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Dear Mark

Network Rail Business Plan – next steps for ORR

With the Hendy report now published, this is the right time to ensure we all have a common understanding of the next steps, particularly where ORR needs to take a decision. This should help ensure work is carried out efficiently and that plans and processes are transparent to all those affected, both to the industry and to wider stakeholders.

From the ORR's perspective, we will continue to focus on our regulatory role in the context of the overall CP5 settlement and your licence; hence that is the scope of this letter. The CP5 settlement established a set of outputs that Network Rail needed to deliver, efficiency assumptions and the associated funding. While Network Rail's reclassification and the introduction of a cap on borrowing have impacted on the settlement, they have not changed the underlying structure of the settlement. Similarly, your broader licence and legal obligations remain unchanged. These obligations reflect the need to consider future users and funders of the network as well as current ones.

In summary, the areas where we need to do further work with Network Rail can be grouped into:

a) Core business: the potential sustainability and safety impacts of the reduction to planned civils renewals volumes;

b) Regulatory performance targets: your latest performance forecasts which show England & Wales PPM targets not being met;

c) Enhancements: ORR's role in the follow up on the Hendy report where, although we are not involved in the prioritisation decisions, we will oversee the change control process among other roles;

d) Monitoring future financial implications/risks: this covers (1) monitoring future financial risks to the Network Rail business in the context of the very small headroom against the borrowing limit in CP5 and (2) monitoring the financial implications of your CP5 plans for CP6, where the plans will result in higher expenditure and lower income than otherwise would have been the case; and

e) Asset disposals: the next steps on asset sales, where the ORR may need to resource up for an increased volume of sales. Our role is in relation to disposals, where we need to carry out a public interest test to balance the benefits of the sale against possible future rail uses of the land.

a) Core business: operations, maintenance and renewals expenditure

Reductions in civils renewals volumes

As the Hendy review says:

> *'the core business plan for operating, maintaining and renewing the rail network has also needed to be updated as Network Rail is unable to achieve the savings assumed for the five year period.'*

The main planned change at this stage is in civils renewals and within this the most affected category is earthworks. Network Rail has a policy for each asset class, which sets out your approach to maintaining and renewing the assets in the short, medium and long term, as well as minimising whole life cost. The policies are one means of demonstrating that NR is managing the network in accordance with best practice and in a timely, efficient and economical manner pursuant to condition 1 of the licence; we regard minimising whole life cost as a fundamental part of this management.

During the work on PR13 Network Rail concluded that civils assets had suffered long-term under-investment and their condition had deteriorated. You proposed to remedy the shortfall and achieve a sustainable condition by increasing the volume of renewals during this control period and the next. We accepted your conclusion and proposed approach, but your plans were not robust enough to justify the increased spend, so we set up the civils adjustment mechanism (CAM), which required Network Rail to submit a bottom-up workbank (setting out the work that needed to be done) for 2016/17 to 2018/19 by March of this year. When we reviewed the CAM submission which included this plan of works, we were broadly content that the work was consistent with your asset policies, but we could not determine the efficient level of funding because of your uncertainty about the costs, which appear to be significantly higher than you expected during PR13.

Your proposal now is to reduce the volume of civils renewals materially below the level proposed in the CAM submission particularly for earthworks (on which planned spend is significantly reduced). While we recognise that civils cost pressures have to be managed within the wider challenge of delivering the CP5 settlement as a whole, your licence requires you to comply with your asset policies and maintain and renew the network in accordance with best practice as far as is reasonably practicable. One aim of these provisions is to ensure the condition of the existing network does not deteriorate. This is important both in terms of maintaining performance and to ensure the interests of future users and funders of the network are secured as well as current users and funders.

Potential implications for sustainability of the asset base

You are reviewing the planned volumes of structures and earthworks renewals in order to justify your revised plans. You might need to consider whether your asset policies need to be amended in light of the revised plan. You will update us on this work in January. We will need to consider whether your amended plans, and asset policies as appropriate, are consistent with maintaining and renewing the network in accordance with your licence obligations. We will complete our reviews as quickly as we can, but it will depend on the extent of the changes to your plan.

Potential safety implications of reduction to planned renewals

Discussions continue between our teams on the safety implications of the planned changes to civil renewals. These cover methodological issues around forecasting likely impacts, the feedback from your routes on the implications of the proposed cuts and the impacts on required maintenance. Anna Walker has written (27 November) separately to you on this. We will need to assess where we are when those discussions are complete, and if differences remain, how we handle these.

b) Regulatory performance targets

As the Hendy report says, 'there is further work required to complete the update of the core business plan which includes agreeing the regulatory treatment of updated train performance forecasts with ORR'.

This reflects the fact that you have stated you will not meet the England & Wales PPM targets for the remainder of the control period. You have told us that you will let us have your analysis by mid-January, and the crucial issue is how you demonstrate you are doing everything reasonably practical to improve performance, given the importance of these targets for passengers. We will then need to discuss this with you.

