

UK Rail Industry Forum, 14 September 2016

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Speaking note

Thank you for inviting me to speak at the UK Rail Industry Forum today.

The Office of Rail and Road is an organisation which, at its heart, has been set up to protect the interests of road and rail users – improving the safety, value and performance of railways and roads today and in the future.

It is well understood by those of us here today that effective and efficient rail networks matter to us all: they feed the economy and wider society by contributing to productivity and economic growth.

The opportunity for the regulator to help secure these benefits for the UK economy comes in part through the periodic review process. This is the regulatory process through which the costs and outputs delivered by Network Rail for a five year period are determined – a process we kicked off in May with the publication of our initial consultation document, and which will conclude two and half years later with our final determination in October 2018, hence the regulatory short hand for the process - ‘PR18’.

As those of you who have been involved in periodic reviews previously will understand, this is a really important opportunity for all those involved in the railways to have a say in what its future looks like for the following five years.

Unlike periodic reviews in other sectors, which have historically focussed on the relationship between the regulator and the regulated company, the periodic review in railways has usually attempted to do more. It provides an opportunity to determine not only the outputs, and cost of

those outputs to be delivered by Network Rail, but to look much more widely at the incentives it creates on users of the rail network.

And it is that breadth which necessitates a process which:

clearly recognises the issues that the rail industry faces today - something which can only be done with proper dialogue with a wide range of stakeholders and an opportunity for us as a regulator to demonstrate that we are listening;

and meets the needs of key stakeholders retaining the benefits which the legislation provides for a clear commitment to funding for delivery of a specific set of outputs.

So what are those important issues that face the railway today? I will touch on three, but there are clearly others, before going on to consider how we can build on developments within the industry to support our regulation of Network Rail, and finally ending by giving you a sense some of the responses we have received to our initial consultation document.

First of all, growth. There has been sustained growth in passenger numbers over many years, which is a success story. As a result, Network Rail's network is increasingly busy, with train kilometres up by nearly 25% since 2005-06. Capacity improvements have benefitted passengers and freight customers and allowed more services to run, but passenger numbers and freight volumes are forecast to continue to grow - albeit that any forecast of demand comes with uncertainty around the rate in particular.

A busier network increases the challenge for Network Rail across its roles: there are more constraints on the time available to maintain and renew the infrastructure; timetabling additional services is more complex; greater passenger numbers need to be accommodated at stations and when boarding trains; and capacity constraints limit the expansion of services despite the strong demand for them.

Meanwhile, passengers are funding an increasing proportion of the costs of running the railway, with the balance met by taxpayers. Understandably, there is a very public focus on fares, value for money and the level of service and performance that passengers expect in return.

And for Network Rail's freight customers, we are seeing some significant shifts. There have been substantial declines in coal volumes, set against growth in intermodal and construction-related freight over recent years. These shifts pose questions; how can the network best support freight growth, and provide it with the flexibility required to meet the needs of its new customers?

Turning to the reclassification of Network Rail, while we are all now familiar with this as a concept, some of the implications for the industry are only beginning to play out. It means that Network Rail now competes much more directly for funding with hospitals, schools and defence and that the binding borrowing limit provides a much harder constraint on Network Rail than previous arrangements, which rightly or wrongly allowed it to raise its own debt off the regulatory asset base.

When coupled with the constraints on public spending, this highlights the need to:

make the best use of the current network, as opportunities for additional investment – beyond the major committed schemes – might be limited;

and identify alternative additional sources of funding for the railway which is at present almost exclusively limited to receipts from the farebox and from taxpayers, via central government. This question of funding is for me a separate debate from the financing of the railway; that is a more political debate. As a regulator we are agnostic to the colour of the money, but recognise that the incentives it creates in the industry can be different.

And finally there continue to be challenges on Network Rail's efficiency where some costs have risen in the last couple of years, when we had expected them to fall. This has been discussed at length in the context of enhancements which resulted in Sir Peter Hendy's replanning of the enhancement programme, together with a number of other reviews over the course of last year. But it is also the case that the cost of renewals has increased. Together the effect has been to place additional pressure on Network Rail's financial position, leading to the deferral of £9.5 billion of enhancements expenditure and £2.5 billion of renewals expenditure from the current funding period to the next funding period.

So if these are some of the many challenges facing Network Rail and the industry over the coming year, how are they responding and what are some of the developments taking place that we think will address these concerns and which we can build on collectively to improve the service received by passengers and freight customers.

The most significant of these has been seen in a number of changes to how Network Rail organises itself, with a greater role for the routes and the creation of a 'system operator' within the business, maintaining the 'big picture' view to manage realisation of the opportunities presented by greater devolution to route level.

