Carl Hetherington

Deputy Director EMS

Oliver Mulvey, Deputy Director, Rail Strategy, Department for Transport

Paul Marshall, Group Controller, Network Rail

29 March 2022

Dear Oliver and Paul,

ORR's review of Network Rail's RF11 delivery plan update for the financial year ending 1 April 2022

This letter provides ORR's views on Network Rail's latest delivery plan update for its operating, maintenance, and renewals (OMR) activities, this is its period 11 re-forecast in year 3 of control period 6 (CP6), known as 'RF11'. The plan sets out what it is forecasting to deliver and its income and expenditure forecasts for 2022-23 and 2023-24.

Network Rail updates its OMR delivery plan for CP6 on an annual basis[1]. ORR reviews the updated plan to help hold Network Rail to account against the PR18 Final Determination. Specifically, we focus on:

1. Network Rail's progress against its 2019 Delivery Plan, which sets out how Network Rail intends to deliver our PR18 Final Determination, and is approved by the Secretary of State (SoS);
2. changes since the last annual update to Network Rail's Delivery Plan (the 2021 Delivery Plan), which we reviewed last year[2]; and,
3. changes since the last iteration of the plan (the RF8 plan, e.g. Network Rail's re-forecast of its plan at period 8 in year 3 of CP6) that we reviewed. We documented that review by way of a note (our 'RF8 note') and provided this to the Department for Transport (DfT) on 31 January 2022. We also shared the note with Transport Scotland.

Since our RF8 note, Network Rail has made some changes to its plan as part of RF11, which we have considered. This letter sets out our views on the RF11 version of Network Rail's plan.

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[1] Network Rail also updates its enhancement plan as part of its re-forecast. However, for the purposes of this review, and as agreed with DfT, we do not hold Network Rail to account for the delivery of CP6 enhancements.

[2] [ORR's review of Network Rail's RF11 delivery plan update for the financial year 2021-22 - Letter to DfT and Network Rail dated 31 March 2021]

We have not identified any material changes in the RF11 plan that could require sign-off from the Secretary of State (SoS)[3]. Overall, the RF11 plan remains broadly aligned with the Delivery Plan 2021, as well as the Delivery Plan 2019 (DP19) that the SoS approved for CP6 following our PR18 Final Determination. This is consistent with our RF8 note sent to Network Rail and DfT in January 2022.

However, our review did identify a small number of significant issues that could undermine Network Rail's ability to deliver on its overall CP6 commitments. These include the:

- delivery of its efficiency challenge, with a significant step up in years 4 and 5 of CP6;
- increased backend loading of renewals, which creates a risk that some schemes are not completed in CP6 and/or would need to be deferred to CP7; and
- wider fiscal challenges facing the economy (including inflation), which means that it will be even more important that Network Rail better explains in its plan why it considers its remaining risk funding (£323 million) to be adequate.

This is particularly significant given that, with just two years left of CP6, Network Rail has less time and resources to address issues and recovery any under-delivery. If Network Rail fails to meet its CP6 commitments, this will also have implications for funding and delivery in CP7. We will keep these issues under review and provide a further update later this year.

Annex A provides further information on the issues we have identified with Network Rail's plan. Annex B provides some further comments on Network Rail's plan by presenting progress against the issues raised in the RF8 note (Annex C).

I am happy to discuss any of the points raised in this letter with you.

Yours sincerely,

Carl Hetherington

Carl Hetherington

Deputy Director, Economics, Markets and Strategy, ORR

[3] If there are any material differences in outcomes, risk profile and/or the financial position compared with the original delivery plan for the control period, these would need to be agreed with the SoS and must remain consistent with any of Network Rail's regulatory commitments.

Annex A: Changes made to Network Rail's plan at RF11

Network Rail has made certain changes to its plan at RF11 that reflect, in part, some of the issues we raised with it at RF8. We discuss below the key changes/issues.

Annex B sets out the full list of issues raised with Network Rail at RF8 and progress against these.

