Responses to the second consultation on PR18 Financial Framework

PR18 Consultation
Office of Rail and Road
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23rd April 2018

Arriva Response to ORR's 2nd Consultation on the PR18 financial framework

This letter responds to the ORR's 2nd consultation on the PR18 financial framework. The response is provided on behalf of Arriva plc, its subsidiary Arriva UK Trains Limited and its wholly owned train operating companies (TOCs), Arriva Rail London Limited, Arriva Rail North Limited, Arriva Trains Wales/Trenau Arriva Cymru Limited (ATW), Grand Central Rail Company Limited, The Chiltern Railway Company Limited (CR) and XC Trains Limited (XC). Arriva is a wholly owned subsidiary of Deutsche Bahn AG (DB AG).

Arriva views the PR18 process as a significant opportunity to ensure that the structure and processes of the rail industry deployed in CP6 are aligned to the delivery of shared industry objectives; particularly safety, efficiency, growth and strong performance. It is also essential that the outputs that the industry delivers meet the needs and expectations of rail users and funders. We therefore welcome the opportunity to respond to this consultation and are pleased to engage in wider industry dialogue to help develop appropriate arrangements for CP6.

Arriva has also played an active part in the Rail Delivery Group (RDG) work on PR18 and supported the preparation of the response provided to this consultation by RDG. Where Arriva has not responded directly to the questions raised by ORR in its consultation document, ORR should refer to the RDG response in that area which Arriva endorses.

In establishing the CP6 financial framework for Network Rail Arriva believes that, above all, it is essential that the Routes, NSO and Network Rail support functions are provided with sufficient resources to deliver the outputs that Network Rail's customers and funder reasonably expect. In determining the required resource level, there should of course be an expectation that Network Rail will undertake its activities in a cost effective manner. However, expectations in this area should be set at a level which is demonstrably deliverable with a reasonable degree of certainty and not be aspirational.

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At present, through a review of the Route Strategic Business Plans, it would appear that the resources being made available to the Routes are not considered by Network Rail to be sufficient to ensure the delivery of the outputs that customers and funders are looking for.

It is important that this gap is addressed transparently in the short time remaining in the PR18 process – if necessary innovative approaches should be considered.

It is unclear if the ORR's observation that "DfT has not included funding specifically to cover financial risks in its SoFA" means that the SoFA does not include funding to cover risks or that these funds are not separately identified. It seems unlikely that Network Rail's status as an arm's length public sector body will make it immune to the effects of such risks. Clarity in this area would be beneficial.

Central to dealing with this issue will be the establishment of appropriate and transparent arrangements for Network Rail to manage the financial risk associated with unforeseeable events which might occur in the course of CP6. Clearly, these arrangements need to be established in the context of loss of the mechanisms that Network Rail was previously able to deploy to address such risks and must be transparent to all parties.

At present, Network Rail has included contingency funds in the Route Strategic Business Plan Budgets – Arriva welcomes this approach as it provides direct local control of how risk might be managed without the need for repeated replanning of activity with the resultant loss of efficiency, as observed in CP5.

Currently, Network Rail has also provided a significant contingency fund to be held centrally. While Arriva recognises the potential benefits of a strategic centrally managed approach to addressing significant risks, Arriva has concerns with this approach as it appears to have left the Routes reporting a shortfall in the funding necessary to deliver the outputs expected by customers and funders with no clarity as to how these central funds are accessed. Furthermore, it could potentially hinder the further development of devolution if the routes can go "cap in hand" to the centre.

Arriva would look to Network Rail to develop its thinking in this area further by considering how it will progressively release contingency funds held centrally to the Routes as CP6 progresses and the remaining term reduces. This work should include consideration of the affects on end users, Network Rail customers and funders. Network Rail should also consider allocating more of the central contingency fund directly to the Routes in conjunction with the establishment of suitable mechanisms to deliver flexibility to reallocate funds between Routes in the course of CP6. However, Arriva would not support the establishment of a portfolio of "cancellable" schemes as this has a material chance of creating delivery inefficiencies and disrupting the already challenging planning process, not to mention the potential detrimental impact on performance.

As an organisation managing real-time operations as well as a diverse asset base (including many significant structures where the historical condition may be uncertain) and which are also subject to external impacts beyond its control, Network Rail needs to be equipped with appropriate mechanisms to deploy the resources made available to it flexibly. This flexibility should include the ability to:

- Move money (including contingency funds as discussed above) between Routes subject to appropriate control mechanisms as addressed in ORR's Working Paper 8 on managing change affecting the PR18 settlements
- Moving money between years
- Switching expenditure between operating and capital expenditure
- Reprogramming work between years to:

- align with the resources and money available,
- release resources and money to address unforeseen circumstances
- align activity with the best use of the network to provide train services
- package work to deliver the best delivery efficiency.

Thankfully, the nature of Network Rail's activity does provide it with the opportunity to make good use of such flexibility and Arriva wish to see this deployed.

Therefore, Arriva would suggest that Network Rail should be provided with a level of financial flexibility to address routine and small scale changes – a 10% flex along the lines of that provided to the Highway's Agency has been suggested. However, Network Rail should also be enabled to deploy a greater level of flex if:

- this would enable it to unlock delivery cost reductions, end user benefits or operational improvements
- the financial flex is aligned with a change in the activities being undertaken.

As has been demonstrated in CP5, the absence of such flexibility can lead to instability in work banks, reductions in work done, repeated replanning and increases in delivery costs and a detrimental impact on the end user, whether passengers or freight customers

The approach to indexation for CP6 is a specific case of one of the external risks that Network Rail will be tasked with managing with the constraints it now has as an arm's length public sector body. It appears to Arriva that these risks are not specifically associated with the choice of index but more to the limited flexibility that Network Rail faces in a situation where the indexation of Charges income does not match inflation in its cost base – a challenge which is increased give that grant income is not to be indexed.

Arriva's experience of managing costs based associated with operational and asset management activities suggests that staff costs seem to align more closely with RPI while other costs are influenced by factors not reflected by either RPI or CPI and often increase faster than either of these indices. In addressing the issue of indexation of access charges, ORR should take account of the indexation mechanisms deployed in the contracts that Network Rail's customers have with transport authorities and end users – it is important that indexation mechanisms across the rail industry remain aligned.

The best approach to this challenge seems to lie in ensuring that the arrangements established to enable Network Rail to manage risk are appropriate - including the approaches to flexibility and change management. It is essential that these mechanisms include appropriate arrangements for consultation and other engagement with Network Rail's customers.

Yours sincerely

Richard McClean
Managing Director

Department for Transport

Conrad Bailey
Director, Rail Strategy, Reform and Analysis
Department for Transport

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24 April 2018

Dear John,

Financial Framework for Control Period 6

Thank you for the opportunity to provide input to the development of the financial framework for Control Period 6 (CP6). I am writing to set out Government's views on the draft proposals and to confirm the agreed Government position on the extent of financial flexibilities that will be granted to Network Rail (NR) during CP6.[1] At the outset, I would like to thank the ORR for the constructive way in which it has worked with the Department on these issues over many months.

Financial Flexibilities

We are now in a position to confirm that from the start of CP6, the financial arrangements put in place around NR at the time of its reclassification to the public sector will no longer apply. These arrangements, which assigned NR spending to Annually Managed Expenditure (AME) were a useful and necessary measure to allow the incorporation of NR into a public sector accounting regime without disruption to either the operation of the railway or wider public spending. However, as we move into CP6, it is right that NR is brought into closer alignment with other Government bodies of a similar nature. I can therefore confirm that from 1 April 2019, NR spending will, for the most part, be scored under the Departmental Expenditure Limit (DEL) regime. The exception to this will be NR's expenditure relating to: interest costs (including accretion), corporation tax, revaluation of derivatives and revaluation of pensions. We have determined that as this expenditure is essentially outside of NR's control, classification as AME is more appropriate. Switching the majority of NR's spending to a DEL regime is designed to support NR to take firmer action to control its annual spending levels and supporting Network Rail with improving its cost forecasting, supporting realistic and deliverable project estimates. In broader terms, our intention is also to ensure a greater predictability of NR's substantial spending.

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[1] This response should be treated in the context of the Secretary of State's Statutory Guidance to ORR - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/629698/guidance-to-the-office-of-rail-and-road.pdf - and in particular the emphasis on the ORR's duty to have regard to the funds available to the Secretary of State for railway purposes.

Government accepts that the specific nature of NR's business means that a strict application of normal DEL rules would not be appropriate to achieve the Government's objectives and effectively deliver the continuing record levels of Government investment committed for CP6 to improve our railway. In particular, Government acknowledges a degree of inherent volatility in some of the work NR undertakes, which is further exacerbated by the timing of the key Christmas engineering works within the financial year (and Easter when it falls within March) and the increased risk of severe weather disruption in the period from January to March. Additionally, Government fully recognises the importance of ensuring a degree of flexibility to enable Network Rail to appropriately and efficiently manage what are often complex projects. Government has therefore agreed a package of additional bespoke flexibilities, in excess of those granted to most other public sector organisations, to enable NR to manage its business effectively within a DEL environment.

Taking into consideration, therefore, the dual requirements of public sector spending stability and appropriate flexibility for NR to manage its business efficiently and effectively, Government is offering the financial flexibilities to NR for CP6 as set out in the Annex to this letter.

The end-year flexibility being offered is almost without parallel in the public sector and represents an exceptional measure by Government to maximise NR's ability to manage risks in an efficient and effective manner. It reflects the Government's clear commitment, whilst ensuring appropriate budgetary control, to support the delivery of the CP6 capital programme, helping to deliver a safe and more reliable railway.

Other issues relating to the Financial Framework

More broadly, the UK Government welcomes the proposals put forward in the Second Consultation on the Financial Framework. We are grateful to ORR, as we highlight above, for the extensive engagement with Government in recent months and are very pleased by the extent to which the consultation reflects both our objectives for the railway as articulated in our HLOS and SoFA and the realities of the public sector financial regime into which NR will be incorporated for CP6.

