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Dear stakeholders

Our conclusions on the initial consultation on the 2018 periodic review of Network Rail

Summary

1. Today, we are confirming that we will change how we regulate Network Rail. We will be putting an increasing focus on regulating each of Network Rail's route businesses, building on changes that the company is making to devolve more responsibility to these routes. This move to 'route-level regulation' will encourage closer working between Network Rail and train operators, and increase the role of local funders. It will allow us to make more use of comparison between routes when we assess the company's plans and then hold it to account for delivery.
2. In addition, we will regulate Network Rail's national system operator business separately; implementing regulation that is tailored to this important function so as to support improved timetabling, use of the existing network and analysis of how the network should be enhanced over time.
3. Together, this will provide for greater focus on the issues that matter to passengers and freight customers, including better reliability and capacity for more services.
4. These two changes will require a significant amount of work to get right and to realise the full benefits that they could unlock. Reflecting this, we have decided to limit the changes to the charging and incentives framework to those areas where there is a clear and pressing need for reform, or where there are opportunities for incremental improvement and simplification.
5. This means that we will continue to prioritise work to improve the transparency of fixed costs, but only use this work to make specific changes to charges – to inform what fixed costs should be recovered from open access passenger operators to support the development of on-rail competition and to inform the update of the market can bear test for freight charges mark-ups.
6. We will not be taking forward geographical disaggregation of the variable usage charge (VUC) or any further work on material under recovery of the VUC in PR18. Changes to the capacity charge (which currently helps to recover extra Schedule 8 costs as traffic grows) and the route-level efficiency benefit sharing mechanism (which encourages Network Rail and train operators to work together) would involve some difficult choices and we will be setting out options for these. Only limited changes will be made to



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the possessions and performance regimes (Schedules 4 and 8), to tackle specific problems so that they deliver better for end users.

7. Alongside our determination in 2018, we intend to set out plans for further reform to charges. This work will take place during this and the next control period, but no decisions would be taken until the next periodic review (PR23).

8. Our work has benefitted from extensive engagement with stakeholders – in particular through working groups facilitated by the Rail Delivery Group (RDG) – and the ideas and evidence that have been shared with us.

Introduction

9. The 2018 periodic review (PR18) will determine what Network Rail is required to deliver in control period 6 (CP6)¹ and the funding it is given to support this. This will feed through into the service passengers and freight customers receive and, together with taxpayers, ultimately pay for. As such, PR18 is a key means by which we will protect the interests of rail users.

10. In May 2016, we published our [initial consultation](#) on PR18. This set out our high-level approach to the review and was supported by several working papers issued over the summer. The initial consultation closed on 10 August 2016 and we received 59 responses from a broad range of stakeholders, including passenger and freight customers/representatives, the supply chain, regional transport bodies, Network Rail, train operators and governments.

11. We would like to thank all those who took the time to respond to the consultation and to engage with us on its content. Having carefully considered the points made to us and relevant evidence, this letter sets out our decisions on our objectives, prioritisation and aspects of our high-level approach for PR18. It also sets out next steps. We have also published the [responses](#) along with a [supporting document](#) which summarises the key points raised by stakeholders and our response to these.

The context in which are carrying out PR18

12. Our consultation noted the importance of taking account of and responding to the context in which we are carrying out PR18. In general, stakeholders agreed with the main areas of context that we described in chapter 2 of the consultation. This included, among other things: the challenge for the railway to cope with growing and changing demand, including in respect of delivering appropriate performance to passengers and freight customers; the fundamental change brought about by the reclassification of Network Rail as a public sector body; and the challenge for Network Rail to become more efficient and deliver better performance.

¹ We currently expect that CP6 would run from 1 April 2019 to 31 March 2024.

13. Some stakeholders stressed particular points, including: the importance of encouraging third party investment in the railway; the issues arising from Brexit; a need for greater consideration of the implications of High Speed 2 for Network Rail in CP6; and the importance of franchise reform and potential changes to station ownership. We agree that all of these points are relevant to our review and will reflect on them in our ongoing work.

Approach

14. In the consultation, we set out our proposed aims and objectives for PR18, reflecting how the review could support Network Rail's delivery of improved outcomes for passengers and freight customers. We proposed putting particular priority on improving the efficiency of the network and how to make better use of the existing network, while continuing our focus on safety. In addition, we highlighted the importance of facilitating changes to how enhancements are taken forward by funders.