Unless we refer to a specific region or part of Network Rail, the numbers in this letter are for Network Rail as a whole.

1. **Network Rail's risk funding has reduced further mainly due to rising inflation.**

At RF8, we identified that the remaining risk funding in CP6 was £710 million. We considered that, given the impact of COVID-19 and that we are now a further year into CP6, this was becoming a more reasonable position than in the previous year. However, we also said that the continuing effect of COVID-19 (including future variants) and the current high inflation rates would have a negative impact on risk funding, which was not fully reflected in the plan at RF8.

Since RF8, Network Rail has drawn down a further £387 million of the risk fund, largely to cover the impact of higher-than-expected inflation in the regional plans. This is a significant amount. The latest Bank of England forecast for the Consumer Price Index (CPI) is 7.05% for June 2022, falling to 3.59% in June 2023[4], at RF8 Network Rail's assumptions for the same figures were 3.18% and 2.14% respectively.

This means that Network Rail only has £323 million of risk funding remaining to manage the impacts of any unexpected financial risks in the next two years. This is a concern given the current economic uncertainty and that by the end of year 3, £2.3 billion of risk funding with either have been used or allocated in CP6. The remaining funding represents c.61% (P61) of potential risks according to Network Rail's own risk modelling. This is lower than the coverage at RF8 (P67) and the start of CP6 (P80). However, this movement was partly expected given, as we say above, some risks (e.g. inflation) had not been quantified in the risk analysis at RF8.

Predicting the future impact of inflation is challenging, and even more so in the current economic climate. For example, the impacts of Brexit, the Covid pandemic and wider geopolitical instability have caused significant disruption in recent months and may continue to do so. Network Rail's plan is therefore uncertain and could change.

[4][Redacted]. It uses November inflation forecasts to understand the impact of inflation on its contractual costs.

Network Rail considers that a further 1% increase in inflation (i.e. above the RF11 assumptions for each remaining year of CP6) could increase costs further by c. £70 million in 2022-23 and by £40 million in 2023-24 (in total £110 million).

This high level of future uncertainty makes it even more important that Network Rail better explains in its plan why it considers £323 million of risk funding to be adequate, as well as the key risk mitigation strategies it is considering. This should include Network Rail clearly explaining how, if necessary, instead of drawing down risk funding it could manage financial risks in other ways. As part of this, Network Rail should clearly identify projects that could be easily 'turned on and off' (e.g. re-prioritised and possibly deferred to CP7) to help manage its remaining risk funding position efficiently. We have made this point to Network Rail before, and it explained that some of this analysis has been done. However, we have yet not seen it. We will be discussing this further with Network Rail.

In our RF8 letter, we said that Network Rail needed to strike a balance between using risk funding to address cost increases that have already happened, making sure there is enough risk funding to cover future risks and not leaving unused risk funding at the end of the control period. We recognise that getting this balance right is difficult and that the CP6 risk funding process has provided stability to the planning process. However, it is still unclear if Network Rail has appropriate governance arrangements in place to ensure that this funding is distributed at the right time and is used in the most efficient manner in the regions. We expect Network Rail to provide further clarity on this prior to our P6 review later this year.

2. [Redacted]

[Redacted]

Network Rail has told us that it does not yet have a firm plan in place to deliver these increased efficiencies. We also note that it has already increased its CP6 efficiencies target from £3.5 billion to £4.0 billion [Redacted]. This is already a stretching target and any additional efficiencies beyond the £4.0 billion target would be challenging to deliver given that:

- Network Rail needs to deliver a significant 'step up' in its efficiency challenges in years 4 and 5 of CP6; and
- some of Network Rail's planned efficiencies in year 3 have already slipped into later years and, whilst some of the shortfall has been made up with workforce reform initiatives, there is a risk that some of these may not deliver as planned.

We will work closely with Network Rail over the coming months to understand how it plans to deliver the £4.0 billion efficiencies and any additional efficiencies.