In particular, we consider that the structure of the ORR's proposed building blocks approach appears to be a pragmatic approach to converting the requirements of the HLOS into a regulatory settlement for a public sector company. The ORR's proposed approach to the ring-fencing of enhancements funding to separate it from operations, maintenance and renewals activity, as articulated in paragraph 1.22, provides proper recognition for the categories of spending outlined in the SoFA and represents a sensible implementation of the separation of enhancements funding from the regulatory funding cycle, as articulated in our recent Rail Network Enhancements Pipeline.[2]

NR's Financial Forecasting
As a general point, and as indicated above, we very much agree that Network Rail's performance at forecasting and controlling expenditure requirements needs to be improved for CP6. We welcome the ORR's steps to further develop its approach to

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[2] https://www.gov.uk/government/publications/rail-network-enhancements-pipeline

efficiency and financial performance assessment to hold Network Rail to account in this respect (as referred to in paragraph 1.44), consistent with our response to the ORR's consultation on this issue earlier in the year.

CP6 transition

We note the ORR's recognition in paragraphs 1.23-1.24 that the "early start" policy utilised in CP5 would not be appropriate in the context of a public sector NR. We nevertheless regard it as critical that NR is as well placed as possible to begin the delivery of its CP6 work programme from the first day of the Control Period. As the ORR recognised in its renewals efficiency consultation,[3] challenges at the very start of CP5 means that it was never possible to recover – this must be avoided.

Therefore, while we agree with ORR's reasoning in respect of the "early start" policy, we would like to encourage ORR to use its full range of regulatory levers to ensure that NR is making proper preparations for the transition into CP6 and, in particular, that the planning and procurement for CP6 renewals is sufficiently advanced to allow these works to begin in a timely manner from the very start of the period.

Indexation

We are highly supportive of ORR's proposal to switch the indexation of track access charges (and, as a consequence, of NR's RAB balance) from RPI to CPI for CP6 for the reasons set out in the consultation. In doing so, the same overall assumption for access charge income must be retained across the period.

For the purposes of CP6, Government's preference would be for the use of CPI, rather than CPIH, as the former is, for now, a better understood measure. This issue should be considered again during planning for CP7.

RAB values

While recognising the significantly changed landscape for CP6, following the reclassification of NR to the public sector, we nevertheless agree with the ORR on the importance of maintaining an accurate RAB valuation, for the reasons set out at paragraph 1.69 of the consultation document.

Weighted Average Cost of Capital

We agree with the proposals in paragraph 1.101 of the consultation document.

Financial Risk Management

We note the reasoning within the consultation on Financial Risk Management and are reassured by the ORR's commitment to further examining and challenging NR's risk management measures as part of the PR18 process.

We have not, to date, offered specific comment on the proposal within the NR Strategic Business Plans to reserve £2.6bn for the purposes of risk management in England & Wales. We have received representations from a number of stakeholders that the size of this risk provision has impacted on the funding available to routes and consequently on forecast levels of train performance and asset sustainability. This is obviously a matter of

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[3] http://orr.gov.uk/rail/consultations/pr18-consultations/consultation-on-improving-network-rails-renewals-efficiency

significant concern to us, but we recognise it is for the ORR, rather than Government, to reach final conclusions on this issue.

We would, however, like to take this opportunity to articulate some of the principles which we think should be core to any decisions on NR's risk management approach:

- Any risk management approach must **support, rather than undermine, the critical principle of ambitious and effective route devolution** and send clear signals to NR about the importance of robust cost control.
- We recognise that this may entail the necessity for some level of central risk facility, to prevent route budgets from being "impacted" at the first sign of risks crystallising, reducing the level of route commitment and preventing Route Managing Directors from having an appropriate opportunity to deliver their business plans. We ask the ORR to carefully and robustly scrutinise the £2.6bn risk fund to ensure that it is appropriate for the prudent management of financial risk, with a view to ensuring that maximum responsibility practicable is devolved to the routes, without recourse to the centre.
- We would therefore encourage NR and ORR to examine means by which the routes could be given responsibility for the management of risk to the greatest extent consistent with prudent financial management. This might, for instance, involve actually or notionally profiling a greater level of work within each route from the existing Group Portfolio Fund to support the delivery of performance objectives.
- The Governance of the Group Portfolio Fund must include an appropriate, effective role for the routes across the entirely of the Fund – underlining the critical role they must play.
- We would further note that risk buffers will be reflected in NR's DEL budgets and will therefore be subject to the same constraints on flexibilities between years as other aspects of NR spending and hence would encourage both NR and ORR to reflect on the implications of this for the balance between reserved contingency funding and "at risk" profiled works.
- We regard it as critically important that there is a firm barrier between any risk provision made, on the one hand, for England and Wales and that made, on the other hand, for Scotland. Funds provided through the SoFA for England and Wales should not be used to mitigate risks that may materialise on the Scottish route and vice versa.
- In respect of the footnoted statement on page 44 of the consultation, in accordance with the principles of Managing Public Money, Government would not wish NR to increase its commercial insurance of financial risk, except where required by law to do so.

We anticipate further discussions on this issue later in the year, following the publication of the Draft Determination.

Other Single Till Income (OSTI)
We noted the proposals in the consultation document regarding potential changes to the presentation of OSTI. At present, we are not sufficiently sighted on the rationale for this change. We understand that the ORR is in discussion with NR on this point and that it is about clarifying definitions, but would welcome a further discussion with the ORR on this issue.

British Transport Police

As a point of clarification, on paragraph 1.109, it is entirely correct to say that BTP costs will be funded separately from SoFA in England and Wales. For the avoidance of doubt this will not involve direct grant funding of the British Transport Police Authority, but enabling Network Rail to have sufficient resources to meet their obligations under their Police Service Agreements – we continue to agree with the underlying principle that the user pays for transport policing and we will clearly expect Network Rail to take all reasonable steps, engaging with the British Transport Police Authority, to support BTP efficiency. As you recognise, particularly in the light of changes to the timing of the devolution of the BTP in Scotland announced by the Scottish Government,[4] so that it is now likely to take place in CP6 (with specific timing current subject to a re-planning exercise), further discussions will be required between the Governments on this issue. We would welcome a further specific discussion on this issue with the ORR on this issue.

In conclusion

We are grateful for the constructive manner in which ORR has engaged with Government on the development of the CP6 financial framework. The reclassification of NR to the public sector and its shift into a DEL budgeting regime for CP6 has had very significant implications for the shape of the financial framework, which has required rapid and innovative thinking by all parties. It is only thanks to the co-operation of both ORR and NR that we are now in a position to articulate our expectations in respect of financial flexibilities.

We believe that the package of flexibilities that Government has offered represents the best possible balance at this time between the twin demands of stability for the national accounts and flexibility for NR to deliver its portfolio efficiently and effectively, helping to create a better performing railway. This, alongside improvements to NR's forecasting capability regarding its costs, should support more effective delivery in CP6. However, it remains important to note that instability in NR spending may require Government to investigate the possibility of tighter controls.

The success of the CP6 settlement, of which the Financial Framework is a core component, is therefore critical to the future of the rail funding environment and delivering a railway that works for its users. I look forward to working with you over the coming months to help maximise the chances of success.

Yours Sincerely

Conrad Bailey
Director, Rail Strategy, Reform and Analysis

[4] See: https://news.gov.scot/news/railway-policing-integration?_ga=2.98568990.1222460468.1524729869-2001383511.1516375487

Annex: NR Financial Flexibility Regime for CP6

Key issue	Government position
Flexibility	Note that: the term "year" means financial year ending 31 March; the term "CP6 Budget lines" means the CP6 budget profile formally agreed by government following the publication of the ORR's Final Determination – the CP6 Budget lines may differ from the Final Determination. 6 weeks before Budget, DfT will inform HMT of flexibilities NR wish to use. We would expect to approve movements of up to 10% of current and future year's CDEL deferred to later years and up to 10% of any future year's CDEL accelerated to earlier years (excluding the current year). These flexibilities are subject to a cap of a 10% increase in CDEL for any individual year when compared to the CP6 Budget lines, although NR would also be able to request larger movements 6 weeks before Budget, which HMT would consider as part of the wider fiscal picture. HMT would then decide at Budget whether to approve the submitted flexibilities. At Supplementary Estimates, DfT then submit their latest estimate of flexibility NR require as part of the normal Budget Exchange process. HMT would expect this request with respect to the current year to be within £200m of the original Budget request - for reprofiling with respect to future years. Given the importance of NR's Christmas work, HMT would accept one final update in the first week of January. Again, HMT would expect this request with respect to the current year to be within £200m of the original Budget request - for reprofiling with respect to future years. 20 working days after year-end, NR should inform DfT about any year-end underspends and the reason for the underspend. DfT will then inform HMT within another 20 working days. HMT would expect to approve reprofiling up to 2% of CDEL year-end underspends (compared to the CP6 Budget lines) deferred to later years, including the current year. Reprofiling of year-end underspends would be included within the 10% cap for any individual year's adjustment – as set out above. The 2% would be additional to the 10% flexibility allowance for the year in which the underspend has occurred. Absolute amounts for the mechanism set out above will be determined when the CP6 Budget lines have been agreed. By way of example, the table below sets out the maximum that DfT could defer to later years or accelerate to earlier years for NR (this is

currently illustrative and based on the OBR forecast, as formal CP6 Budget lines have not yet been set):

	2019/20	2020/21	2021/22	2022/23
NR CDEL profile	6,462.7	6,373.7	6,665.6	7,146.4
10% flexibility cap	646.3	637.4	666.6	714.6
2% year-end flexibility	129.3	127.5	133.3	142.9

Note that a "current year" budget can only ever be increased through use of the 2% year-end underspend flexibility mechanism.

The flexibilities agreed for NR will also be reviewed at the next Spending Review. However, whilst not prejudging the outcome of the Spending Review, we would expect the reporting requirements to remain unchanged i.e.: 6 weeks before Budget; December for Supplementary Estimates; first week of January for the final update; and 20 working days each for NR and DfT for any year-end underspend. We would also expect similar levels of flexibility (including year-end flexibilities) to remain.

Flexibilities will only apply to CDEL. RDEL flexibility will continue to be governed by Consolidated Budgeting Guidance (Chapter 2) in the regular way – i.e. full flexibility for NR to move current year RDEL to current year CDEL at Supplementary Estimates and also to move up to 0.75% RDEL from current year to a future year at Supplementary Estimates (with DfT permission since RDEL flex is a departmental-wide flex).