In the Network Rail monitor we noted that you are not currently able to report on progress against the Possession Disruption Index - Passenger (PDI-P) output target. This is an important target as its purpose is to reduce the disruption to passengers from engineering works. We will need this information to assess progress against this target. You have told us that a project to reinstate PDI-P reporting capability is on track to complete in January 2016 and we look forward to reviewing this.

c) Enhancements

The Hendy report sets out your proposed priorities for enhancement projects, following discussion with DfT. We are not involved in the discussion on priorities but we will have a role in specific areas.

We see our role as covering oversight of the change control process, monitoring the revised enhancement delivery plan, next steps on the ECAM (enhancement cost adjustment mechanism) and monitoring the enhancement improvement plan.

Change control

Network Rail publishes an enhancement delivery plan which sets out when projects will reach certain stages in their development and when they are to be completed. This document provides transparency to stakeholders, ensures they are all informed and makes the link with other aspects of rail industry delivery such as the bringing into service of new trains.

The milestones in the plan can only be changed following a consultation with affected stakeholders and this process serves an essential public interest function.

In regulatory terms your published enhancement delivery plan will need to be change controlled to reflect the outcome of the Hendy review process. The Hendy report states that DfT plans to do an 8 week consultation following the publication of the detailed project by project descriptions, which we understand will happen shortly. I understand the principal purpose of this DfT consultation is to inform whether the Secretary of State should accept the revised plan, but you will be targeting affected stakeholders alongside this to inform your formal change control request through the regulatory framework.

In terms of the formal change control request, our role is to ensure that a robust process is followed, and we would expect it to follow the established process. So changes to the enhancements delivery plan must be clearly explained to affected stakeholders, the responses from whom must be considered and a rationale be given for the final decisions. Our final acceptance of any proposed change will be published on our website to ensure transparency.

Ongoing monitoring

Once the revised enhancement delivery plan is published we will monitor progress against it, as now, in a forward looking way, seeking to identify if milestones are likely to be met.

ECAM

We will need to determine the efficient costs of projects, but we will review exactly how the ECAM process works from now on, and whether any changes are needed. We will discuss this with you in the New Year.

Network Rail's enhancement improvement plan

The Hendy report rightly highlights the importance of your enhancement improvement plan. This plan is designed to improve Network Rail's capability to plan, cost and deliver projects. We will continue to work with you on this and monitor progress against this plan in a forward looking way.

This plan is part of a wider capability improvement plan that you are developing and we will need to agree timescales for this to be completed.

d) Monitoring future financial implications/risks

The Hendy report notes the financial risks Network Rail faces and the very low forecast headroom against the borrowing limit. The report states any further cost increases would need to be funded by additional borrowing, further asset sales or further deferral of renewals.

Likely delivery of efficiency savings is of course crucial to being able to forecast future headroom and you have said you are improving the accuracy of your forecasts, as the first year forecasts for the core business were missed. You agreed to set out the improvements you are making by mid-January. This should include how you will produce robust rolling forecasts that cover the whole of the control period.

You have also said you are working on identifying when decisions would need to be taken on expenditure on major renewals if financial risk did materialise and it was decided to address it through deferring planned renewals. Our role here would be to review your assessment of compliance against asset policies and to ensure any overall consistency issues (e.g. on performance) have been identified by Network Rail.

The re-profiling of the enhancement programme, the changes to the renewals programme and the asset divestments will have implications for the next control period.

The Hendy review states that some enhancement works planned for CP5 will now be carried out in CP6 and this work will need to be funded in that period. The planned reductions in civils renewals in CP5 would mean that civils renewals spend would be higher in CP6 than it otherwise would have been. And, depending on which assets are divested, there will be less income from these assets in CP6 than what would otherwise have been the case. So the financial position has worsened for CP6. We need to see your overall assessment of the financial impact. You have agreed to provide this by the end of January.

We have a separate discussion with your team planned about the financial position in Scotland for both CP5 and CP6 and we will discuss the position in Wales with the Welsh Government.

e) ORR's role in Network Rail's planned asset disposals

Depending on exactly what assets you plan to divest, ORR may have an approval role where there is a public interest issue around the benefits of the sales/leases versus potential future rail related uses for the land. The requirements are set out in your network licence and the associated published guidance note.

You are working on what exactly you intend to sell. Once we have received that information we can establish how we will need to respond to what could be a far bigger programme than we previously assumed for CP5.

We will resource this work accordingly to ensure we discharge our role in an effective and timely way.

Please contact me if you want to discuss any of the issues in this letter further.

I am copying this letter to Bernadette Kelly at DfT, Aidan Grisewood at Transport Scotland and Mal Drury-Rose, Welsh Government. We are also placing a copy on our website.

Yours sincerely,

Richard Price

Richard Price
Chief Executive, Office of Rail and Road