3. Network Rail provided further information on its workforce modernisation plans and the impacts of these plans on its retention of corporate knowledge.

At RF8, we outlined that we are monitoring progress on Network Rail's workforce modernisation plans to ensure that it is not compromising on efficient and safe delivery. Network Rail has provided further information on its plans at RF11.

Network Rail has told us that its HR department agreed a set of assessment criteria for all regions and functions to use in reviewing applications for its Special Voluntary Severance Scheme (SVSS). These covered:

- safety: the impact on its ability to deliver a safe service if voluntary severance was granted and if an individual held a recognised safety critical role and/or a key safety post;
- identifying the impact on skills: for example, identifying those technical skills that are difficult to replace; and
- identifying the impact on service delivery: for example, identifying the key tasks the individual does.

Local Review Panels were devolved to the regions and functions and Network Rail's HR department provided briefings and held workshops for all panel members to ensure a consistent approach in applying the criteria set out in the above bullets. Each region and function took an additional assurance step whereby the regional MD and HR Director would review every decision by the Review Panel, by looking across the piece to ensure that there was no overall business impact in accepting the applications. [Redacted]. Network Rail also told us that SVSS was not open to operational roles within maintenance and operations, and that a full list of roles deemed to be business critical were signed off by each region and function and published.

Network Rail has told us that those accepted for SVSS will be leaving in a managed and phased approach based on the needs of each region/ function. [Redacted] Network Rail's approach is to help it maintain the appropriate knowledge and capability within its business during the transition. Although we have not seen examples of this, it is useful that Network Rail has assured us that local arrangements are in place to minimise the loss of knowledge and capability, for example:

- cataloguing emails, putting communications in corporate file locations such as Sharepoint;
- training other team members;
- sharing the known contacts related to the role;
- handover notes and mechanisms to smooth the transition of work;
- where the accountability is still required, backfill opportunities have become available or accountabilities have been shared amongst remaining employees across the team; and
- some business areas are also in the process of restructuring to better align their resources to their strategic objectives.

However, we still have some concerns that Network Rail has not fully explained how it will monitor the impact these plans may have on its wider commitments to asset management, safety, and train performance. We will be meeting with Network Rail to discuss this and to understand further the impact of these plans on its retention of corporate knowledge and we will provide a further update at our P6 review later this year.

4. Network Rail provided further information at RF11 on the costs and savings associated with the changes made to the track worker safety arrangements.

At RF8, Network Rail did not provide enough clarity on the costs and savings associated with the changes made to the track worker safety arrangements. It has now provided further information on this, following engagement by Network Rail's Technical Authority with each of the regions.

The total cost of delivering these changes is now forecast to be £382 million (compared with £491 million at RF8). This is made up of the:

- capital implementation costs of £227 million (post-efficient) in CP6. This is a reduction from £249[5] million at RF8 and Network Rail has said this reduction has been made through positive procurement efficiency; and

- on-going operational costs of this programme of £130 million (post-efficient). This is a reduction from £147 million at RF8. Network Rail has made progress on identifying these operational costs since RF8, although we note that there is still more to do to understand what these costs are and how they differ from normal operating costs; and

- the cost of the Planning 4 Delivery (P4D) programme aspect of these changes in the regions is £25 million (down from £95 million at RF8).

At RF8, the changes were forecast to deliver £100 million of savings[6]. Network Rail has told us that these are associated with a better approach to safe access. Network Rail has agreed to come back by the end of March 2022 with the cash value of these efficiencies, which need to be accurately separated from COVID-19 costs and 'Modernisation' proposals. We also expect Network Rail to specify the time period over which these savings are expected to materialise. Once we have received this information we will provide it to DfT.

When we discussed the Planning 4 Delivery (P4D) programme costs with Network Rail, it told us that it made changes beyond the scope of the improvement notices in

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[5] In our RF8 note, we had updated information from Network Rail so we include the latest forecast at the time which was £229m.