Does anything remain within AME?	Interest costs (including accretion), corporation tax, revaluation of derivatives and revaluation of pensions remain within AME. As in line with other budgets, such as HE, depreciation (including property revaluations) will be managed within ring fenced RDEL.
Resource Income Capital Receipts	NR can retain additional income, up to 10% above its income line compared to the agreed profile of CP6 Budget lines, which will be formally set following the publication of the ORR's Final Determination, without recourse to HMT; above 10% with HMT agreement NR will need to seek permission from HMT, via DfT, to retain any capital receipts.

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[redacted]

24 April 2018

Dear John,

SECOND CONSULTATION ON THE PR18 FINANCIAL FRAMEWORK

I am writing in response to ORR's consultation on the financial framework for PR18, which was published on 27 March 2018. I hope that you find our response helpful as you continue to develop the CP6 financial framework.

This letter builds on the previous responses we have provided to your first PR18 consultation and update letter on the CP6 financial framework. In the rest of this letter we summarise our views on the most significant issues raised in the consultation: treatment of inflation; budgetary flexibility and financial risk management. In an appendix to this letter, we have also addressed each of the detailed questions raised in ORR's consultation.

Context

Some of the issues covered by ORR's consultation are likely to be of interest to only a small number of people with specialised knowledge, which could lead stakeholders to assume that these topics are of limited importance. We recognise that many of the topics in ORR's consultation are indeed complex and not straightforward to understand. However, they are very important for Network Rail's financial viability and stability in CP6. For example, the country is currently experiencing a period of volatile inflation. Therefore, ORR's decision about how Network Rail's funding should change each year to take account of the cost inflation we face is a very significant financial issue for CP6.

Proposed change from RPI to CPI as inflation indexation measure

The cost inflation that Network Rail faces has been shown to be consistently above RPI. This results from the company being exposed to industry-wide construction costs that track well above RPI (apart from during recessions) and from rail industry salaries that tend to be RPI-linked. Our estimate of the blended cost inflation that we are likely to face in CP6 is 0.4% above RPI each year, which is consistent with what ORR's consultants found in PR13. This estimate excludes costs, such as our index-linked debt, that will be funded outside of the SoFA (and so outside of the Final Determination) in CP6.

Historically, ORR has always allowed Network Rail to increase charges and other contractual payments (including Network Grant) by RPI each year. However, ORR's 'minded to' proposal to move to CPI in CP6 is based on RPI no longer being a National Statistic and that the Office for National Statistics (ONS) does not think that RPI is a robust measure of inflation. ORR has indicated that the change to using CPI is a 'technical change' that should have a limited impact on Network Rail (i.e. it should not affect the funding that we receive in CP6). We welcome this statement from ORR.

Our CP6 plan was presented in 2017/18 prices, on the basis that the costs in our plan would be uplifted by RPI to arrive at CP6 funding in cash prices. Therefore, it is important that ORR's Final Determination takes account of the difference between RPI and CPI in its estimate of our efficient costs (CPI is currently around 1% lower than RPI each year). If ORR do not take account of the input price inflation we will face in CP6, this is equivalent to an unachievable increase in efficiency of up to c.£1.3bn over the control period.

Following our SBP submission in February 2018, we have provided ORR with further analysis to support our view that the cost inflation we face is consistently above RPI. We consider this analysis to be robust. Therefore, this should give ORR sufficient evidence to reflect the underlying cost inflation that we face, appropriately, in the Final Determination.

ORR's proposed move to CPI will also have some wider impacts, which need to be fully assessed by ORR before it makes a decision on this issue:

- *Efficiency reporting*: ORR's move to using CPI to index our charges and the costs in our CP6 plan could have a negative presentational impact on our efficiencies in our CP6 plan. During CP6, we think that we should continue to report against RPI as well as CPI for the first few years of CP6 to better explain our outturn costs on a comparable basis with previous control periods. We note that other regulators have recognised the need for forms of transitional arrangements in moving to CPI;
- *Stakeholder views of our costs*: we are concerned that customers, funders and other stakeholders will see ORR's move to CPI as evidence that our costs in fact move in line with CPI. These stakeholders may put pressure on ORR and Network Rail to agree to an unachievable efficiency challenge in CP6; and
- *Impact on train operators*: although we are not aware of any material financial impact on franchised operators (or franchising authorities) from this change, we think that ORR should confirm this with franchising authorities as it develops its impact assessment of this proposal.

<u>Budgetary flexibility for Network Rail</u>

A crucial element of our current financial framework is that we have appropriate flexibility to adjust budgets between years of the control period, between expenditure categories, and between routes. This is a particularly important issue because Network Rail operates complicated infrastructure assets and work programmes are often spread over a number of years. Therefore, we strongly agree with ORR that we need flexibility in CP6 so that routes can respond to risks and opportunities during the control period to support the efficient delivery of outputs for customers and funders.

Our funding, and subsequent plans for CP6, are based on the governments' SoFAs and ORR's PR18 determination. However, the government budgetary controls that we may face in CP6 could make it highly unlikely that we will be able to retain all of the funding available in the Final Determination. This is because, if we spend less than our annual budget, we could lose the unspent funding, and if we spend more, then this could lead to DfT accounts being 'qualified' by

NAO[1]. The qualification of DfT's accounts would damage the reputation of both Network Rail and DfT and we would plan, and work, in a way that we never exceed our budget.

This is, ultimately, a Government decision and so we are continuing to work constructively with DfT and HMT to develop appropriate budgetary controls with some flexibility for CP6. We are, however, keen to make sure that stakeholders are fully mindful of the implications of imposing such constraints on Network Rail. As part of our discussions with Government, we have, therefore, been careful to identify the consequences of implementing budgetary controls that do not adequately take account of the complexities of our business. For example, we think that a lack of flexibility could:

- cause our planning of projects to become more risk averse. This could mean we focus on smaller scale work programmes, which may result in a loss of economies of scale and possibly inefficient use of resources (including track access windows);
- restrict the ability of asset managers to respond to changing conditions during the year. In order to meet outputs, short-term interventions may be needed to sustain performance (e.g. to counter the impact of severe weather). These interventions typically involve lower value, operating expenditure and so require the ability to increase opex, offsetting future capex activity;
- mean that we are unable to take advantage of unanticipated opportunities if we do not have the ability to move spending between resource spending and capex, or between years;
- lead to the cancellation of projects in later years of the control period to free-up funding for projects that have been delayed. This sort of workbank instability can lead to inefficiency, cost escalation and further deferrals; and
- mean that we have to hold larger amounts of funding for risk and uncertainty to avoid exceeding our agreed annual budgets, which we would then lose if we do not spend it in the year.

Therefore, we consider that an appropriate amount of flexibility is necessary to allow Network Rail to deliver its outputs efficiently. Ideally, this flexibility would allow money to be brought forward from later in the control period as well as being carried forward from one year to another. It would also include the flexibility to transfer funding between capital and resource budgets, and flexibility to change planned expenditure between the time of Network Rail's supplementary estimate submissions and full year outturn expenditure.

Financial risk management

Network Rail, like any other company, faces the risk that actual income and expenditure levels could be different from its plans. However, unlike other companies, we have no normal equity buffers to accommodate such risks. Therefore, it is important that we have sufficient funding to operate, maintain and renew the GB rail network, which includes funding for risk and uncertainty. We strongly agree with ORR that the efficient management of financial risk is an important issue for Network Rail and that we should be funded appropriately for the risks that we face in CP6.

[1] DfT's accounts would be qualified if other parts of DfT's overall budget remained in line with (or were also above) planned income and expenditure and Network Rail overspent against its budget.

The England & Wales SoFA did not specifically include a financial allowance for risk and uncertainty. However, CP5 has amply demonstrated that route circumstances, network priorities and risks can shift significantly over such a time period. With the vast majority of CP6 funding already committed to routes, a degree of flexibility at network level is still necessary.

We consider the most efficient approach to managing the financial consequences of risk and uncertainty in CP6 is to hold a small proportion of total funding (just 5%) at a network level in our plan (the 'Group Portfolio Fund') and progressively release it over CP6 so that we can adapt and react without disruption to the core plans in the routes. This means that, if significant risks do materialise, there is a much lower chance that we would need to transfer funding between routes, which would cause planning instability with complex and costly implications (this happened when South East route required additional funding of just £50m in CP5).

Our proposed approach to managing risk and uncertainty would also enhance the competitive environment between routes. For routes to receive additional funding from the Group Portfolio Fund in CP6, they would need to have strong economic opportunities and evidence of robust delivery of their plans. If all funding is committed to routes now, this would reduce the incentive for better route performance – it would, effectively, create eight monopolies with no inter-business competition.

The governance and controls for the Group Portfolio Fund in CP6 would be incorporated into our corporate business planning framework up to and including Board oversight and shareholder team review. This should provide transparency and confidence to DfT and ORR that we will make best use of the full funding available during CP6.

Routes already have a list of CP6 investment options in their strategic plans that could be delivered using the Group Portfolio Fund. These schemes are not fully developed and so routes will continue to develop these investment options throughout CP6. The list of priority schemes will continue to evolve during CP6 so that it reflects changing circumstances and emerging information. We think that it is important to continue to re-assess the priorities for investment as part of the business planning process. This will ensure that, when funds are released, we make the best possible use of them, at that time, in the most appropriate part of the network.

In the absence of the Group Portfolio Fund, ORR's alternative is for routes' investment plans to be set rigidly at the start of the control period. This approach runs the risk of making the wrong investment choices, by missing out on better investment opportunities or committing to schemes that are not yet mature, and needing to cancel projects if risks arise.

Next steps

My team and I are keen to continue working with ORR throughout the periodic review process to develop the CP6 financial framework. Please note that no part of this response is confidential and we are content for it to be published in full.

Yours sincerely,

Jeremy Westlake
Chief Financial Officer

Appendix: Responses to ORR's consultation questions

<u>1. Policy positions on financial issues for PR18 and remaining uncertainties</u>

A. *Do you think our proposed changes to the presentation of OSTI and charge income categories will improve transparency?*

We think that the purpose of Other Single Till Income (OSTI) is to identify the revenue that Network Rail receives from income streams that are not set by ORR as part of the periodic review process.

We think that the categorisation of OSTI in previous periodic reviews has caused confusion about which charges are regulated and which are not. This is also particularly important for the way that the Freight and National Passenger Operator (FNPO) route will be regulated from CP6 onwards. In the past, freight income has been treated as OSTI, even though freight income is made up of regulated track access charges, which are determined at a periodic review.

