Network Rail’s response to ORR’s PR23 draft determination

Key messages for England & Wales and GB policy responses

31 August 2023

Introduction

This document sets out our key messages in response to ORR's 2023 Periodic Review (PR23) draft determination for England & Wales (E&W), and its draft decisions on key policy areas (which apply across Great Britain), published on 15 June 2023. Underpinning our key messages are a suite of documents, including our detailed response to ORR's draft determination, as well as responses from our regions, System Operator and national functions. Our draft determination response provides updated Control Period 7 (CP7, April 2024 to March 2029) financial projections (where appropriate), and these are expressed in 2023/24 prices (using the May 2023 Bank of England CPI forecast).

Context

The context for PR23, and more generally the last few years for the railway, has been exceptionally challenging. Since March 2020 and the start of the Covid-19 pandemic, there have been radical changes in the ways that passengers use the railway, and a significant, and continuing, reduction in industry revenue. Covid-19 has exacerbated already challenging economic circumstances in Great Britain, adding to the pressures on public finances and the availability of funding for rail. Furthermore, we have been, and will continue to be as we move into CP7, impacted by high and volatile inflation. The value of our CP7 funding has been eroded by c.£1.5bn since the Government's High Level Output Specification (HLOS) and Statement of Funds Available (SoFA) for CP7 were published in December 2022, due to inflation being higher than assumed at that time. Other challenges include continuing to experience more frequent extreme weather events across the network associated with climate change, which our assets have generally not been designed to cope with.

Responding to all these challenges requires us to work collaboratively with industry so that we can deliver the best level of safety, customer service, asset management, cost efficiency and train performance for passengers and freight users. We are pleased to set out ambitious efficiency improvements for CP7, building on the £4bn we anticipate achieving in CP6. Our plan for CP7 balances the core CP7 deliverables of safety and train performance with investment for the longer term, so that Network Rail, and the industry, is prepared to support further growth and continue to deliver for passengers and freight users in CP8 and beyond.

Our key messages

We welcome the engagement we have had with ORR, Government, passenger and freight operators and other stakeholders, during the course of PR23 on the wide range of topics that are critical for Network Rail and for the success of the railway in CP7. This engagement is important to us, both at a company level and through our regions and functions, and will continue as we develop our delivery plan and move into CP7.

We are pleased that ORR has accepted in its draft determination much of what we set out in our SBP but there are areas where we have significant concerns on the regulator's proposals. In some areas we have made constructive progress in our discussions with ORR since it published its draft determination but there remain a number of issues where we are asking ORR to review and alter its proposals ahead of its final determination. Our key points are set out below.

1. **Given the challenges and uncertainties we face in CP7, it is essential that ORR is flexible and pragmatic in its approach to regulating Network Rail, recognising the high level of anticipated change as PR23 is concluded, and the challenges we face during CP7.**

   We expect ORR's approach, particularly around setting CP7 targets, to be consistent with Government's principles for economic regulation originally set out in 2011 and reinforced by its 2022 economic regulation policy paper, including adaptability, coherence, efficiency and predictability. In applying these ORR must recognise Network Rail's specific characteristics and that ORR's performance targets cover the whole industry so need to take into account how train operators' contractual arrangements with funders are established. ORR's approach should provide a clear line of sight to its statutory duties, which are defined in and limited in statute, and which include acting in a manner which ORR considers will not make it unduly difficult for holders of network licences to finance any activities or proposed activities where ORR has functions. ORR's approach should also provide clarity on how it has sought to balance its duties in a way best calculated to promote the public interest.

   We note that other regulated companies, including those in the water, energy and airports sectors, are experiencing similar uncertainty but have regulatory protections and tools to respond that Network Rail does not (e.g. inflation protections, financial and risk adjustment mechanisms, and the ability to raise capital from private equity and debt investors) – and that most other UK regulators have introduced new or augmented uncertainty mechanisms reflecting heightened macroeconomic uncertainty. We recognise that the nature of our ownership and funding means that some of these protections / mechanisms would not be possible, and as a consequence we have established a risk fund to absorb risks that may materialise during the control period. But overall, this underlines the need for adaptability and proportionality in how we manage our activities and cost base, as well as how our outcomes are defined and monitored. Flexibility must be an essential part of ORR's final determination.