[6] In our RF8 note, we referred to these as savings but Network Rail has now told us these are actually theoretical savings.

response to operational incidents and the desire to improve safety throughout the organisation. The further changes were not made to address the improvement notices nor at the request of the Safety Task Force programme.

Network Rail decided to accelerate the delivery of this programme from July 2022 to December 2021 because it thought it needed to in order to ensure compliance with the notices. There will have been extra costs as a result but separating these costs from COVID-19 costs is difficult, for example increased costs from lower productivity possibly due to access changes or increased sickness absence. Nevertheless, Network Rail should provide better transparency over the extra costs incurred in the regions in advance of our P6 review later this year.

5. At RF8 we explained that the position on renewals spend and volumes varies across different asset types and that we would provide more information on this at RF11.

At RF8, we said that whilst overall the profile of total spend on renewals in years 2, 3, 4 and 5 of the control period was broadly flat (e.g. £3.9 billion in year 2 to £4.2 billion in year 5), the position on spend and volumes varies across the different asset types.

Network Rail has not had the opportunity to make progress in understanding the full consequences of variances in planned renewals volumes against the Delivery Plan 2019 baseline since RF8 (see Annex B for further information). However, we do now know that the spend profile has changed and in particular £0.3 billion of spend has been moved from year 3 to year 4 (£0.2 billion on signalling). This is consistent with the supplementary estimates agreed with DfT to roll forward £250 million of renewals funding from year 3 to year 4[7].

Delivery of these renewal volumes in year 4 and 5 will be challenging for Network Rail. We are concerned that this increased backend loading of renewals is creating risks that some of these schemes will not be completed in CP6 and/or would need to be deferred to CP7, creating additional funding pressures in CP7. For example, the Southern region has moved several structures renewals from year 3 into years 4 and 5 due to environmental constraints and land/possession access challenges, whilst the Scotland region has recently deferred a large signalling scheme to CP7 (Portobello Relock)[8]. That said, we note that the national functions within Network Rail are accelerating some items from CP7 into years 4 and 5, including elements of their electrical safety delivery programme.

[7] In addition, £100 million of enhancement funding was agreed with DfT to be moved from year 3 to year 4.

[8] This is in relation to a decision linked to enhancement schemes.

The regions remain confident in their ability to deliver their renewals. Nevertheless, Network Rail should provide us with further assurance of its ability to complete delivery of its planned renewals in CP6 and explain any deferrals to CP7.

6. The risk situation in Scotland remains challenging but the region has recently taken some difficult decisions to potentially improve its remaining risk funding.

At RF8, we also raised concerns about the level of risk funding remaining in Scotland where the remaining uncommitted risk funding was £13 million. The risk situation remains challenging in Scotland, and given the various changes in funding and the issues discussed in this section of our letter, it is not clear what the underlying position is. Although the region has recently taken some difficult decisions which potentially improved the availability of remaining risk funds, some of this has been offset by further use of the risk fund to offset the anticipated impact of high inflation. The final RF11 risk position in Scotland is £34 million[9].

The net increase in remaining risk funding is largely driven by two changes: firstly, the region has identified £26 million of potential savings in operational expenditure and secondly it is planning to defer £53 million of renewals (across signalling, structures, telecoms and buildings). This is offset in part by additional risks and inflationary pressures identified since RF8, and we note that £24 million of Carmont-related costs have not yet been included in the plan. Network Rail Scotland has assured us that the deferred renewals will be specifically ring-fenced within the risk fund, with the possibility of re-introducing some of these renewals in the final year of CP6. A final decision will be made on this by summer 2022.

We recognise why Network Rail Scotland has taken the preliminary decision to defer renewals but are concerned about the impact that this will have on both asset sustainability (see point 7 below) and the plan for CP7 (as work deferred in CP6 is likely to be carried forward to the next control period). We also have concerns around the deliverability of the £26 million of operational savings identified. A large portion of the funding remaining in Network Rail Scotland's risk fund is dependent on delivery of these savings and other initiatives which may not be fully realised[10].