15. Accordingly, our proposed aim and objectives were as follows:

Aim: "A safer, more efficient and better used railway, delivering value for passengers, freight customers and taxpayers in control period 6 and beyond"

Objectives:

"To establish a framework that encourages Network Rail to:

- (i) ensure the ongoing safety of the network;
- (ii) improve the efficiency of operating, maintaining, renewing and enhancing each of the routes in CP6 and beyond; and
- (iii) improve its understanding of the capacity and performance of the network.

To support government funders and operators to make better informed decisions about expansion and use of the network."

16. We highlighted how this aim and the objectives would benefit users of the network, not least as a more efficient and better used network would mean better performance by Network Rail in areas that matter to passengers and freight customers, such as improved reliability and more capacity for additional services.

17. Stakeholders broadly agreed with our proposed approach, with many strongly agreeing with the importance we placed on prioritisation. There were also suggestions that there should be additional outcomes or objectives, including financial sustainability for Network Rail, sustainability of the railway in general and a network that is responsive to the needs of passengers. Our supporting document discusses these in more detail.

18. Reflecting the broad consensus, we are confirming our proposed aim, objectives and approach.

How we deliver our priorities and focus the review

19. Chapter 4 of our consultation set out five key areas through which we proposed to focus the review in order to deliver our aim, objectives and priorities:

- (a) a focus on regulating at a route-level;
- (b) improving the regulation of system operation;
- (c) refining the framework for outputs and how these are monitored;
- (d) increasing transparency around costs and improving incentives; and
- (e) supporting new ways to treat enhancements.

20. We discussed how these areas of focus could add value and what they could potentially involve. Over the summer, we published working papers discussing options and issues for each of these areas, other than for (d) where our engagement continued to build on our publications earlier in the year and in 2015.

Route-level regulation and system operation

21. There was strong overall support from stakeholders for our proposed focus on route-level regulation and improving our regulation of system operation. Many stakeholders had detailed comments on these, including setting out potential risks that would need to be mitigated and concerns that the scale of implementing reforms in these areas would require substantial industry effort.

22. We confirm these areas as particular priorities for PR18. We consider both to be fundamental to delivering a more efficient and better used railway in CP6 and beyond, and would support a step-change in how Network Rail operates. This includes a greater focus by each Network Rail route on the issues that matter most to passengers and freight customers, to improve the service that they receive. Key to achieving this will be through a much closer relationship between each route and its train operator customers and stakeholders (including end user representatives). We are however conscious of the scale of the delivery challenge in implementing these areas. There needs to be further discussion on what is a challenging but realistic pace of change.

23. We now need to focus on the detailed implementation of route-level regulation and changes to the regulation of system operation. Significant discussion has taken place over the summer on these areas via stakeholder feedback on [working papers 1-3](#). This engagement will continue and as part of this we are now consulting on how the regulation of Network Rail's national system operator might work. Separately, the next major step on route-level regulation is to ensure that Network Rail's business planning process supports this shift in regulatory approach. With this in mind, next week we will be issuing for consultation our draft guidance to Network Rail on its strategic business plans (SBPs), including for the routes and the national system operator (see paragraph 46 below).

Refining the framework for outputs and how these are monitored

24. Our proposals for refining the outputs framework included reflecting the shift to routes and system operation, increasing the involvement of train operators, end user representatives and local stakeholders in informing the setting of outputs and making performance metrics more passenger-focused.

25. Stakeholders were mainly in favour of our high-level approach. While many detailed points were made, there was significant emphasis that outputs should reflect the needs of end users. There was support for a much greater role for train operators and local stakeholders in informing the setting of outputs and greater transparency over performance to support them in holding Network Rail to account.

26. We are confirming our proposed high-level approach in this area. In doing so, we recognise that there will be significant work required to deliver a revised framework for outputs (including the role of scorecards within this) alongside route-level regulation. We set out more detailed proposals and issues in our [outputs working paper](#) (WP4) and we will engage further with stakeholders on the issues arising from the responses to the working papers.

27. The role of train operators and others in informing outputs is discussed in the engagement section below.

Increasing transparency around costs and improving incentives

28. We received extensive comments in respect of our proposals relating to transparency of costs, charges and incentives. While there was significant support for better transparency of what drives cost on the network, there was some opposition to translating this information into more cost reflective charges. Also, many stakeholders were concerned that industry and ORR resources would be stretched too thinly if PR18 carried out major changes to charges alongside implementing a shift to regulating at route and system operator level. Freight stakeholders were particularly concerned about the uncertainty of major charging reform for the freight sector. They also noted that most of the benefits of major reform relied upon franchised passenger operators being exposed to changes in those charges and that it was currently unclear whether this would happen.