   We support the principles of ORR's managing change and holding to account policies, and robust and challenging regulation more generally. However, it is essential that ORR recognises in its final determination that we have, through PR23, and will continue to, in CP7, face an unprecedented level of change and uncertainty. We are concerned that the current provisions in the draft managing change policy will not provide sufficient flexibility in being able to manage the scale, frequency and complexity of the change we anticipate in CP7 – and at times duplicate other reporting arrangements. Overall, we are concerned that the requirements of the draft policy may not be proportionate nor enable an agile approach to managing risks, particularly where changes are unexpected and / or outside of our control. This does not appear in line with the Government's principles for economic regulation.

We have a collective responsibility to avoid any mechanisms that create false expectations, tensions, and unnecessary and inefficient bureaucracy in progressing the changes that we know will be necessary both before, and during CP7. This is critical for Network Rail and the industry being set up for success in CP7. Ahead of the final determination we would welcome further discussions with ORR on proportionate criteria and thresholds for managing change during CP7.

2. **We accept almost all of ORR's proposed £550m increase in core asset renewal expenditure in CP7, albeit comprising a different mix of assets across our regions.**

   We have accepted the majority of ORR's proposed increase in core asset renewals expenditure, which largely reflects the assurance carried out by our Technical Authority at the time of our SBP. We have included important additional expenditure on earthworks, structures and track assets in our regional plans. We expect, given the level of core asset renewals in CP7, and notwithstanding the £550m to be added, there will be a projected reduction of 2.5% in the Composite Sustainability Index (CSI), which is one of ORR's key metrics for CP7 – and measures the long-term sustainability of the infrastructure. Our current view is that long-run core asset renewals demand would require expenditure of around £19bn in CP8 and £20bn in CP9 (compared with around £15bn in CP7), to achieve a more sustainable position in respect of asset condition in CP9 onwards.

   We have also identified other additional funding pressures of c.£400m in our plan since making our SBP submission, which are not included in ORR's draft determination. These relate to the level of use of high output ballast cleaning in CP7 and changes in the assumptions on future income compared to those assumed in the SoFA. This means that the total additional expenditure required in our plan compared to our SBP is c.£900m.

3. **To fund the increases in core asset renewals and the other funding pressures we have identified a range of specific savings (and income stretch) within region and function plans and included the remainder as an overlay of c.£600m (2.1%) in regional plans.**

   We have considered the targeted options for expenditure reductions set out in ORR's draft determination, and have taken forward the proposals to reduce Route Services' expenditure and a modest proportion of expenditure on the West Coast Main Line (North) renewals programme. Recognising the strategic and commercial importance of our digital signalling programme and Project Reach, we have not reduced funding for these areas. However, we plan to 'soft ringfence' funding for WCML(N) and digital signalling so that if they underspend this funding can be used for priority needs on the network, or else retained for the risk fund. Our approach strikes the right balance between protecting safety and train performance, and not being overly reliant on a small number of areas to deliver savings. As above, it is critical that we are able to maintain as much flexibility as possible in our overall plan, to respond to emerging challenges as we continue our planning for, as well as during, CP7.

We plan to address the £600m overlay in regional plans through a series of deep dives on key areas of our plan to identify opportunities for further savings ahead of our CP7 delivery plan. We are also exploring further market-led, whole-industry opportunities, building on the initial work in our SBP. As part of these deep dives, we will also assess the impact of how we address the overlay on the delivery of our CP7 outcomes. We will use ORR's managing change process to alter the outcomes for CP7 between the final determination and CP7 delivery plan, where required. We will work closely with ORR as this work progresses.

4. **We accept ORR's move to our 'risk adjusted' plan for England & Wales and have moved c.£1.5bn of 'contingent' funding in region plans to the 'cash risk' fund.**

   However, the additional c.£1.5bn of risk funding is offset by the impact of inflation. Based on the May 2023 Bank of England inflation forecast, the value of our CP7 funding has been eroded by c.£1.5bn, since the SoFA was published. Moving to the risk adjusted plan has allowed us to absorb this risk (which is one of the key purposes of the risk fund). It has also reduced our planned renewals volumes in CP7. Our assessment of the latest August 2023 Bank of England inflation forecast is that there is no material further impact on our CP7 net costs, although we will need to continue to monitor the impact of updated inflation forecasts on the deliverability of our CP7 plans.