We do not think that changes to OSTI will drive major changes in behaviour within Network Rail. However, we think that PR18 is a good opportunity to clarify the purpose of OSTI and review the types of income that sit within it. These changes should improve the transparency and understanding of the way that Network Rail's CP6 funding is calculated.

Therefore, we agree with ORR's presentation of OSTI proposed for CP6.

B. *What are your views on budgetary flexibility for Network Rail in CP6?*

As we explain in the main body of our letter, a crucial element of our current financial framework is that we have appropriate flexibility to adjust budgets between years of the control period, between expenditure categories, and between routes. This is a particularly important issue because Network Rail operates complicated infrastructure assets and work programmes are often spread over a number of years. Therefore, we strongly agree with ORR that we need flexibility in CP6 so that routes can respond to risks and opportunities during the control period to support the efficient delivery of outputs for customers.

This is, ultimately, a Government decision and so we are continuing to work constructively with DfT and HMT to develop appropriate budgetary controls for CP6. As part of our discussions with Government, we have, therefore, been careful to identify the consequences of implementing budgetary controls that do not adequately take account of the complexities of our business.

C. *What are your views on our minded to proposal for CP6 to switch from RPI to CPI for the indexation of access charges and payment rates in other mechanisms where we set the method of indexation? Have we identified all of the relevant impacts?*

Input price inflation

As we explain in the main body of our letter, the cost inflation that Network Rail faces has been shown to be consistently above RPI. This results from the company being exposed to industry-wide construction costs that track well above RPI (apart from during recessions) and from rail industry salaries that tend to be RPI-linked. Our estimate of the blended cost inflation that we are likely to face in CP6 is 0.4% above RPI.

We welcome that ORR considers the move from RPI to CPI to be a 'technical change' and that it should not affect the funding we receive in CP6. However, our CP6 plan was presented in

2017/18 prices, on the basis that the costs in our plan would be uplifted by RPI to arrive at CP6 funding in cash prices. Unless ORR's Final Determination takes account of the difference between RPI and CPI in its estimate of our efficient costs (CPI is around 1% lower than RPI each year), this is equivalent to an unachievable increase in efficiency of up to c.£1.3bn over CP6.

Following our SBP submission in February 2018, we have provided ORR with further analysis to support our view that the cost inflation we face is consistently above RPI. We consider this analysis to be robust. Therefore, we expect that this should give ORR sufficient evidence so that it can reflect the underlying cost inflation that we face, appropriately, in the Final Determination.

Schedule 8

ORR highlights in its consultation that there would be an impact on Schedule 8 payment rates from moving to CPI indexation of contractual payments in CP6. However, ORR suggests that, for CP6, this should not be significant because Schedule 8 payments are assumed to be zero in our plan.

By the end of CP5, we forecast that Schedule 8 payments to train operators will total around £800m over the control period. If we experience train performance that deviates materially from ORR's periodic review assumptions again in CP6 (either above or below forecast), the use of CPI to index Schedule 8 rates could have a significant impact on the payments between Network Rail and train operators.

We also face the same issues for Schedule 4 compensation payments and the Access Charge Supplement, the net of which is assumed to be zero. However, by the end of CP5, we forecast that we will pay out around £15m more in Schedule 4 payments than we receive in ACS income.

We have already discussed the impact of moving to CPI indexation at the Schedule 8 industry working group, and welcome further discussions with ORR to better understand the impact of this change on the Schedule 4 & 8 regimes.

We also note that, due to the timing of the Schedule 8 recalibration, the industry requires a decision from ORR on the inflationary measure to apply to Network Rail Payment Rates by 20 April 2018. As this is after the deadline for responses to the consultation, we have raised this issue with ORR separately.

RAB indexation

ORR explains in its consultation that it is minded to switch to indexing Network Rail's RAB balance each year by CPI, in line with its 'minded to' position on indexation of the wider CP6 settlement. In other sectors, where regulators have moved to CPI, the lower increase in the RAB in each year (due to CPI indexation) is offset by providing higher, real, allowed return income as a result of a higher real cost of capital[2]. When ORR carries out its full WACC calculation of the revenue requirement, the WACC it applies should reflect the use of CPI.

[2] The weighted average cost of capital (WACC) for a regulated company is normally calculated based on observed nominal rates, which are then deflated using an agreed measure of inflation. Therefore, if CPI is used as the deflator, rather than RPI (RPI is usually significantly higher than CPI), the real WACC value will be higher than under an RPI framework. The allowed return is normally calculated as the WACC multiplied by the forecast RAB value.

D. What are your views on our minded to proposals for RAB adjustments and asset disposals?

Network Rail is currently exploring new, innovative ways to fund investment in the railway in the years ahead, which could include the disposal of some of our assets. For example, Network Rail is in the process of selling its commercial estate business in England & Wales. Network Rail is also working with the Welsh Government to discuss the possible transfer of the Core Valley Lines in Wales. Therefore, it is important that ORR has a clear policy for the treatment of asset disposals in CP6.

We propose that the disposal of non-core railway assets in CP6 should follow the same approach as in CP5, i.e. that no adjustment is made to Network Rail's RAB. However, if ORR decides to make a RAB adjustment, we propose a de minimis threshold of c.£100m to avoid disincentivising sales in the normal course of business, e.g. releasing pieces of land to deliver new homes, and to avoid introducing onerous administrative processes.

We accept that it may be appropriate to adjust the RAB for sales of core railway assets in CP6. If such an adjustment was made, we think that a £100m de minimis threshold should apply and that the adjustment, above this threshold, should be based on an estimate of the value of the RAB associated with the assets.

Our view is that the RAB adjustment should be based on an estimate of the replacement cost of those assets, which is scaled to the value of the RAB (consistent with the approach being adopted for the disposal of the Wales Core Valley Lines). We consider that this approach would provide an incentive to maximise proceeds from disposals because the RAB reduction would be lower than the sales price, if we are able to sell an asset for more than its estimated RAB value. However, if ORR adjusts the RAB by the sales prices of a disposal, this is likely to provide less of an incentive to maximise sales proceeds.

We do, however, welcome that ORR recognises that using an estimate of the RAB value of an asset (using replacement cost data) is an appropriate approach to determine a sales price, where a sale is not on the open market, for example, where there is a transfer of assets between public bodies.

In concluding its policy in this area, we think that ORR should consider the treatment of asset disposals in other regulated sectors. We do not think that Network Rail's different funding structure should be a reason to discount the approaches used in other sectors.

E. Do you have any other comments on our minded to proposals for the financial framework for PR18?

In its SoFA, DfT committed to making adequate funding available to meet our costs that are not included in the CP6 funding envelope. These costs include our debt repayment obligations, financing costs (including FIM fee) and British Transport Police (BTP) costs. We are continuing to work with Government to agree the detailed processes and timings for how we notify / forecast amounts covered by those expenditure categories and how we receive these amounts from DfT. In particular, as security is a key aspect of the railway, we are seeking clarity on the quantum and control we have of the funding for BTP.

We think that ORR should be transparent about the forecast of our entire cost base, including those costs that are not included in the SoFAs. By doing this, it will provide transparency to stakeholders and funders of the overall cost of our CP6 plan, rather than focusing on a particular subset of costs that may change from one control period to the next, based on funding decisions from Government.

2. Calculating route revenue requirements

A. *Do you have any views on how we are proposing to calculate SO, route-level and England & Wales and Scotland revenue requirements for CP6, i.e. is it clear enough?*

Network Rail continues to be a single corporate entity. Therefore, whilst our funding arrangements will change for CP6, we think that it is important to keep the key elements of the regulatory framework to maintain transparency of our performance and to retain flexibility for the future. This includes keeping the building blocks approach to calculating our CP6 revenue requirements.

ORR's consultation sets out the building blocks that it proposes to include in its calculation of our CP6 route revenue requirements. ORR's list excludes expenditure not covered in DfT's SoFA, such as British Transport Police, financing and corporation tax costs. However, we think that ORR should continue to include these costs in the revenue requirement, even if they are funded outside of the SoFA. This will allow for comparison to previous control periods and also create a clearer picture of Network Rail's overall funding requirement for CP6.

B. *Are there ways we could make the presentation of financial information for our PR18 determination more transparent?*

We think that the approach we have taken in presenting the financial information in our SBP submission provided transparency of route, System Operator and national function income and costs. We are aware that ORR has raised concerns about the complexity of the information we provided as part of the SBP. However, this reflects that Network Rail is a devolved organisation and that we wanted to show the fully allocated costs of each route.

3. Financial risk management

A. *Do you think the risk management approaches referred to in this chapter will:*

- *allow Network Rail's routes to efficiently manage risks and exploit opportunities?*
- *be transparent?*
- *help to preserve the integrity of route level financial settlements?*
- *comply with any government restrictions on budgetary flexibility and other government budgeting rules?*

Network Rail, like any other company, faces the risk that actual income and expenditure levels could be different from its plans. However, unlike other companies, we have no normal equity buffers to accommodate such risks. Therefore, it is important that we have sufficient funding to operate, maintain and renew the GB rail network, which includes funding for risk and uncertainty. We strongly agree with ORR that the efficient management of financial risk is an important issue for Network Rail and that we should be funded appropriately for the risks that we face in CP6.

We agree with the criteria that ORR has set out in its consultation to describe what a good approach would look like. However, we also think that any approach to managing risk and uncertainty in CP6 should allow routes to efficiently manage risks and exploit opportunities during the control period.

We think that our proposal to include a Group Portfolio Fund in our plan is the most efficient approach to managing the financial consequences of risk and uncertainty in CP6, and that it aligns with the criteria that ORR sets out in its consultation. For example, to ensure that our funding is used efficiently, governance and controls of the Group Portfolio Fund will be incorporated into our corporate business planning framework, up to and including Board oversight. Recognising the separate funding arrangements in Scotland, the Group Portfolio Fund in our Scotland CP6 plan will be ring-fenced.

Under our proposals, route businesses would be able to decide how to use the money from the Group Portfolio Fund that they hold in their plan, consistent with existing governance arrangements for other areas of spend, such as levels of delegated authority and investment regulations. Routes would be required to report transparently on outturn income and expenditure during CP6, and explain any areas where outturn varies from plan.