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[9] We note that this is different to the £71 million that Network Rail Scotland reported to Transport Scotland at P11 following additional adjustments, including for inflation. In its P12 report, Network Rail Scotland noted it's final RF11 risk funding position was £46 million, which is different to the £34 million mentioned above because of timing differences in the recognition of group financial adjustments.

[10] Network Rail Scotland's level of available risk funding also assumes the successful implementation of its workforce modernisation programme [Redacted], and delivery of all its forecast CP6 efficiencies, which are both challenging targets to deliver, with significant inherent risk.

Network Rail Scotland's financial risk position and how this is managed remains on the regulatory escalator and we will continue to keep it under close review in the coming months.

7. Network Rail Scotland has advised us that it will fall below the regulatory floor for the Composite Sustainability Index at the end of year 3 of CP6.

As part of our PR18 Final Determination for Scotland we set a regulatory floor[11] for the Composite Sustainability Index (CSI)[12] at 2.4% for the end of CP6 compared to Network Rail's target of 2.9%. At the end of year 2 of CP6, the CSI in Scotland was forecast as 2.8% by the end of CP6. Network Rail Scotland has recently advised us that it is now forecasting CSI of 2.18% by the end of CP6, which is below the floor. This is driven by decisions to cancel/defer work (in particular some high output work) to keep total expenditure within the limits of the PR18 Final Determination. The forecast level would be further reduced to 1.94% if the £53 million of renewals discussed above are also deferred.

In practice, this means that Network Rail Scotland is not delivering sufficient renewals to achieve the levels of asset sustainability it agreed to in the Final Determination. A reduction in asset sustainability in the long term is likely to cause a deterioration of network assets through ageing and wear-out. This will have implications for areas such as train and freight service performance.

We have discussed this issue with Network Rail Scotland and, as an initial step, we have agreed that the Scotland region should consider the options available and the actions it is taking or proposes to take. Network Rail Scotland's CSI measure is important and is now on the regulatory escalator and we will continue to keep it under close review in the run up to our P6 review later this year.

8. Network Rail provided us with its updated long term scorecard outputs and templates showing progress in its customer engagement.

Our review of long-term scorecards found that most regions remain committed to deliver at least the level of train performance set out in PR18. Network Rail has, for several regions, continued to apply a level of stretch to its performance targets, which is consistent with the approach taken in 2021-22. We note that there is further work to do in order to fully agree customer scorecards and ensure full alignment with the long-term scorecards. This is largely because operators do not finalise their plans until after Network Rail does. While there are limited targets already agreed, most regions appear to be on course to agree targets in April 2022.

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[11] A regulatory minimum floor signals the point below which the ORR would be likely to consider formal investigation into whether Network Rail has breached its network licence. The floor is set at a level at which we consider performance to be unacceptable.

[12] This is a measure which shows the percentage improvement of asset sustainability compared to the baseline (the CSI value measures the cumulative change against the start of CP5 baseline).

Network Rail is adopting a different approach for the majority of freight operators. It proposed moving away from separate scorecards towards periodic customer satisfaction forms and agreeing and monitoring delivery of a prioritised list of joint deliverables. As part of RF11, Network Rail provided evidence confirming that the new approach has been endorsed by the majority of these Freight Operators. We consider this a positive development.

The customer agreement templates that Network Rail included as part of its RF11 submission provide us with some evidence of positive engagement with most train and freight operators. Overall, the process of engaging with operators and agreeing targets appears to be maturing. We note improvements in several regions. In particular Southern, North West and Central and Eastern have started to engage with operators earlier in the process and train operators have confirmed that the Partnership/Alliance Boards are useful forums to agree targets. Previous improvements have also been retained, for example, the changes that Network Rail Scotland had implemented on its engagement with cross border operators.

