.2% for charter, in real terms.

In addition, using CPI to index charges instead of RPI will mean charges are on average 5% lower than they otherwise would have been at the end of CP6. Greater collaboration between Network Rail and operators to improve efficiency also has the potential to further mitigate any increases in subsequent control periods.

(b) **Charges that recover fixed costs of the network will be reformed to support competition over time**. New open access passenger operators will face higher charges for ‘inter-urban’ services, where demand is sufficiently strong to allow these costs to be met. This can support them having greater access to these parts of the network. These additional charges will be reflected in our assessment of the likely benefits generated by open-access applications and will inform our decisions on whether to grant access to the network. Existing open-access operators will be protected from these charges over CP6, for their existing business.

(c) **Financial performance incentives on the company will be updated**, including to reflect the new research that ORR commissioned on how passengers plan their journeys and the impact of delays. More generally, the incentives on punctuality and delay (notably 'Schedules 4 & 8') will be updated to reflect the most recently available data, and we welcome the industry-led process that will deliver many of these updates.

Summary and next steps

41. Network Rail's February 2018 strategic business plans are a significant step towards securing improvements for passengers and freight customers in the next control period.

42. However, we have asked Network Rail to make a small number of significant updates to its plans – these are summarised below. Network Rail has agreed to undertake additional work to identify what these scenarios would involve, while reserving its position on whether or not to accept our draft determination.

43. Through our assessment of Network Rail's plan, we have identified a number of opportunities (circa £1bn in CP6) for Network Rail to increase its income or reduce its expenditure by being more efficient and reducing the funding for R&D. However, Network Rail is also not proposing to spend enough on the network to maintain sustainability at the start of CP5 level, and we think it can use the money we have identified to increase its spend in this area. This is shown in Table 1 below.

Table 1: Summary of ORR adjustments to Network Rail's SBP

£m, 2017-18 prices	Additional income / reduced expenditure (£m)	Additional expenditure £m
Additional efficiency challenge	(586)	
Reduction in GB R&D funding to £100m	(309)	
Additional property income	(64)	
Additional safety compliance		80
Asset sustainability – increase in committed expenditure on renewals		circa £1,000
	(959)	**circa £1,000**
Other items: - **performance innovation fund (initial GB funding of £10m)**; **and** - **Crossrail charges income of between £250m and £300m.**		

44. There remains some uncertainty around these figures, as they are based on a series of forecasts.

45. The table below summarises our proposals on risk funding in CP6.

Table 2: Summary of risk funding (England & Wales, 2017-18 prices)

Proposed breakdown of risk funding	
Route-level risk fund	£600m
Contingent renewals, held at route level	£856m
Group portfolio fund	£856m
Total[3]	**£2,311m**

Next steps

46. Ahead of our final determination at the end of October 2018, we have asked Network Rail to amend its plans to allocate a further circa £1bn of funding to routes. Network Rail has agreed to commence the work needed to identify the updates that it might make to its plans, should it accept this aspect of our draft determination. This information will be provided to ORR in late July, allowing further consideration ahead of our final determination.

47. A reallocation of £856m of risk funding should also be made into the routes' plans, to be held as 'contingent renewals'. Before the start of CP6, we want routes to identify the additional activity that would take place, and the broad outcomes that would result, if risks did not materialise.

48. After our final determination, Network Rail will prepare its plans for delivering against the determination, and we expect stakeholders to be closely involved in the preparation of those plans.

[3] Total does not sum due to rounding differences.