5. **There is uncertainty around inflation and input price estimates in CP7. While we consider that our latest input prices assumptions are robust, we have held c.£1bn of our £1.7bn input price inflation in our cash risk funding.**

   Our latest analysis suggests we will still face significantly higher input price inflation than that assumed in the draft determination. We consider that the Europe Economics analysis used by ORR was flawed as it did not take account of the current inflation environment, and the impacts of lagged effects on input prices, or Network Rail's specific circumstances compared to the other regulated companies it used as the basis for its analysis. We will continue to discuss our proposed approach to holding c.£1bn of input price inflation in the cash risk fund with ORR ahead of the publication of its final determination.

6. **Once adjustments have been made for the latest view of inflation and input prices, our total CP7 cash risk fund is c.£1.5bn. We continue to face significant uncertainty in CP7, including from inflation, input price estimates and wider risks, and if these materialise at a significant scale they will exhaust the available cash risk funding.**

   To illustrate this, if inflation is 1% higher than the assumption we use for our plan for each year of CP7, it would have an impact of c.£0.8bn on our net costs in the control period. We also face other financial risks in CP7, such as the impact of extreme weather on the network, Schedule 8 costs, revenue reductions or shortfall in efficiency delivery. This reinforces the need for flexibility in ORR’s final determination and approach to regulating Network Rail in CP7. This includes recognition that we may need to use the managing change process if risks materialise in CP7 that exhaust the cash risk fund available (especially noting the uncertainty around input price inflation). To provide transparency of decisions in relation to risk, we have agreed with ORR and Government a set of principles for the enhanced monitoring and reporting of risk funding in CP7. We think that, when taken together, our cash risk funding and the flexibility in the regulatory framework that we are seeking from ORR should provide a sufficient basis for planning and delivery in CP7. Table 1 summarises the movements in cash risk funding compared to our SBP.

Table 1: Movements in the level of cash risk funding available in CP7

£bn, 2023/24 prices	Impact on cash risk funding (compared to SBP)	Risk funding available
SBP cash risk funding		0.5
Move to risk adjusted plan	1.5	2.0
Impact of latest inflation forecasts	(1.5)	0.5
Input price provisions to risk	1.0	1.5
Resulting cash risk funding		**1.5**

7. **We have raised with ORR our significant concerns around its proposed approach to setting CP7 train performance trajectories. Recent discussions with ORR to find an alternative, more appropriate, approach to setting the CP7 regulatory baselines for train performance (the '2+3' approach) are a constructive step forward. However it is essential that targets for years 1 and 2 of CP7 are realistic and underpinned by credible assumptions and evidence.**

   As agreed with ORR, we will provide an addendum to this document by 14 September which will include proposed point values for years 1 and 2 of CP7 and updated performance ranges for years 3 to 5. It is now imperative that the train performance targets that ORR sets in its final determination for years 1 and 2 of CP7 are based on solid evidence and clear assumptions around operators' contributions (which are currently uncertain).

   There are many inputs that we know materially impact train performance that remain uncertain – more so than has been experienced in previous control periods. These include service patterns (which will be influenced by DfT and operators' annual business planning decisions) and passenger numbers. Network Rail cannot be expected to develop robust train performance forecasts for whole industry performance measures without robust assumptions for train operators. We are therefore concerned by the lack of recognition ORR has shown in recent discussions for the annual business planning process and timings for setting train operator performance targets, and the uncertainty this drives into being able to reliably forecast whole industry performance for year 1 – even though this is only seven months away.

   We recognise the application of ORR's statutory duties must be balanced in a way best calculated to promote the public interest. One of those duties is to promote improvements in railway service performance. This is an ambition we share. However, we have material concerns that the level of stretch being indicated for years 1 and 2 of CP7 by ORR for Network Rail and train operators disregards the inherent uncertainty we have repeatedly pointed to and evidenced, and the level of pressure and risk in our plans. We are concerned this stretch is not underpinned by robust analysis, and risks setting up the industry to fail from day one. This does not reflect an appropriate balance of ORR's public interest duties, nor is it consistent with the economic regulation principles – including the need for coherence between the regulation of Network Rail and the contractualisation of performance targets between train operators and DfT.

When the industry is working hard to rebuild confidence in the railway post Covid-19 and other challenges in CP6, setting unachievable targets will create unnecessary tension, confusion and bureaucracy, ultimately having a detrimental impact on industry reputation and morale. If the final determination train performance targets are not based on credible assumptions and evidence, we will adjust them immediately through the managing change process (ahead of the start of CP7).