The remaining funding held outside routes, at a portfolio-level, on behalf of all routes would be used for investment options or to cover the financial cost of risk and uncertainty materialising, such as significant movements in inflation, extreme weather events not covered by insurance and new requirements to react to operational support requirements for the railway (illustrated by the additional operations, maintenance and renewals expenditure needed for Thameslink in CP5). The use of the Group Portfolio Fund, held at a portfolio-level, will also be governed through our corporate business planning processes.

B. *What do you think of the reservation of 'headroom' funding approach, the approach that fully allocates funding to routes and the hybrid approach?*

We understand that funders want us to spend the money they have made available in the SoFAs on improving the railway for customers, rather than on risks that materialise during CP6. This is of course the intent. However, the most efficient approach to managing remaining investment option selection and the financial consequences of risk and uncertainty in CP6 is to progressively commit remaining funding in our plan once priority changes and risks are better understood.

We highlight the main advantages of our approach, below:

- provides an opportunity to balance remaining investment between routes, as new information arises during the control period;
- creates competition between routes to hit or outperform their budgets. For routes to receive additional funding from the Group Portfolio Fund in CP6, they would need to have strong economic opportunities and evidence of robust delivery of their plans;
- if significant risks do materialise, there is a much lower chance that we would need to transfer funding between routes, which would cause planning instability (this happened when South East route required an additional £50m of funding in CP5 and caused great consternation in other routes);
- avoids wasteful re-planning to deal with day-to-day risks materialising;
- 'pools' the risk (the 'portfolio effect'), which means we need to hold less funding for risk and uncertainty in our plan in aggregate;
- requires transparency and a disciplined approach; and

- lead-times for delivery would be shorter as routes continue to develop and prioritise their list of investment options.

The second option, identified by ORR, is to commit the entire CP6 funding envelope to route schemes at the start of the control. We highlight a number of issues with this approach, below:

- we could over-commit, compared to what we realistically think we can deliver in CP6;
- even a small risk materialising will require considerable effort to re-plan as many projects are not stand-alone and have linkages to other aspects of the plan – we saw this when South East route needed additional funding in CP5, which was taken from other routes;
- would remove the competitive tension between routes to access additional funding. If all funding is committed to routes now, this reduces the incentive for better route performance – it would, effectively, create eight monopolies with no inter-business competition;
- it will not be possible to accurately define every project now to create a perfectly balanced plan for every route for the whole control period;
- does not allow for flexibility on where best to spend our CP6 funding as new information emerges during the control period; and
- likely to have a negative effect on the motivation of routes in CP6 if we have to remove projects from their plans.

ORR's third option, a hybrid approach, simply appears to result in a smaller Group Portfolio Fund than the £2.6bn included in our SBP submission, i.e. committing more funding to routes and holding an even smaller proportion of total funding at a network level in our plan to release over CP6. We do not think an approach, which commits significantly more funding to route schemes at the start of the control period, would provide us with sufficient flexibility in our plan to manage change and the risks that could materialise in any of the routes during CP6. Without sufficient headroom in our plan, this approach would have the same issues as those we have identified, above, in relation to the option to fully allocate funding to routes. The extent of the impact will depend on the size of the headroom ORR makes available in its Final Determination.

C. *Do you consider that Network Rail's proposal for a group portfolio fund is a necessary feature of risk management by Network Rail in CP6 at both a route and business wide level?*

We consider the most efficient approach to managing the financial consequences of risk and uncertainty in CP6 is to hold a small proportion of total funding (just 5%) at a network level in our plan (the 'Group Portfolio Fund') and release it over CP6 so that we can adapt and react without disruption to the core plans in the routes. This means that, if significant risks do materialise, there is a much lower chance that we would need to transfer funding between routes, which would cause planning instability (this happened when South East route required additional funding in CP5, and for just £50m).

Our proposed approach to managing risk and uncertainty would also enhance the competitive environment between routes. For routes to receive additional funding from the Group Portfolio Fund in CP6, they would need to have strong economic opportunities and evidence of robust delivery of their plans. If all funding is committed to routes now, this would reduce the incentive for better route performance – it would, effectively, create eight monopolies with no inter-business competition.

Routes already have a list of CP6 investment options in their strategic plans that could be delivered using the Group Portfolio Fund. These schemes are not fully developed and so routes will continue to develop these investment options throughout CP6. The list of priority schemes will continue to evolve during CP6 so that it reflects changing circumstances and emerging information. We think that it is important to continue to re-assess the priorities for investment as part of the business planning process. This would ensure that, when funds are released, they we make best use of them, at that time – and in the most appropriate part of the network. The decision to allocate the Group Portfolio Fund would be carried out in a transparent and controlled manner and reported up through the Board.

The governance and controls for the Group Portfolio Fund in CP6 will be incorporated into our corporate business planning framework up to and including Board oversight and DfT Shareholder team review, which should provide confidence to DfT and ORR that we will make best use of the full funding available during CP6.

One of the most significant risks we face in CP6 is inflation. The maximum Network Grant in DfT's SoFA is set in cash prices. Therefore, although ORR has proposed continuing the current practice of increasing our access charges by inflation during CP6, we will have to manage the impact of inflation risk on the majority of our expenditure in CP6. We estimate that the impact of inflation on our cost base would be c.£1.3bn over CP6 per percentage point of inflation above forecast. Given we are in an era of heightened inflation volatility, this is a significant concern for us.

D. Do you agree that we should retain the current re-opener provisions in track access contracts?

In the event of an unexpected material change in circumstances, ORR can re-open the CP5 determination to change Network Rail's allowed revenues for the control period by resetting its access charges. We recognise that making changes to access charges part way through a control period could be unsettling, and further government funding may not be available. However, we think that re-openers are an important part of the regulatory framework as the alternative would be to provide Network Rail with sufficient funding to cover all possible risks, however, remote. This is unlikely to represent value for money. Also, retaining re-openers ensures the same approach as other regulated utilities.

We think that ORR should retain re-openers in CP6 to help Network Rail manage material unforeseen circumstances.

Separately, we are currently in discussions with ORR and industry stakeholders about the use of Schedule 8 re-openers during CP6, specifically about creating clarity for when the existing Paragraph 17 mechanism in track access contracts can be used. We consider that this is a particular issue for the Crossrail and Thameslink programmes, since the performance impact of these schemes is currently incredibly difficult to forecast accurately.

Rail Delivery Group

Response to

ORR's second consultation on the PR18 financial framework

Date: 24 April 2018

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Rail Delivery Group response to

ORR's second consultation on the PR18 financial framework

Organisation: Rail Delivery Group

Address: 200 Aldersgate Street, London EC1A 4HD

Business representative organisation

Introduction: The Rail Delivery Group (RDG) was established in May 2011. It brings together Network Rail and passenger and freight train operating companies to lead and enable improvements in the railway. The purpose of the RDG is to enable Network Rail and passenger and freight train operating companies to succeed by delivering better services for their customers. Ultimately this benefits taxpayers and the economy. We aim to meet the needs of:

- Our Members, by enabling them to deliver better outcomes for customers and the country;
- Government and regulators, by developing strategy, informing policy and confronting difficult decisions on choices, and
- Rail and non-rail users, by improving customer experience and building public trust

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[redacted]

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Introduction

1. This document outlines the key points from our members in response to the ORR's Second consultation on the PR18 financial framework.

2. RDG is content for this response to be published on the ORR website.

3. ORR's consultation considers a range of topics within the CP6 financial framework. We have focused our response on what we consider to be the three most significant issues.

Budgetary flexibility

4. While recognising that Network Rail operates within a public sector context, RDG strongly believes that Network Rail must have an appropriate degree of flexibility to adjust its budgets within CP6.

5. Network Rail is a large, complex business and will, in CP6, be required to deliver a portfolio of major infrastructure projects, many of which will span multiple years. Therefore, we agree with ORR that Network Rail needs reasonable flexibility in CP6 so that routes can respond to risks and opportunities during the control period to support the efficient delivery of outputs for customers and funders.

6. Reducing Network Rail's ability to flex budgets in CP6 will make it more likely that Network Rail would not be able to use the full funding available in ORR's determination. This is because Network Rail could be forced to take a more risk-averse approach to planning to ensure that it does not exceed its budget in any year of the control period. This could lead to the deferral or cancellation of planned work, which would result in wasteful re-planning, and making it less likely that Network Rail will deliver its planned outputs. This would be an unsatisfactory outcome for funders, taxpayers and passengers alike.

7. As we stated in our response to ORR's consultation on improving Network Rail's renewals efficiency, change in the renewal programme makes it harder for suppliers to plan for and respond to the rail industry's demands, which can contribute to a "downward spiral of deferred work and higher costs for the work done".

8. RDG believes that Network Rail should have a level of flexibility that allows it to bring forward and to defer expenditure between years in CP6 and to move funds between capex and resource budgets. Network Rail will need to ensure that parties affected by such changes are informed or consulted as appropriate and, where relevant, changes happen in accordance with an agreed process for change control.

9. Furthermore, while we understand that discussions with the governments are ongoing, we believe that the ORR, as independent regulator, should be clearly setting out what it considers to be the appropriate level of financial flexibility to enable efficient delivery by Network Rail in CP6.

Financial risk management

10. RDG's view remains that the ORR must include within in its settlement a sufficient allowance for risk and uncertainty. This is particularly important for CP6, given that Network Rail will not be able to access additional funding, above ORR's PR18 determination funding, to deliver the outputs in the governments' HLOSs. Combined with

the fact that Network Rail is likely to face increasing budgetary constraints in CP6, this means that the way in which funding for risk is handled in CP6 is a very important issue. RDG welcomes the ORR's confirmation that this will be recognised in its CP6 determination.

11. During CP6, unforeseen changes and events will occur that could lead Network Rail to incur additional costs. Ensuring that Network Rail receives appropriate funding for risk and uncertainty will help to reduce the likelihood that such unforeseen changes require disruptive re-planning, which may in turn be detrimental to its ability to deliver its work plans in as efficient a way as possible.

12. RDG agrees with Network Rail's proposal to hold a small portion of its total funding at a portfolio level, which can be allocated to where on the network it is needed most, without the need to cancel or re-plan scheduled activity. Network Rail will, of course, need to be clear about the mechanism through which these funds would be released to the Routes as CP6 progresses and how such funds would be allocated to projects by the Routes.

13. RDG would be less supportive of an approach whereby risk funding is fully allocated to 'cancellable' activities for the reason identified by the ORR at paragraph 3.38 – specifically that this approach has the potential to introduce inefficiencies and to disrupt the planning process, which may also have a detrimental effect on suppliers.