29. There was broad support for retaining the current structure of the possessions and performance regimes ('Schedules 4 and 8') albeit with many suggestions for how the regimes could be improved.

30. We have reflected on the evidence and arguments put forward about the relative benefits of major reform to charges in PR18. We consider that reform of charges could be an important way of supporting improved efficiency over time, particularly if governments increase the degree to which franchised passenger operators are exposed to changes in these charges. But given the progress that we now expect to be made in the shift to route-level regulation (which should make a significant contribution to improving efficiency), and the limited capacity of all parties to successfully implement further

changes, we consider that charges reform should be focused on particular aspects of the charging framework (i.e. fixed charges) with other changes being a lower priority at this time. On this basis:

- (a) we will explore incremental, rather than fundamental, improvements to variable charges in PR18, including simplification of charges where there is a case for this. This means that, for PR18, we will not continue work on options for the geographic disaggregation of the variable usage charge (VUC), or take forward work to consider the implications (if any) of the differences between the current bottom-up calculation of the VUC and econometric benchmarks;
- (b) in line with existing commitments, we will continue to prioritise reform of fixed track access charges so that open access operators (OAOs) make an appropriate contribution to fixed costs, alongside the Department for Transport's (DfT's) work to consult on introducing a public service obligation (PSO) levy for OAOs. In line with legislation, our work on access charges will require us to update our analysis of what the market segments can bear in both the passenger and freight sectors; and
- (c) we will continue with the work to improve the transparency of fixed costs.

31. In December 2016, we will set out more detail about the package of reforms that could be implemented in PR18. This will include a mix of proposals for simplification and more detail on the proposals set out above. We will also:

- (a) set out more detail on potential options for reform of the capacity charge;
- (b) set out options for the role of the route-level efficiency benefits sharing scheme (REBS), which is intended to encourage closer working between Network Rail and train operators to improve efficiency; and
- (c) set out proposals for improvements to Schedules 4 and 8 while retaining their current structure, so that they better deliver for rail users.

32. Alongside our determination in 2018, we intend to set out plans for further reform to charges. This work will take place during this and the next control period, but no decisions would be taken until the next periodic review (PR23).

Supporting new ways to treat enhancements

33. There was mainly support for our proposals to explore and implement new ways to treat enhancements, linking with how DfT and Transport Scotland were minded to fund improvements to the railway in future. However, several freight stakeholders flagged a concern that freight enhancements may get neglected and supply chain organisations stressed the need for longer-term assurance about workloads where enhancements were taken out of the periodic review process. Some stakeholders raised the importance of encouraging third party investment in the network.

34. We will continue to develop proposals for the regulatory treatment of enhancements, working closely with stakeholders on this following their responses to this consultation and [working paper 5](#) on enhancements. We recognise the importance of attracting third party investment. Indeed, we support Network Rail's work looking at opportunities for private sector investment as well as the work led by RDG to explore the opportunities and barriers here. Our PR18 work will also look at opportunities for strengthening incentives for investment in cross-border enhancement projects.

35. Our consultation also highlighted the issues associated with Network Rail's plans to upgrade its signalling technology (under its 'Digital Railway' programme). Responses were relatively limited on this point. We continue to discuss these issues with funders and Network Rail, with a view to deciding the extent to which this programme needs to be reflected in the PR18 determinations.

Developing the high-level framework for the review

36. Chapter 5 of our consultation set out more detail on how we might implement our proposed high-level approach, including two specific proposals: that we expect CP6 to run for five years; and that we will use the 'single-till' approach. Both proposals attracted broad support from stakeholders and we can confirm that we are continuing our PR18 work on this basis.

Process and engagement, including the involvement of train operators, funders and other stakeholders in the development of Network Rail's strategic business plans

37. Stakeholders generally welcomed our proposed open and collaborative approach to engagement as set out in chapter 6 of our consultation. There were comments about how challenging the draft timetable might be to achieve.

Form of engagement

38. Throughout our consultation document, we emphasised the benefits that Network Rail's shift to devolve more responsibility to routes and its national system operator could bring. In particular, it should support closer relationships between Network Rail and customers/stakeholders and make Network Rail more accountable to its customers.

39. There was significant support for this greater engagement, both in PR18 and on an ongoing basis in CP6. Many stakeholders wished to be involved, and there were various suggestions for how this engagement could work. These ranged from proposals for direct involvement of end-users (passengers in particular) to inform plans, to more focused engagement between Network Rail routes and train operators.