Despite the progress noted above, our review did identify some issues. We recognise that whilst Wales and Western did engage with operators, in some instances, resource pressures delayed target setting. In Scotland, none of the customer scorecard templates had been completed by operators making it difficult to gauge whether operators were satisfied with the targets agreed or their engagement with Network Rail. We note that Network Rail Scotland expects to discuss targets at the next quarterly performance community joint delivery group. We will take forward these points with Wales and Western and Scotland to understand where improvements can be made.

We recently reviewed changes that Network Rail had proposed to four measures on its regional comparison scorecard from 1 April 2022 (Year 4 of CP6). This included changes to the methodology for the On Time metric; changes to the elements within the Complaints Handling Index measure: replacing the data source that comprised the Passenger Satisfaction measure at managed stations; and updating the Enhancements Milestones measure. We sent your team a letter with our opinion on these changes on 24 March 2022.

9. [Redacted]

[Redacted]

Annex B: Network Rail progress against the issues raised at RF8

RF8 issue	Progress made at RF11	Next steps
Assurance around the longer-term impacts of being behind on its effective volumes in the areas of plain line, switches & crossing and structures.	Network Rail did not have time to address this issue for RF11.	• Network Rail should provide us with further assurance around the longer-term impacts of being behind on its effective volumes in these areas. • As explained at RF8, Network Rail has agreed to conduct an in-depth review by Q1 2022-23 of the impact of taking a more short-term approach to asset stewardship and deferring or de-scoping renewals. We are also undertaking targeted assurance reviews in this area, which we expect to conclude early this year. • We hope to include the outcome of these reviews in our Annual Assessment of Network Rail in summer 2022.
'Shadow' reporting of Network Rail's maintenance numbers.	Network Rail's regions provided us with its new maintenance indicator as part of its RF11 plan. We expect the accuracy of the data to improve over the next quarter.	• We expect Network Rail to continue to report its maintenance indicator as part its plan, as a draft, if necessary.
An explanation of the reasoning on the level of risk funding available to each of the E&W regions.	Please refer to Annex A.	Please refer to Annex A.
An explanation on the policy/approach to determining the allocation of regions' risk funding.	Please refer to Annex A.	Please refer to Annex A.
Regional/functional meetings to discuss any safety implications of changes to the plan prior to RF11.	Network Rail did not have time to address this issue for RF11.	• Network Rail should fully consider the safety implications of any changes that it is making to its plan. • We expect Network Rail to speak to us about changes to its plan and discuss with us how it has considered any safety implications prior to submitting its P6 update. Network Rail are currently working with us to establish which

RF8 issue	Progress made at RF11	Next steps
		meetings are most appropriate to discuss changes to its plan and any safety impact that has, to more towards a progressive assurance approach.
More detailed information on the implementation of the Lord Mair/Dame Slingo recommendations, including the individual costs of each action plan and how they will be funded.	Network Rail's regions did provide us with some information, however we require additional information so that we can understand how they are implementing the recommendations.	• We have received some information, including an integrated plan, that Network Rail has developed to deliver the recommendations arising from the Lord Mair and Dame Slingo report. This includes confirmation of which recommendations they will not progress or formally track (and a brief statement of why). • We expect Network Rail to provide greater detail for each action plan so that we can understand how the recommendations are being implemented, what the cost for each plan is and how they are being funded. We also require further detail of the reasoning for not progressing some of the recommendations. We expect Network Rail to do this before the P6 update. • If the action plans do not include the relevant cost information, then additional information should be sent to us which shows the costs of each action plan, and how they are being funded. • Finally, we expect Network Rail to also provide us with a full breakdown of the capital costs it has incurred to date operationalising the interventions that have been implemented.
Better transparency on the costs and savings associated with the changes made to the Track Worker Safety arrangements.	Please refer to Annex A.	Please refer to Annex A.

Annex C: RF8 note - please see attached.

https://www.orr.gov.uk/sites/default/files/2022-06/rf8-note-january-2022.pdf