8. **We welcome that ORR has accepted our overall efficiency target of £3.2bn for the risk adjusted plan. Delivering these efficiencies will be extremely challenging not least given the nature of the approach it has been necessary to take to asset renewals.**

   This is primarily due to the fact that we are seeking to achieve relatively the same efficiency across less activity (i.e. the shift from the full plan to the risk adjusted plan) and that 30% of efficiencies relate to our share of the industry savings from rail reform, with legislative change continuing to be delayed. However, not all reform initiatives require legislative reform. ORR support to drive / deliver whole-system savings will be essential. More broadly, our response provides further detail on the efficiency initiatives that underpin our plans, including more detail on operational efficiencies (which ORR raised as a challenge in the draft determination) and Project Reach efficiencies.

9. **We will deliver a safe plan in CP7 to support our vision to get 'everyone home safe everyday' and remain strongly committed to the safety outcomes set out in our SBP. We have developed a bow tie risk assessment framework which we will use to demonstrate our understanding of the change in risk profile as a result of conducting fewer renewals in CP7 (due to renewing at less than steady-state levels and through the shift to the risk adjusted plan, discussed below), including assessing the level of alignment between our maintenance and renewals plans, and how we will manage this.**

   This framework identifies the threats and mitigations that could influence what we consider to be the primary safety risk (i.e. that our infrastructure is unable to safely support the delivery of the train plan). Each region will complete the bow tie risk assessment and will prioritise the asset types that are a significant risk precursor to train accident risk (i.e. track and structures). This framework complements our existing 'business-as-usual' safety risk management approach and our assurance / governance processes that will continue to apply in CP7.

   The safety bow tie risk assessment also supports us in evaluating specific areas of concerns. For example, we have used the safety bow tie risk assessment to demonstrate the alignment between our maintenance and renewals plans in CP7 (including that the funding provisions for maintenance activities in CP7 are scaled appropriately) and identify any gaps which we will seek to address as part of the development of the delivery plan and into CP7.

We have welcomed ORR's constructive engagement and input on the development of the assessment framework, and its support for the approach to populating these as part of our CP7 delivery plan.

10. **We do not support ORR's decision to now not fully implement its original proposals for c.75% (average) lower Network Rail Schedule 8 Payment Rates at the start of CP7.**

This will result in train operators being overcompensated by delays caused by Network Rail and freight and charter operators. Given the constrained level of funding in CP7 and challenging train performance objectives, ORR's currently proposed performance targets (notwithstanding the 2+3 approach and the reset for years 3-5), and the availability of risk funding, any performance shortfall, and corresponding Schedule 8 outflows, would have a material impact on Network Rail. This will be exacerbated by Schedule 8 payment rates that are inaccurate and higher than they should be.

We are not clear on ORR's justification for this proposal nor how ORR have accounted for the risks of defunding vital infrastructure works that would arise from the overpayment to train operators as a result of unjustified payment rates or unrealistic benchmarks. In particular, if we are forced to reduce renewals expenditure beyond the move to the risk adjusted plan to fund Schedule 8 payments (or other risks that materialise), this will increase the level of service affecting failures, further impacting performance levels. This is not a hypothetical risk as we saw this happen in CP5 where we paid out c.£1.2bn (2023/24 prices) in Schedule 8 payments to operators and had to divert funding from core asset renewals activity to fund this. One way to mitigate this risk could be to introduce a 'dead band' around Schedule 8 payments where money flows within these thresholds are paid into an industry performance improvement fund which both Network Rail and train operators can use to fund performance improvement schemes. However, an even simpler way to mitigate this risk would be to implement the full 75% reduction in payment rates now and review the evidence in time for the recalibration as part of the '2+3' approach.

We note that ORR's 2+3 approach to setting performance regulatory baselines would result in a Schedule 8 recalibration. Therefore, we have assumed in our plans that the full c.75% (average) reduction in the Network Rail Payment Rates would apply in years 3 to 5 of CP7, following the c.45% (average) reduction for years 1 and 2 given ORR's recent decision.

More broadly, we support ORR's proposals to introduce a mechanism for in-control period recalibrations of Schedule 8 (alongside the automatic recalibration as part of the 2+3 approach) and also to allow Schedule 8 to be 'switched-off' for operators procured by Great British Railway, where legislation permits. As noted above, flexibility and the managing change process in CP7 will be critical, particularly where Schedule 8 flows could be significant, which would reduce our risk funding further.

We summarise the key changes we have made to our plans, as described in the points above, in annex A.