14. ORR notes that the risk funding arrangement for CP6 is the subject of ongoing dialogue with the governments. Again, RDG believes that it is for the ORR to set out the level of risk buffer that it thinks Network Rail needs in CP6.

15. Finally, given the increased budgetary constraints that we expect Network Rail to be operating under, RDG reiterates its view that it is of increased importance that the ORR's determinations incorporate efficiency assumptions for CP6 which are achievable with a high degree of confidence.

Use of CPI as inflation measure

16. In the consultation, ORR proposes to use CPI, rather than RPI for the annual indexation of access charges and payment rates in other mechanisms. Though RDG agrees that this is sensible, for the reasons given in the consultation document, ORR must make sure that this proposed change has no material impact upon the level of funding that Network Rail receives in order to deliver its outputs.

17. RDG agrees with the broad approach outlined at paragraph 1.57 of the document but requests that, if ORR decides to move forward with this proposal, it gives careful consideration to the potential impacts of the change in order to avoid any unintended consequences. For example, given that many costs in operators' businesses are indexed using the RPI measure, whether this change causes any adverse knock-on effects on operators.

18. In addition, the input price inflation faced by Network Rail has typically been higher than both CPI and RPI. For this reason, the ORR needs to be clear in its communications surrounding this change so as not to give the impression that CPI is a more accurate measure of the inflation Network Rail actually faces.

April 2018

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ORR SECOND CONSULTATION ON THE PR18 FINANCIAL FRAMEWORK
RESPONSE FROM THE RAILWAY INDUSTRY ASSOCIATION (RIA)

1. INTRODUCTION

1.1 This submission constitutes the response from the Railway Industry Association (RIA) to the above consultation published on 27 March 2018.

2. BACKGROUND TO RIA

2.1 RIA is the trade association for UK-based suppliers to the UK and world-wide railways. It has over 200 companies in membership covering all aspects of rolling stock and infrastructure supply and covering a diverse range of products and services. As well as the vast majority of the larger, multi-national companies, 60% of RIA's membership base is comprised of SMEs.

2.2 The recently launched report from Oxford Economics shows that the UK rail sector contributes annually over £36 billion Gross Value Added (GVA) to the UK economy, employs 600,000 people and generates £11billion in tax revenues. It is also a growing industry with the numbers of rail journeys expected to double in the next 25 years along with significant growth in rail freight traffic. The full report can be accessed via the following link: https://www.riagb.org.uk/RIA/RIA_new/Press/Oxford_Economics.aspx

2.3 RIA provides its members with extensive services, including:

- Representation of the supply industry's interests to Government, Network Rail (NR),TfL, HS2, ORR and other key stakeholders
- Providing opportunities for dialogue and networking between members, including a number of Special Interest Groups
- Supply chain improvement initiatives
- Provision of technical, commercial and political information every week
- Export promotional activity, through briefings, visits overseas, hosting inwards visits
- Organising UK presence at exhibitions overseas.

Executive Summary

- **RIA would urge the ORR and DfT to ensure Network Rail (NR) has the appropriate level of financial flexibility to smooth work profiles should problems arise in CP6. This means the agility to move money between years, budgets and between regions/routes in the event of over or underspends in particular disciplines.**
- **The consultation document refers to 'budgetary flexibility' in CP6, and implies that without this, there could be a return to annualised budgeting; so to be clear, RIA would not support a return to annual budgeting, which would jeopardise NR's ability to efficiently deliver CP6 and have a deleterious impact on the rail supply chain too.**
- **The rail industry is a complex one with long lead times and project durations which simply do not lend themselves to an annual budgeting approach.**
- **Under annual budgeting, payment to suppliers may be delayed towards the end of a financial year, causing cash-flow issues.**
- **This uncertainty may also encourage suppliers work in other sectors at a time when rail needs a buoyant supply chain.**

- **RIA is concerned that NR forecasts are premised on there being only a 50% chance that the routes can deliver their OM&R activities within their forecast expenditure**

3. RESPONSES TO CONSULTATION QUESTIONS

Q1 DO YOU THINK OUR PROPOSED CHANGES TO THE PRESENTATION OF OTHER SINGLE TILL INCOME (OSTI) AND CHARGE INCOME CATEGORIES WILL IMPROVE TRANSPARENCY?

3.1 The proposed changes to the presentation of OSTI appear logical; this is reinforced by Network Rail (NR) having already made the same changes to the classification of OSTI adopted in its Strategic Business Plans (SBPs). These changes in income categories should improve transparency, as they now clearly show that the components of OSTI would consist only of income from charges the ORR does not set and income from commercial agreements. It is important to highlight that these presentational changes are income neutral, in that the reduction in OSTI would result in an equivalent increase to NR's net revenue requirement.

Q2 WHAT ARE YOUR VIEWS ON BUDGETARY FLEXIBILITY FOR NETWORK RAIL IN CP6?

3.2 The consultation document makes reference in paragraph 3.23 that NR may be subject to restrictions on spending money in different years than originally agreed. It is not entirely clear how tight these restrictions might be, but our specific concern is that this might lead to the imposition of annual budgets on the routes which is what we would expressly wish to avoid.

3.3 RIA absolutely understands the need for Government to exercise appropriate accounting control over Network Rail (NR) and to encourage efficiency, but our serious concern is that in CP6 this may lead to NR becoming subject to annualised budgets similar to local authorities and indeed to British Rail prior to privatisation in the 1990s, which we believe would have entirely the opposite effect.

3.4 In our March response to ORR's earlier consultation on NR's Strategic Business Plans we said in the Executive Summary and more specifically at 7.10 of the main text that:

"It remains a concern for CP6 that, in continuing to be subject to Government accounting procedures, NR may be subject to an unwelcome financial straightjacket which could prevent them taking timely and appropriate action prudently to move money between budgets and between regions/routes in the event of over or underspends in particular disciplines. It is also a concern should routes be required to operate under an annual budget regime, and we believe that routes should have similar financial agility to move money between years, should that be prudent and necessary. **We would urge ORR and DfT to look at this to ensure NR has the appropriate level of financial flexibility to smooth work profiles should problems arise in CP6."**

3.5 The rail industry is a complex one with long lead times and project durations which simply do not lend themselves itself to an annual budgeting approach. We believe a return to annual budgeting would be a seriously retrograde step, potentially taking the industry back to the short-termist annual funding regime in place with British Rail prior to privatisation, which would provide questionable increased financial control and would likely undo the welcome, but albeit not optimal flexibility afforded by the 5-year Control Period approach (also now adopted by both Roads and Water, which were previously funded on an annual basis).

3.6 RIA recently asked a cross-section of high-level rail supply member company representatives (several of whom have had prior experience in the utilities and other sectors) to identify what they saw as the major consequences of a return to an annual funding regime, and they highlighted the following:

- Clients, including Network Rail, will be reluctant to either plan or commit to long-term work bank volumes because of annual budgetary constraints. This will reduce workload certainty/visibility to the supply chain, which in turn will deter suppliers to invest in people (eg apprentices), new kit and innovative processes. As the supply sector has said repeatedly in response to the Hendy, Shaw and Bowe reviews, and in many other submissions and consultation responses, we believe that the provision of a visible and reliable workload profile would reduce costs by up to 30% (eg the uncertainty risk is factored into pricing). We have already had difficulty in achieving such confidence as part of the 5-year Control Period (particularly in renewals), let along trying to achieve this on an annual basis which significantly exacerbate the problem and would almost certainly import added cost and delay;
- Clients will be encouraged to release quantities of inappropriate or not-properly-planned work in the last quarter of the financial year, which is a well-known symptom of an annual budgeting approach and is self-evidently grossly inefficient. Alternatively, clients may be prompted to defer necessary work (subject to there being headroom in the following year's budget if money cannot be moved from one year to the next), or to interrupt capital programmes in order to stay within annual budgets. We have seen recently the results of deferring renewals in CP5 and the detrimental impact upon the supply chain and annual budgeting could lead to peaks and troughs of workload within individual years as well as within 5-year Control Periods. This cannot be an efficient way of managing a complex rail network;
- Access to clients would become more difficult towards the end of a financial year, as they concentrate on the year-end audit;
- Payment to suppliers may be delayed towards the end of a financial year, causing cash-flow issues;
- This uncertainty may also encourage suppliers work in other sectors at a time when rail needs a buoyant supply chain;
- Both clients and suppliers would probably need to increase their teams to cope with increased workload that this would entail – ie increased time and effort expended in working towards precise annual budgets, quite apart from distracting both from their core deliverables – all of which adds to cost;
- It would place increased pressure on client/supplier relationships which might break down as a result – i.e. it would encourage an adversarial/transactional, rather than the required collaborative approach; and
- It would be difficult to see how an annual approach this would work in a long-term alliancing environment.

3.7 RIA does understand that Government accounting pressures, quite rightly, place a premium on efficient delivery and tighter cost control in CP6, and the supply chain remains completely committed to working with all stakeholders to help achieve that. Whilst, as part of that, there is a need to monitor and review spend on planned programmes, we believe – for the reasons set out above – that returning to a fixed annual budgeting approach would result in the exact opposite of the delivery and cost control benefits intended; and this would be seriously detrimental to both the efficient delivery of CP6 and the rail supply chain.

Q3 WHAT ARE YOUR VIEWS ON OUR 'MINDED TO' PROPOSAL FOR CP6 TO SWITCH FROM RPI TO CPI FOR THE INDEXATION OF ACCESS CHARGES AND PAYMENT RATES IN OTHER MECHANISMS WHERE WE SET THE METHOD OF INDEXATION? HAVE WE IDENTIFIED ALL OF THE RELEVANT IMPACTS?

3.8 The ORR's proposed move to the use of CPI over RPI would be in line with wider adoption of CPI in other regulated industries. RPI ceased to be a national statistic in 2013. The Consumer Prices Index (CPI) has been used for inflation targeting by the Bank of England since 2003. A report published by the UK Statistics Authority, in January 2015, recommended that the Government and regulators should move towards ending the use of RPI as soon as practicable. In July 2017, the Office for National Statistics (ONS) designated the use of CPIH (consumer price inflation including owner-occupiers' housing costs) as a national statistic. Other regulators are moving towards the use of CPI over RPI as their measure of inflation. For example, OFWAT will transition from the use of RPI to CPI or CPIH from 1 April 2020.