ORR is strongly supportive of that work NR has undertaken in devolving operations further into the routes – we think that it provides a real opportunity for Network Rail to improve the way it is able to meet the needs of its freight customers, passengers and funders.

We think in due course that we as regulator will be able to make much better use of the information coming out of routes:

to set price controls which are based on a realistic and achievable set of outputs; and

that comparison of routes will provide on an on-going basis for stronger incentives on those working within Network Rail to improve.

While we have increasingly focused our attention on routes over the last couple of years, to be effective our regulatory approach going forward will need to change further to reflect these changes in how Network Rail operates.

We also need to ensure our approach responds to the opportunities for greater route-level engagement that increased devolution brings for customers and local stakeholders. Importantly, this isn't something which needs to wait until the periodic review process is complete.

We strongly support the work that Network Rail routes has done this year to introduce a route-based scorecards. For the regulator, an important part of developing the outputs for the scorecards, are the discussions Network Rail has with with train operators, to ensure the scorecards reflect what train operators need to best serve their customers. We recognise that this process needs to evolve, that enough time must be allowed to make the conversation between a route and its customers meaningful and that ultimately the routes must be delivering against the scorecards to build credibility with the train operators. Nonetheless we can see real benefit in a mechanism which strengthens the relationship between train operators and Network Rail, allowing the regulator to step back and also creating a stronger line of sight to the passenger or freight customer through the system.

But routes won't work without strong system operation foundations, too. A system operator that excels at timetabling capacity management and analysis can effectively mitigate the risk that increased devolution to routes could undermine the quality of service to those operating across the routes.

ORR considers that the system operator is a key element in our objective of supporting fair access now and in future to the network.

While there are a range of different approaches we could adopt in our regulation of system operation, targeting and adapting our regulatory approach to a centrally based system operator might involve a combination of:

Financial information **about the system operator**, including data about its costs and assets and how these might be expected to evolve over time.

A set of performance measures. These might include some quantitative measures (e.g. national performance, performance of cross-route operators, timetable conflicts) and customer-facing measures (e.g. satisfaction with timetabling).

Greater transparency about performance, to allow customers and funders to challenge how well the system operator functions are being delivered.

Financial incentives on the system operator, reflecting key aspects of performance and potentially linked to the remuneration of relevant staff.

As we consider these approaches we are clear on the aim: for Network Rail to maximise use of capacity to meet the growth in demand and facilitate the best use of its network.

So how are we taking forward the review? The consultation on our overall initial consultation document and two supporting working papers on our approach to the regulation of routes and system operation have now closed. However we are still out to consultation on our approach to Network Rail's outputs and the treatment of enhancements. The working papers and working groups which the Rail Delivery Group facilitate have allowed us to bring ideas forward at an earlier stage in the

regulatory process. We have done this very deliberately as a means of trying to ensure that the final settlement is one which works for the industry that we have today. This is not without risk for the regulator and I recognise it has resource implications for all involved, but I am pleased and grateful for the way everyone has engaged in the process to date.

It remains our aim to publish our response to the initial consultation document in November. That is still some time off, so I thought it might be helpful to set out some of the issues which have been raised. Many of you in the room will have been one of the 58 who responded to the consultation – so first of all thank you.

Most of you recognised the context which is set out in the document and which I started my talk by discussing some of - although inevitably since publishing our document other issues have emerged, not least Brexit, which we will need to consider further. Others, in responding, identified issues which it felt we had underplayed such as HS2, sustainability and finally and perhaps most challengingly important questions were raised around flexibility and our ability to respond to new issues. Inevitably when you carry out a two and a half year project this can be an issue but it is also a feature of a five year settlement and one which we will need to consider further.

We have seen a good level of support for the route level, and system operation focus as set out in our consultation. We welcome the endorsement of this approach and intend to push forward with these, since there is broad agreement that these areas are necessary for setting efficient costs and defining Network Rail's outputs.

More substantively, we have noted submissions from across the sector pointing out the inherent challenges of making changes to the system too quickly and in too wide-spread a fashion. In this context some sectors feel more institutionally exposed than others - the freight community for example, argued for stability to enable them to manage the changes within their markets.

We are considering the feedback we have received and continue to receive very carefully. We are looking at whether, in the light of those responses, further choices need to be made on which areas to focus and at what can be practically and efficiently delivered as part of PR18 – and those areas which may need to be longer term propositions.

We have recognised from the outset that we may well need to prioritise, so that the conclusions of the review fulfil our objective to support a more efficient, safer and better used railway for the benefit of passengers, freight customers and taxpayers; and does so in a way which is rooted in the practicalities and the realities which the industry faces today.

Thank you to those who have engaged with us so far and continue to do so. If anything I have said interests others and they would like to get involved, we would welcome this and I am obviously happy now to take questions on my presentation today.