Key assumptions

A number of critical assumptions underpin our response, and our plan for CP7. These include that:

- There will be no significant changes to existing legislation.
- ORR will reflect the c.75% reduction in Schedule 8 Network Rail payment rates in years 3 to 5 of CP7.
- There will be no significant interventions by ORR in respect of safety that require changes to working practices and the outcomes we can deliver in CP7.
- Inflation will not materially diverge from current forecasts.

These assumptions are important because the amount of risk funding in our CP7 plan, for managing normal business risks, would not be sufficient to absorb significant changes in inflation or other cost or revenue shocks. If these assumptions are incorrect, this will impact our ability to deliver our CP7 outcomes within the funding available, requiring us to initiate the managing change process. Ultimately, we may need to seek a control period re-opener (as per the arrangement set out in track access contracts) although we note this would involve a lengthy process, necessitating a new HLOS and SoFA.

Next steps

We will continue to engage with ORR to support the development of its final determination. This includes providing further information on train performance between this response and 14 September 2023, and we will keep ORR updated on our progress as we work towards addressing the overlays in region plans. Given the financial challenges we are facing, and reflecting the continued need for tough choices and funding prioritisation, continuing to explore market-led whole industry opportunities as part of addressing the overlays, as well as the further iteration of our plans is absolutely critical. We are committed to driving this forward and continuing engagement with ORR on what this means in practice for CP7.

More broadly, ahead of rail reform, it is important the industry works together to identify opportunities to deliver better outcomes for our customers, the communities in which we serve and the taxpayer. All organisations across the railway system have important roles to play in building trust and confidence in the industry, following the challenges faced during CP6, and the need to improve revenue, become more cost efficient and alignment around whole industry train performance planning and delivery. Flexibility and agility from all organisations, including ORR, will be vital in order to enable the industry to succeed in CP7 and beyond.

Following the publication of ORR’s final determination, regions and national functions will update their CP7 plans in early 2024 (notwithstanding Network Rail’s decision to accept or raise objections to the final determination in February 2024). This will form the basis for our CP7 delivery plan, which we will submit to ORR in March 2024. Our regions and national functions will continue to engage with their customers as they further develop their CP7 plans. We also plan to publish final CP7 price lists, consistent with the final determination, in December 2023.

Annex A: Updated England & Wales CP7 financials

Table A1: Summary of CP7 England & Wales expenditure, consistent with our draft determination response

£bn, 2023/24 prices	CP6 (RF3)	SBP	Draft determination response	Draft determination response vs SBP
Operations	3.98	3.78	3.91	0.13
Maintenance	10.49	10.29	10.25	-0.04
Support	4.09	4.74	4.58	-0.16
Industry costs and rates *	1.53	1.67	1.68	0.01
Electricity for traction (EC4T)	2.82	4.06	4.50	0.43
Total operating expenditure (excl. EC4T)	**20.09**	**20.48**	**20.43**	**-0.06**
Renewals	16.62	15.86	15.03	-0.83
Other capital expenditure	2.11	2.36	1.74	-0.62
Total capital expenditure	18.73	18.22	16.77	-1.45
ETCS	0.00	0.81	0.81	0.00
Total Expenditure (excl. EC4T)	**38.82**	**39.52**	**38.01**	**-1.51**
Input prices moved to risk funding	0.00	0.00	-1.01	-1.01
Total Expenditure (excl. EC4T and input price adjustment)	**38.82**	**39.52**	**37.00**	**-2.52**
Risk funding	0.00	0.50	1.51	1.01
Total Expenditure (incl. risk funding, excl. EC4T)	**38.82**	**40.02**	**38.51**	**-1.51**

*Excluding BT Police costs

Table A2: Summary of CP7 England & Wales income, consistent with our draft determination response

£bn, 2023/24 prices	CP6 (RF3)	SBP	Draft determination response	Draft determination response vs SBP
Passenger access charges (VUC, EAUC, FTAC)	8.09	7.18	6.95	0.23
Stations and Depots: Station LTC, Stations Lease, QX and Depots	2.10	3.02	3.24	-0.22
Freight and open access track access charges	0.50	0.46	0.55	-0.09
Electricity for Traction (EC4T)	2.83	4.06	4.50	-0.43
Property and other income	1.05	1.73	1.52	0.20
Schedule 4 access charge supplement	1.64	2.27	1.46	0.81
Schedule 4 and 8 costs	-1.80	-2.34	-1.53	-0.81
Network grant	27.24	27.70	26.32	1.38
Total Income	**41.65**	**44.08**	**43.01**	**1.07**
Total Income (excl. EC4T)	**38.82**	**40.02**	**38.51**	**1.51**