3.9 It may be worth bearing in mind that Government, while widely using the CPI, continues to use the RPI in a number of important areas, including the capping rail ticket prices.

3.10 A switch from using RPI to CPI may have an impact in CP6 on actual levels of general inflation, which may be higher or lower than forecast levels, because network grant income will not be indexed. This would also be the case if RPI was used as the measure of inflation.

Q4 WHAT ARE YOUR VIEWS ON OUR 'MINDED TO' PROPOSALS FOR RAB ADJUSTMENTS AND ASSET DISPOSALS?

3.11 Although reclassification has meant NR has become an arm's length public body, retention of the RAB roll forward incentive and spend to save mechanism, or similar such incentives would appear to be appropriate mechanisms to drive financial efficiency. Any business, whether in the public or private sector, should be able to retain the benefits from an underspend (and bear the cost of an overspend) and have the ability/flexibility to spend to save to reduce costs in the medium to longer term. In NR's context, these mechanisms support the infrastructure manager's asset management strategy and plans.

3.12 The ORR 'minded to' position on asset disposals, set out in paragraph 1.95 of the consultation document, appears to be a sensible approach given the complexities around this issue, and the varying limitation of the options identified in paragraphs 1.89 to 1.94.

Q5 DO YOU HAVE ANY OTHER COMMENTS ON OUR MINDED TO PROPOSALS FOR THE FINANCIAL FRAMEWORK FOR PR18?

3.13 Not at this stage.

Q6 DO YOU HAVE ANY VIEWS ON HOW WE ARE PROPOSING TO CALCULATE SO, ROUTE LEVEL AND ENGLAND & WALES AND SCOTLAND REVENUE REQUIREMENTS FOR CP6, I.E. IS IT CLEAR ENOUGH?

3.14 We agree with the approach that:

- The ORR will be placing greater emphasis on its regulation of the System Operator (SO), which will have an increasingly important role in a devolved NR organisation; and
- Services provided by the SO are recharged to the relevant routes.

3.15 We agree with the proposed approach to calculating England and Wales and Scotland revenue requirements for CP6.

Q7 ARE THERE WAYS WE COULD MAKE THE PRESENTATION OF FINANCIAL INFORMATION FOR OUR PR18 DETERMINATION MORE TRANSPARENT?

3.16 The ORR need to consider the audience/ audiences for this information and tailor the level of detail accordingly. For example, financial information for the general public need not be as detailed as that sought by other stakeholders.

Q8 DO YOU THINK THE RISK MANAGEMENT APPROACHES REFERRED TO IN THIS CHAPTER COULD:

- **ALLOW NETWORK RAIL'S ROUTES TO EFFICIENTLY MANAGE RISKS AND EXPLOIT OPPORTUNITIES?**
- **BE TRANSPARENT?**
- **HELP TO PRESERVE THE INTEGRITY OF ROUTE-LEVEL FINANCIAL SETTLEMENTS?**
- **COMPLY WITH ANY GOVERNMENT RESTRICTIONS ON BUDGETARY FLEXIBILITY AND OTHER GOVERNMENT BUDGETING RULES?**

3.17 From the financial risks information set out in paragraphs 3.1 – 3.10 of Chapter 3 of the consultation document, it is difficult to form a firm view on whether NR will be able to manage all the financial risks it might face in CP6. Without knowing the quantum of the financial impact of specific risks up front, e.g. the frequency, severity and impact of any unforeseen weather-related events or significant increases in input prices, it is not possible to say whether these costs would be fully offset by less exposure to other risks, e.g. British Transport Police costs, interest rates and corporation tax liabilities.

What NR should do is manage those risks that it has control over, such as levels of OSTI. A robust asset management/condition strategy and plan are fundamental to reducing the risk of scope creep and planned activities costing more than forecast due to new asset condition information. Successful delivery of an effective asset management plan should help reduce and manage the levels of payments that need to be made under Schedule 4 and 8 provisions. In respect of inflation risk, this a risk that all commercial entities have to manage.

3.18 NR will need to manage its activities within the constraints of the SoFA and Final Determination, not least as it is no longer able to borrow money for Operations, Maintenance & Renewals (OM&R). Regardless, keeping spending within the financial limit set by the DfT is a good commercial discipline. However, what should be avoided is a repeat of what has occurred in CP5, whereby funding for renewals work was exhausted some 18 months before the end of the control period, resulting in a significant bow of renewals being deferred to CP6.

The 'boom and bust' cycle of work created at the end of one control period and the start of the next is an inefficient way of working and can increase costs by up to 30%. It also creates a lack of certainty in the supply chain impacting on investment in skills and training, equipment and innovation. RIA therefore recommends that the ORR more closely monitor NR's delivery of renewals activity, e.g. volume of possessions booked in advance of anticipated work, forward pipeline visibility, and volume of work contracted for the coming year(s).

3.19 The allocation to routes of expenditure on OM&R should help to increase transparency, not least as expenditure can be assessed against the levels forecast in each route's Strategic Business Plan. What is concerning, however, is that the forecasts are premised on there being only a 50% chance that the routes can deliver their OM&R activities within their forecast expenditure. This level of certainty is low and does not engender confidence in the supply chain. It is difficult to see how forecasts based on a P50 basis can drive efficiency (ie. a 50% probability that the project will be delivered within the risk adjusted price).

3.20 What is essential to the management of financial risk issues is the ability of NR and devolved routes to be able to spend money in different years than originally agreed, i.e. to move money between years, and to be able to switch funding between operating, resource and capital expenditure, as would be common in privately-owned enterprises, as well as to switch money between routes, such as for joint projects. Requiring routes to operate within an annual budget would have significant detrimental impacts (as set out in our response to Question 2 above) and goes against the very principle of devolution. It would tie one hand behind the back of the route and set it up to fail. Moreover, 'budgetary flexibility' as described above, is a necessary tool of financial risk management. Indeed, it is an underlying premise of NR's SBPs.

3.21 We support the ORR's view that NR route directors should be closely involved in discussion of any proposed use of centrally controlled funds; fund transfers that would affect their route; the expectation that route directors would consider the views of their stakeholders in this process. Those stakeholders must include the supply chain, without whom the successful delivery of route business plans would be in jeopardy.

Q9 WHAT DO YOU THINK OF THE RESERVATION OF 'HEADROOM' FUNDING APPROACH, THE APPROACH THAT FULLY ALLOCATES FUNDING TO ROUTES AND THE HYBRID APPROACH?

3.22 The critical factor is that all the funding provided in CP6 is used fully to operate, maintain, renew and enhance the network within the control period. RIA would not want to see any underspends as a result of overly prudent or risk-averse approaches to financial risk management. In particular, we would want to avoid a situation where headroom funding that had been held for several years (such as the central component to manage larger financial risks) was released towards the end of the control period (e.g. if fewer than expected unforeseen events had materialised at that point in time), in order for it to be spent 'quickly' by routes before the end of the control period. This would not drive efficiency and suggests the lack of a smooth work bank pipeline for the supply chain.

3.23 Equally, we would not favour an approach that meant routes did not have access to the full funding required to deliver their business plan, on the basis that the level of reserve held unduly restricted route based activity progressing at the necessary pace from the outset, and hence led to a stop/start work bank for the supply chain or reduced visibility of the pipeline. Holding an amount of funding in reserve at route level, may also reduce the level of assurance routes have about their funding in respect of planning and managing their business.

3.24 For route devolution to work effectively, routes will need to be responsible for their own financial management, albeit within a robust governance framework, e.g. transparency of decision making, timeliness of decision-making, and financially material thresholds above which a central process for accessing headroom funding or Growing Places Fund (GPF) is a formal requirement. So there will need to be governance in place both at a route and central level; and processes need to be sufficiently flexible to enable routes and central functions to operate as agile businesses.

The governance should not be overly bureaucratic, but proportionate to the risk and scale of funding involved. As such, it may not require routes to make a case centrally to release locally-held funds to cover higher than forecast expenditure, e.g. for renewals. RIA fully supports the ability of routes to be able to use their local component to cover higher than anticipated costs, such as for renewals.

3.25 If there is to be a centrally held component of a headroom fund/GPF, this will need to be calculated carefully. By its nature, this component is for bigger financial risk factors, suggesting such risks may not occur within CP6 (so could unduly hold back funding for the network); but if they did occur, they would be financially significant. Paragraph 3.15 of the consultation document states that the total GPF for CP6 is c. £2.6 billion. This equates to roughly 5% of the £47.9 billion SoFA.

It would be helpful if ORR could clarify whether the GPF will be based on the overall level of funding in the SoFA or solely the network grant element of the SoFA (£34.7 billion). RIA presumes it is the former. It may be worth considering whether the GPF could be updated and revised annually to take account of risks that have or have not materialised, such that the GPF is not fixed at the outset for the life of the control period. Risks by their nature are dynamic not static, hence managing them should reflect this.

3.26 It may also be worth ORR or NR exploring the availability and cost of indemnity insurance based on the likelihood of these larger financial risks materialising within the control period. This could potentially reduce the size of the GPF and release more funding to the routes from the start of CP6.

3.27 The approach whereby routes receive their full allocation of funding with cancellable activities could be detrimental to the supply chain in circumstances where the cancellable activities were those provided or delivered by the supply chain, in particular renewals work. This essentially reactive approach is far from ideal – NR and the routes should be managing risk proactively from the outset of CP6.

Furthermore, there is a risk that activity delivered by external contractors and supply chain businesses may become NR or the routes' default approach when cancelling work, as this may be perceived as the least worst or most immediate option when there is a need to limit expenditure quickly in a constrained environment. NR/routes would have a greater degree of cost control over those activities they undertake themselves, such as operations and maintenance, as these would already be part of their fixed overheads. Cancellation of renewals at short notice would be particularly disruptive for the supply chain, as has occurred in CP5.

The consultation document is largely silent on: detailed criteria for deciding which activities would be cancellable; what is considered relatively short notice; and how the impact on performance and stakeholders will be assessed. In the new environment whereby there will be separate settlements for each route and the SO, this becomes even more important.

3.28 While the hybrid approach, which represents a middle way, may reduce the potential disadvantages of the other approaches in that the headroom funding and cancellable activities would be at a lower level, it is also not ideal. All three possible approaches are unproven and hence, de facto, add an additional element of risk.