40. Our consultation noted that there would be constraints to implementing customer engagement mechanisms such as those used by Ofwat in the water industry. In particular, Network Rail will be developing its SBPs early in 2017, which means there is little time to develop and implement new bespoke arrangements to influence these plans, such as

dedicated 'customer challenge panels'; attempting to do so could risk the process being timed out. This point was recognised by some consultees.

41. However, we remain committed to ensuring that there is a clear line of sight between what end users want and what Network Rail delivers. Reflecting this, there need to be meaningful opportunities for Network Rail's route and system operator plans to be informed and challenged by stakeholders, including train operators, funders, freight customers and end-user representative bodies.

42. To this end, Network Rail is setting up stakeholder sessions in February 2017 to support this process (see paragraph 48 below). Our draft guidance to Network Rail on its SBPs sets out further detail on how we expect the interests of passengers and freight customers to be reflected in Network Rail's plans. This includes it making best use of the large body of existing research about passenger preferences (e.g. from Transport Focus' National Rail Passenger Surveys and research from the Passenger Demand Forecasting Handbook). Over time, we will look to build on this approach, including by considering introducing more formal processes for end user engagement in subsequent reviews.

Role of stakeholders in informing outputs

43. As discussed above, many consultees were supportive of a greater role for train operators and other stakeholders to inform outputs, albeit that some stakeholders noted that incentives would not always be aligned with those of end users. This included a point that franchised train operators may not, in CP6, be exposed to the costs of the outputs that Network Rail would be delivering. A further point was made that franchised operators would have a reduced interest in the longer-term impact of Network Rail's plans (e.g. on asset condition) because of their time-limited franchises.

44. We have considered how much we should rely on train operator engagement to inform Network Rail's outputs. While we are not deciding the detail on this now, we will follow the principle that where Network Rail and train operators (with other stakeholders) agree shorter term performance metrics (e.g. through scorecards), this will help to inform the setting of certain outputs in CP6. This will support, among other things, alignment with franchise commitments. However, we consider we may need to take a more traditional approach for setting outputs in some areas, notably such as asset condition and the long term sustainability of the network. We also recognise that the interests of smaller operators on a route need to be given appropriate weight against those of the most prominent franchised operator.

45. We will continue to develop the outputs framework following our outputs working paper, engaging appropriately as part of this, including with the RDG working group on outputs. This includes considering how an improved scorecard framework might work in conjunction with outputs in CP6.

Ongoing engagement and next steps

46. Having concluded on our initial consultation via this letter and the related supporting document, we need to move quickly on to developing the detailed framework. With this in mind:

- (a) we have today published a [consultation](#) on the **development of the regulatory settlement for Network Rail's national system operator in CP6**; and
- (b) we will shortly publish a consultation on our **draft guidance to Network Rail on its SBPs**, which will set out our expectations for the plans it will produce and the process it will follow for this. This will include its route-level and NSO strategic plans.

These will both conclude on 11 January 2017. This will allow us sufficient time to update our guidance to Network Rail ahead of its engagement with customers, funders and user representatives. The system operation document forms part of our ongoing engagement with stakeholders, building on the process of consultation that is underway, and also feeds into our SBP guidance.

47. In December 2016, we will issue consultations on:

- (a) charges and incentives. This will set out options for improvements to the structure of charges and incentives framework; and
- (b) the financial framework. This will inform the development of the regulatory arrangements for the modelling of Network Rail's revenue and financing requirements in PR18, to support financial sustainability and effective performance assessment in the context of a move to route-level regulation.

48. As mentioned in paragraph 42, around February 2017, Network Rail's routes will each be hosting a session with their stakeholders to engage them on their emerging plans and to get input on what they should deliver in CP6 – with a particular focus on operations, maintenance and renewal plans. A session for the system operator will take place following this. Plans for enhancements to the railway will not be a focus of these sessions, given the role of DfT and Transport Scotland in this area. However, DfT, in line with the recommendations of the Bowe Review, is considering the best way of involving stakeholders and users in developing its plans for rail investment. Transport Scotland is publishing a consultation today to inform its infrastructure strategy for 2019 onwards².

49. Our latest programme [timetable](#) is available on our website.

² *Consultation on Transport Scotland's Rail Infrastructure Strategy from 2019*, Transport Scotland, November 2016.

50. We will continue to engage with stakeholders via RDG's working groups, which we have found a useful way to develop ideas³, and through bilateral and other meetings.

51. Once again, I would like to thank stakeholders for their continued valuable engagement in PR18 and I look forward to further discussions in the coming months.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'John Larkinson', is positioned above the printed name.

John Larkinson

³ Meeting notes and, where appropriate, relevant papers from these groups are normally published on our [website](#) once finalised.