3.29 All three approaches to financial risk management set out in the consultation document have pros and cons. It would be helpful if the ORR could clarify whether a cost benefit analysis has been carried out for each of these approaches and whether other regulators have adopted similar approaches and to what effect.

Q10 DO YOU CONSIDER THAT NETWORK RAIL'S PROPOSAL FOR A GROUP PORTFOLIO FUND IS A NECESSARY FEATURE OF RISK MANAGEMENT BY NETWORK RAIL IN CP6 AT BOTH A ROUTE AND BUSINESS WIDE LEVEL?

3.30 In principle, it seems sensible. However, the success of such an approach can only be proven by the way it is operated in practice.

3.31 An advantage of the GPF approach is that through the pooling of risk, the level of certainty that NR as a whole can deliver its business plans increases to 80%.

Q11 DO YOU AGREE THAT WE SHOULD RETAIN THE CURRENT RE-OPENER PROVISIONS IN TRACK ACCESS CONTRACTS?

3.32 RIA has no firm views on this.

Q12 ANY OTHER POINTS THAT YOU WOULD LIKE TO MAKE?

3.33 Not at this stage.

4. CONCLUSION

4.1 RIA welcomes the opportunity to comment on the ORR's 'minded to' proposals on the PR18 financial framework. The welcome SoFA settlement provides an excellent opportunity for the industry collectively to make a step-change to our railway and its growing number of customers. However, the supply chain must also prove to its funders that it can deliver these substantial volumes of work, to continue to receive such funding settlements in future.

4.2 The railway supply chain stands ready to plays its part in a collaborative push to achieve this delivery. In order to do so, we need in turn successful adoption of the points referenced in the Executive Summary.

4.3 We hope this response is helpful and stand ready to discuss any part of it with the ORR.

For more information, please contact RIA Senior Policy Manager Damian Testa.

Second consultation on the PR18 financial framework:
Pro-forma for responses

This pro-forma is available to those that wish to use it to respond to our consultation. Other forms of response (e.g. letter format) are equally welcome.

Please send your response to pr18@orr.gsi.gov.uk by **24 April 2018**.

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Job title	Rail Strategy Manager
Organisation	Transport for Greater Manchester
Email*	
Telephone number*	

*This information will not be published on our website.

Chapter 1

Do you think our proposed changes to the presentation of OSTI and charge income categories will improve transparency?
We provide no comment upon this matter

What are your views on budgetary flexibility for Network Rail in CP6?
In principal we support the notion of such flexibility being permitted. However, we would not want to see cases of a reallocation between routes such that the pre-allocated distribution of funds around the network were to be changed. An example of this would be that money were to be reallocated from one route to another to cope with unforeseen infrastructure failures (e.g. Dawlish Sea Wall repairs). We would much rather than a centrally held fund (or insurance policy) were to be held to cover for such network wide eventualities, outwith the route specific funding.

What are your views on our minded to proposal for CP6 to switch from RPI to CPI for the indexation of access charges and payment rates in other mechanisms where we set the method of indexation?

Have we identified all of the relevant impacts?

Given the adoption by most government departments of the measure of CPI rather than RPI, we would support this switch of indexation.

What are your views on our minded to proposals for RAB adjustments and asset disposals?

We provide no comment upon this matter

Do you have any other comments on our minded to proposals for the financial framework for PR18?

We provide no comment upon this matter

Chapter 2

Do you have any views on how we are proposing to calculate SO, route level and England & Wales and Scotland revenue requirements for CP6, i.e. is it clear enough?

We provide no comment upon this matter

Are there ways we could make the presentation of financial information for our PR18 determination more transparent?
We provide no comment upon this matter

Chapter 3

Do you think the risk management approaches referred to in this chapter could: ▪ allow Network Rail's routes to efficiently manage risks and exploit opportunities? ▪ be transparent? ▪ help to preserve the integrity of route-level financial settlements? ▪ comply with any government restrictions on budgetary flexibility and other government budgeting rules?

What do you think of the reservation of 'headroom' funding approach, the approach that fully allocates funding to routes and the hybrid approach?
We would support the first option presented, that of providing headroom funding. This would allow a central fund to cover financial risks to be drawn from each routes' funding. However, we would not want to see this used as an excuse for poor project management, with particular routes drawing upon this fund excessive or disproportionally. We would request that the degree of drawdown of this funding and the use made of it is reflected in the proposed route scorecards so that it can see where any project or financial poor management may be occurring, and any evidence of such restriction access to this funding in future.

Do you consider that Network Rail's proposal for a group portfolio fund is a necessary feature of risk management by Network Rail in CP6 at both a route and business wide level?
The concept as presented seem sensible.

Do you agree that we should retain the current re-opener provisions in track access contracts?
We provide no comment upon this matter

Any other points that you would like to make

Thank you for taking the time to respond.

Second consultation on the PR18 financial framework:

Please send your response to pr18@orr.gsi.gov.uk by **24 April 2018**.

Full name	Matthew Crawford
Job title	Corporate Finance
Organisation	Transport for London
Email*	
Telephone number*	

*This information will not be published on our website.

We are pleased to see that most of our points in the previous consultation have been addressed within the latest round of consultation. However, please see points below that we do not feel have been addressed.

Chapter 1

Do you have any views on our proposed use of a building block approach to calculate Network Rail's revenue requirement at route level for CP6?

ORR proposes to calculate the overall revenue requirement for Network Rail from the route-level upwards, with a building block calculation for each route. In doing so, it says it will challenge Network Rail's plans and determine its own view of efficient expenditure levels.
TfL supports the building block approach in principle but has some concerns over its application in practice, particularly on the quality of data and incentives.
Regional funders, such as TfL, have limited ability to monitor, scrutinise and challenge Network Rail's costs and outputs when they are provided at a route level. Further disaggregated data is required to allow a more in-depth understanding of cost drivers and to determine efficiency targets more reliably. Analysis at a more disaggregated level than the route-level would enable relevant stakeholders to better understand and test Network Rail's costs and assumptions. TfL considers outputs at the Operator and London wide-level would be useful and appropriate.
Stakeholders can then play a more active role in assisting ORR to robustly challenge Network Rail's plans and views of efficient expenditure levels, and to assess whether outputs required by government can be delivered within the SOFA funding. The role of ORR in this process was not exactly clear in CP5, and rephasing and descoping of CP5 works occurred.

Chapter 2

Have we identified all the important financial issues that need to be addressed in PR18?

This chapter notes "Network Rail's activities in CP5 have cost more than expected and some of its delivery forecasting has not been sufficiently accurate." As ORR will be aware there is a longstanding concern over several control periods as to outcomes of Network Rail's capital programmes compared to budgeted cost and planned delivery schedule. There is a need for greater scrutiny of Network Rail's planning and cost estimation, as well as consideration of the drivers and incentives which influence both planning and delivery.

As noted in response to Chapter 1, analysis at a deeper level than route-level would allow both the ORR and relevant stakeholders (such as TfL) to better analyse and test Network Rail's plans, costings and assumptions. Views on other specific issues raised in this section are outlined below.

Chapter 6

- *Should we retain the RAB roll forward incentive mechanism for CP6 – could it be improved?*
- *Could we develop incentives linked to Network Rail's route scorecards?*
- *Should we develop the spend to save mechanism for CP6?*
- *Are there any other financial incentives you think we should consider?*

TfL supports ORR considering how to incentivise Network Rail to develop ways to reduce its costs and increase its income, for example through the spend to save mechanism. As discussed earlier, Network Rail should also be incentivised to proactively seek alternative funding, for example through development and third-party contributions.
ORR should also consider the effects of the possession compensation regime on the behaviour of Network Rail, funders and operators. In some circumstances, the current regime may lead to excessive possession periods being booked in advance, or dissuade works being undertaken, which are in the long term interests of the railway, due to compensation negatively affecting the economic case. A possession compensation regime should incentivise necessary upgrade works to be undertaken at the right time and in a timely fashion – this could be implemented through recalibration and reintroduction of a free allowance.

No further comment beyond potential financial incentives to improve planning and budgeting discussed earlier.

Adran yr Economi a Thrafnidiaeth
Department for Economy and Transport

Llywodraeth Cymru
Welsh Government

Office of Rail and Road

pr18@orr.gsi.gov.uk

April 2018

Second consultation on the PR18 financial framework

The Welsh Government's Cabinet Secretary for Economy and Transport responded on 21 April 2017 to the ORR's first consultation on the PR18 financial framework.

Although the UK Government has since confirmed through its SoFA and HLOS for CP6 that funding for enhancements are not to be included in the core settlement, the issues raised by the Cabinet Secretary around funding, process clarity and accountability for enhancement schemes remain concerns for us.

We agree that an appropriate degree of budget flexibility for Network Rail is important, but clear explanations need to be documented for any differences between profile and actual expenditure – along with an assessment of impacts on future financial years and overall delivery so that impacts can be understood and managed. A high level of transparency needs to be attached to the arrangements, including the allocation of any risk management fund. Any decisions to move funds from the Wales Route to another part of Network Rail's business, from one year to another, or between capital and revenue expenditure, should not be taken before a proposal has been considered by the Route's Supervisory Board.

We also expect the Route Supervisory Board to be consulted on any postponement or delay to the delivery of renewal and enhancement schemes. Past experience shows clearly that financial risks also arise in relation to enhancements and it will be important for the ORR's role in respect of financial issues around enhancements (including those funded by third parties) to be clarified.

We welcome the focus given to regulation of the System Operator function and the Welsh Government will wish to understand how much revenue has been allocated to deliver the SO's functions in respect of the Wales Route and we will want the level of rigour and transparency associated with financial flexibility described above in respect of the Wales Route to be extended to the SO's, and other central functions' activities.

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It will be important that the ORR engage with the Welsh Government in implementing any change to the indexation of track access charges and ensure that franchise funding flows between the UK Government and Welsh Government in future Control Periods reflect changes in methodology.

In respect of asset disposals, no asset disposals in Network Rail's Wales Route area should be progressed without consultation with the Welsh Government and without a full assessment on the future implications being undertaken, including for the railway's long term financial position. Where any disposals do occur, we agree that a common RAB adjustment policy needs to apply.

We would welcome ongoing direct engagement between the ORR and the Welsh Government as PR18 progresses.

Yours sincerely

Gareth Evans
Transport Policy, Planning and Partnerships